CONDUCT OF BUSINESS SOURCEBOOK (AMENDMENT NO 15) INSTRUMENT 2004

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act (the "Act"):

(1) section 138 (General rule-making power);

(2) section 145 (Financial promotion rules);

(3) section 149 (Evidential provisions);

(4) section 156 (General supplementary powers); and

(5) section 157(1) (Guidance).

B. The rule-making powers listed above are specified for the purpose of section 153(2) of the Act (Rule-making instruments).

Commencement

C. This instrument comes into force as follows:

(1) to the extent that a provision relates to structured capital-at-risk products that provide an agreed level of income, on 20 February 2004;

(2) otherwise, on 16 July 2004.

Amendments to the Conduct of Business sourcebook

D. COB is amended in accordance with Annex A to this instrument.

Amendments to the Glossary

E. The Glossary is amended in accordance with Annex B to this instrument.

Citation

F. This instrument may be cited as the Conduct of Business (Amendment No.15) Instrument 2004.

By Order of the Board
15 January 2004

Annex A

Amendments to the Conduct of Business Sourcebook

In this Annex, underlining indicates new text and striking through indicates deleted text. Where an entire new section is inserted, the place that it goes is indicated and the text is not underlined.

COB TR 4 Transitional Rules for ex-RPB firms

…

~~4~~COB TR 5 ~~Table:~~ Miscellaneous Transitional Rules applying to all firms

(1)	(2) Material to which the transitional provision applies	(3)	(4) Transitional provision	(5) Transitional provision: dates in force	(6) Handbook provision coming into force
…					
9	…				
10	*COB* 3.9.31G(3)	G	Until 16 July 2004, a *firm* may regard the reference in *COB* 3.9.31G(3) to the *FSA's* factsheet entitled 'Capital at risk products' as including the *FSA's* factsheet entitled 'High-income products – Make sure you understand the risks'.	From 20 February 2004 until 16 July 2004	20 February 2004

…

3.2.3 R (1) To the extent that a *financial promotion* relates to one or more of the following:

~~(1)~~(a) a *deposit*; or

~~(2)~~(b) a *general insurance contract*, *pure protection contract*, or *reinsurance contract* only *COB* 3.1 to *COB* 3.5 and *COB* 3.8.4R to *COB* 3.8.6G and COB 3.14 apply, unless the *financial* promotion relates to a *cash deposit* ISA in which case *COB* 3.9.6R(1) and *COB* 3.9.8R also apply~~.~~; and

(2) if the *financial promotion* relates to a *structured deposit*, the following will also apply: *COB* 3.8.8R, *COB* 3.8.9G, *COB* 3.8.11R, *COB* 3.8.12G, *COB* 3.8.15R and *COB* 3.8.16G.

3.8.9 G (1) …

(2) The details of the commitment which is required by *COB* 3.8.8R(1)(b) will depend on the nature of the *investment* being promoted. This could be, for example, the minimum amount which can be invested, minimum or maximum period of *investment* or, where it is the case, the fact that it could be some time before a *person* may see a return on his *investment.* Where an investor's capital would be tied up for more than one month following the last fixed payment due to be made under the contract, this should be made clear in any *financial promotion* for that product.

(3) In giving a fair and adequate explanation of the *investment* or service being provided *firms* should avoid:

….

(e) using prominent headline rates of return where these rates are unrealistic and unlikely to be obtained by most investors.

….

(5) To assist *firms'* compliance with *COB* 3.8.4R (1) and *COB* 3.8.8R (1) in relation to a *specific non-real time financial promotion* further *guidance* ~~on potential problem areas~~ is given in *COB* 3 Annex 4.

….

(7) In giving a fair and adequate explanation of the risk involved, *firms* should, where relevant:

(a) have regard to the provisions in *COB* 5.4.12E and *COB* 5.4.13G; and

(b) identify where there is a possibility of loss of initial capital invested and disclose this as one of the main points in the *specific non-real time financial promotion.*

(8) *Firms* are reminded that, when *communicating* or *approving* a *financial promotion* relating to a *structured capital-at-risk product, COB* 8.2.1R and *COB* 8.2.4R (2) apply.

3.9.3 G Table Location of the provisions applicable to *direct offer financial promotions*

This table belongs to *COB* 3.9.2G

…			
(8)	…		
(9)	Information to be contained in direct offer financial promotions regarding:		
	(i)	…	
	<u>(j)</u>	<u>*Structured capital-at-risk products*</u>	<u>*COB* 3.9.31R</u>

3.9.14 G To assist *firms'* compliance with *COB* 3.8.4R (1) <u>and *COB* 3.8.8R(1)</u> in relation to a *specific non-real time financial promotion* further *guidance* ~~on potential problem areas~~ is given in *COB* 3 Annex 4.

After COB 3.9.30R, insert the following:

3.9.31 R When *communicating* or *approving* a *direct offer financial promotion* for a *structured capital-at-risk product* a *firm* must ensure that the following information is included in the mailing pack or included by a clearly visible electronic link if using e-mail, the Internet or other electronic media:

(1) an explanation of the types of capital-at-risk products generally available and how they would typically work;

(2) an explanation of the risks associated with investing in these capital-at-risk products;

(3) details of the key issues that *consumers* should consider before investing in a capital-at-risk product; and

(4) information about how to complain to the *firm* and how complaints can subsequently be referred to the *Financial Ombudsman Service*.

3.9.32 G (1) When a *firm* complies with its obligations under *COB* 3.9.31R it should ensure that the information it provides includes in particular the following:

(a) reference to the different risk profiles of generally available capital-at-risk products when compared with capital secure products such as *deposits*;

(b) reference to the fact that, because of the risk to capital, capital-at-risk products should only form part of an *investment* portfolio;

(c) reference to the fact that, before buying, investors should check they understand the way the product is priced, the charges involved, the length of time their money will be tied up and the consequences of cashing in the product early; and

(d) contact details for the *FSA's* consumer helpline and website.

(2) The *FSA* would regard a *firm* that provides a copy of the *FSA's* factsheet about capital-at-risk products entitled 'Capital-at-risk products' as complying with its obligations under *COB* 3.9.31R. *Firms* can obtain copies or buy the artwork by using the *FSA's* online order form at www.fsa.gov/pubs, Consumer publications.

(3) Where a *firm* provides a copy of the *FSA's* factsheet, it may wish to include the following wording in its covering literature:

"The enclosed factsheet about capital-at-risk products is from the Financial Services Authority (FSA), the independent watchdog set up by Parliament. Please read this document carefully.".

COB 3 Annex 4

<u>Additional guidance on particular types of financial promotion</u>~~Guidance on potential problem areas for financial promotions which identify and promote specific investments and for direct offer financial promotion~~ (G)

1 This annex forms part of *COB* 3.8.9G(5) and *COB* 3.9.14G. <u>More than one table may be relevant to any one *financial promotion.*</u>

2 Table Contents

<u>Section I : Guidance relevant to specific non-real time financial promotions for particular product types</u>	
A	**AVC Schemes (including FSAVCs)**
B	**~~PEP or ISA transfers~~ <u>Bond Funds</u>**
C	**~~Corporate bond funds or similar contracts~~ <u>With-profits bonds</u>**
D	**~~'Guaranteed' products~~ <u>Pensions – phased retirement</u>**
<u>Section II : Guidance relevant to direct offer financial promotions for PEP or ISA transfers and personal pensions and stakeholder pension schemes</u>	
E	**~~With profit bonds~~ <u>PEP or ISA transfers</u>**
F	**~~Pensions – phased retirement~~ <u>Personal pensions and stakeholder pension schemes</u>**
<u>Section III: Guidance relevant to specific non-real time financial promotions for products with identified characteristics</u>	
G	**~~'High Income' products~~ <u>Guaranteed or protected products</u>**
H	**~~'Stock market bonds'~~ <u>High income products</u>**

I	**~~'Hybrid bonds'~~ <u>Stock market products</u>**
J	**~~Personal pensions and stakeholder pension schemes~~ <u>[deleted]</u>**

…

Renumber the following tables in COB 3 Annex 4 as indicated below, and amend as shown.

4 <u>7</u> Table ~~B~~ <u>E</u>

PEP or ISA transfers

…

…

~~5~~ <u>4</u> Table ~~C~~. <u>B</u>

Bond Funds

A firm constructing a financial promotion for corporate bond funds or similar contracts should take account of the following:

(1) Clear description of the risk

…

(2) Quoting out of date yields

Financial promotions often feature prominently the yield on the fund. In some cases the actual yield being paid at the time the promotion is communicated is materially different to the yield quoted. Owing to lead times, inaccuracies can occur if the market is moving rapidly, but yields several weeks or months out of date are misleading. The promotion should quote the date at which the rate applied. It is ~~unwise~~ <u>misleading</u> for ~~items~~ <u>financial promotions</u> with a long shelf life to feature prominently a rate which may become invalid.

(3) Funds not fully invested

…….

~~6~~ <u>9</u> Table ~~D~~. <u>G</u>

Guaranteed <u>or protected</u> products

1. Equal prominence to guaranteed and not guaranteed benefits

~~(a)~~ Firms should give equal prominence to the description of benefits which are guaranteed and of benefits which are not.

~~(b) If the word 'guaranteed' is highlighted, or otherwise emphasised, equal high-lighting, or emphasis should be given to the fact that any elements which are 'not guaranteed' are not guaranteed.~~

~~(c) If the reference to guaranteed income is highlighted in, for example, a 'back to back' scheme combining an annuity which is guaranteed with a five year policy or ISA, the proceeds of which are not guaranteed, the fact that the benefits under a life assurance policy or ISA are not guaranteed must be stated with equal prominence.~~

2. ~~Past performance~~ <u>Guaranteed income but not capital</u>

~~The FTSE index began in 1984 and reference is often made to its performance. Examples of 'back testing' are often given to show that the index has not fallen in any five year period since 1984. The experience may not, however, be representative of current conditions and if so the results are capable of being misunderstood. Including earlier experience may result in a more balanced presentation of risk.~~

<u>(a) A clear statement should be made where relevant benefits are not guaranteed.</u>

<u>(b) If any guarantee is given, the guarantor should be named.</u>

<u>(c) An equivalent annualised rate of return should be quoted if the cash rate is quoted.</u>

3. ~~Averaging~~ <u>Guaranteed or protected amount payable at the end of the term</u>

~~Contracts are normally based on the assumption that the index being used will rise. The use of the average level of the index will reduce the investment potential of the contract. Where the averaging periods cover more than the last six months of the contract term, it should not be implied that averaging is to protect against falls at the end of the term. It should be made clear that investors benefit only from some of the performance of the index and that one effect of averaging is likely to be to constrain the final level of the index used to calculate benefits.~~

<u>The words 'guarantee', 'protected element' or similar may be used to describe the minimum amount payable at the end of the term. This is usually provided at some cost to the investor and *financial promotions* therefore need to make clear what that cost is and how it is imposed.</u>

4. ~~Maximum benefits~~ Counterparty risk

~~These should not be promoted as a particular feature if the economic circumstances required to meet those benefits require investment conditions more favourable than those which would need to prevail to achieve the higher of the growth assumptions specified by the FSA.~~ *Firms* should ensure that *financial promotions* for products with a protected element to them, which is not guaranteed, include an explanation of the associated risk of counterparty failure. *Firms* should avoid giving a misleading impression of the capital security.

~~7~~ 5 Table ~~E~~ C

With-profits bonds
..

~~8~~ 6 Table ~~F~~ D

Pensions - phased retirement
..

~~9~~ 10 Table ~~G~~ H

High income products

1. Income Term

…..

2. Problem of disclosure of risks

(a) If the rate of income available is at some capital risk or at the expense of growth, or the income or a portion of it comprises a return of capital, these facts should be clearly explained.

(b) If direct or indirect comparison is made with a deposit, there should be a prominent statement that the investment does not include the security of capital which is afforded under a deposit.

~~3. Guaranteed income but not capital~~

~~(a) A clear statement should be made where:~~

~~(i) the relevant benefits are not guaranteed; or~~

~~(ii) no benefits are guaranteed.~~

~~(b) If direct or indirect comparison is made with a building society or with other forms of deposit, there should be a prominent statement that the investment does not include the security of capital which is afforded under a deposit with a bank or building society.~~

~~(c) If any guarantee is given, the guarantor should be named.~~

~~(d) An equivalent annualised rate of return (for example 8.16% relating to a cash return payable of 8% per annum half yearly) may be quoted if the cash rate is quoted more prominently than the equivalent annualised rate and the nature of the equivalent annualised rate is described.~~

~~(e) An equivalent gross return (allowing for notional income tax) may be quoted provided that it is:~~

~~(i) less prominent than the actual cash return; and~~

~~(ii) stated that tax is not recoverable by investors.~~

~~4.~~3. High income bonds, high income unit trusts and similar types of collective investment schemes

……

~~10~~ <u>11</u> Table ~~H~~ <u>I</u>

Stock market ~~bonds~~ <u>products</u>

Stock market ~~bonds~~ <u>products</u> are those investments which offer returns linked to the price of <u>equities or</u> an index such as the FTSE 100.

~~(1) Minimum amount payable at the end of the term~~

~~The word 'guarantee' is usually used to describe the minimum amount payable at the end of the term. This guarantee is usually provided at some cost to the investor and promotions therefore need to make clear what that cost is and whether it is levied:~~

~~(a) from the start, for example by means of an additional initial charge; or~~

~~(b) only if the guarantee is invoked, for example by reference to an index or other indicator which includes capital growth but excludes investment income.~~

~~(2)~~ (1) Potential for Growth

…….

~~(3)~~ (2) Amount invested

…….

~~(4)~~ (3) Gross returns and tax on underlying fund

……..

~~(5)~~ (4) Taxation of investor

…….

~~(6)~~ (5) Early Encashment

…….

(6) Averaging

Contracts are normally based on the assumption that the index being used will rise. The use of the average level of the index will reduce the investment potential of the contract. Where the averaging periods cover more than the last six months of the contract term, it should not be implied that averaging is to protect against falls at the end of the term. It should be made clear that investors benefit only from some of the performance of the index and that one effect of averaging is likely to be to constrain the final level of the index used to calculate benefits.

(7) Maximum benefits

These should not be promoted as a particular feature if the economic circumstances required to meet those benefits require investment conditions more favourable than those which would need to prevail to achieve the higher of the growth assumptions specified by the FSA.

~~11.~~ ~~Table I~~.

~~Hybrid bonds~~
~~A hybrid bond refers to those life policy investments which combine one investment designed to provide income with another designed to return all or part of the capital. Potential problems with the promotion of 'hybrid bonds' are listed below. These should all be clearly explained, where applicable, in a direct offer financial promotion:~~ ~~(1) although the word 'income' is used to describe the regular payments generated from part of the investment, only part of each payment derives from interest earned on that money. The balance consists of a return of the capital itself;~~ ~~(2) although payments may be promised at a pre-defined level for a set period, there should be no implication that the original capital is guaranteed to be returned;~~ ~~(3) part of the investment is often invested in vehicles which offer opportunities for rapid growth, with risks of loss;~~ ~~(4) whilst the larger tranche is typically invested in a unit linked bond, the income producing tranche is given the greater prominence resulting in an unbalanced picture of the investment and the risks.~~

~~12~~ 8 Table ~~J~~ F

Personal pensions and stakeholder pension schemes
….

…

5.4.4 E The reasonable steps in *COB* 5.4.3R should include the steps set out in *COB* 5.4.6E to ~~*COB* 5.4.10E~~ *COB* 5.4.12E as appropriate, in relation to transactions in the following types of *investment* or activity:

……

(7) *structured capital-at-risk products* (see *COB* 5.4.12E).

…

After COB 5.4.11E, insert the following:

5.4.12 E (1) Unless (2) applies, in relation to a transaction in a *structured capital-at-risk product*, the *firm* should provide the *private customer* with a notice containing a clear, fair and adequate description of the *structured capital-at-risk product* which is to be the subject of the transaction, in a manner calculated to bring to the attention of the *private customer* the risks involved, in particular (and if applicable):

(a) that the return of initial capital invested at the end of the investment period is not guaranteed and therefore the *private customer* may get back less then what was originally invested;

(b) that the amount of initial capital repaid may be geared, which means that a small percentage fall in the related index may result in a larger reduction in the amount paid out to the *private customer*;

(c) that any maximum benefit advertised to the *private customer* is only available after a set period, indicating how long that period is;

(d) that redeeming a product early may result in redemption penalties and a poor return;

(e) that the initial capital invested may be placed into high risk investments, such as non-investment grade bonds;

(f) that the rate of income or growth advertised to *private customers* may depend on specified conditions being met, indicating what these conditions are;

(g) that the *private customer* should not enter into the transaction unless he is prepared to lose some or all of the money he has invested;

(h) that the *private customer* should satisfy himself that the *structured capital-at-risk product* is suitable for him, in the light of his circumstances and financial position, and if the *private customer* is in any doubt he should seek professional advice; and

(i) a clear, fair and adequate description of any other relevant risks affecting the value, trading price, and realisation of the value of the *structured capital-at-risk product.*

(2) If the *firm* is acting as an *investment manager*, it should provide the notice referred to in (1) as part of its *terms of business*, but need not provide a notice before each transaction in a *structured capital-at-risk product*, provided that the *structured capital-at-risk product* is within the range of *structured capital-at-risk products* described in the *terms of business*.

5.4.13 G In relation to a transaction in a *structured capital-at-risk product,* if it is relevant, *firms* should comply with *COB* 5.4.7E.

…

6.6.5 R *COB* 6.6.4R does not apply to a *firm* when it provides a *projection*:

…

(7) provided in accordance with *COB* 8.2.4R and *COB* 8.2.17E where the *life policy, scheme* or *stakeholder pension scheme* is a *structured capital-at-risk product*.

…

8.2.1 R This section applies to a *firm* when it:

(1) …

…..

(3) (a) *sells* a *structured capital-at-risk product* to a *private customer;* or

(b) *advises* a *private customer* on a *structured capital-at-risk product*; or

(c) *communicates* or *approves* a *financial promotion* relating to a *structured capital-at-risk product* to a *person* who is a *private customer;* or

(d) manages the relevant assets of the issuer of a *structured capital-at-risk product*.

…

8.2.4 R (1) A *firm* to which *COB* 8.2.1R (1) or (2) applies must, promptly and at suitable intervals, provide the *customer* with a written statement containing adequate information on the value and composition of the *customer's* account or portfolio with the *firm*, as at the end of the period covered by the statement, unless *COB* 8.2.6R applies.

(2) A *firm* must not carry out any activity in *COB* 8.2.1R (3) unless it:

(a) provides; or

(b) takes reasonable steps to ensure that there are arrangements for providing;

promptly, and at suitable intervals, investors in a *structured capital-at-risk product* with a written statement containing adequate information on the value and composition of the investor's *structured capital-at-risk product*, as at the end of the period covered by the statement.

(3) A *firm* need not comply with (2) if *COB* 8.2.6R (Exceptions from the requirement to provide a periodic statement) applies.

…

8.2.10 E Table: Periodic statements – timing and content

This table belongs to COB 8.2.7E.

Periodic statements: timing and content				
…				
Suitable intervals	(2)	A *periodic statement* should be provided:		
		(a)	six-monthly, to a *private customer* or an *intermediate customer* not subject to 2(d), unless the *customer's* account or portfolio consists entirely of *structured capital-at-risk products*, in which case the *periodic statement* may be provided once in any period not exceeding 12 months;	
		…		
Adequate information	(3)	A *periodic statement* should contain:		
		(a)	(i)	the information set out in *COB* 8.2.11E;
			(ii)	if applicable the additional information in *COB* 8.2.12E, *COB* 8.2.13E, *COB* 8.2.14E, ~~and~~ *COB* 8.2.15E and *COB* 8.2.17E; and
			(iii)	…

After COB 8.2.16G, insert the following:

8.2.17 E Table: Periodic statements – additional information required for a *structured capital-at-risk product*

This table belongs to COB 8.2.10E (3)(a)(ii)

Additional information required when a *firm sells*, *advises* on or *communicates* or *approves* a *financial promotion* relating to a *structured capital-at-risk product* to a *person* who is a *private customer,* or manages the relevant assets of the issuer of a *structured capital-at-risk product*

1 Statement of 'snap shot' maturity value

A statement of the maturity value of the *investment,* on the assumption that the relevant index, indices, 'basket' of selected stocks, or other factor remained at the level they were on the closing date of the period covered.

2 Changes in maturity value

A statement of the levels of the relevant index, indices, 'basket' of selected stocks, or other factor, at which the maturity value of the *investment* would be less than the amount of the initial capital invested, and an indication of by how much less the maturity value would be.

3 Risk warning

A warning that the value of the relevant index, indices, 'basket' of selected stocks, or other factor can go up or down.

Annex B

Amendments to the Glossary

Insert the following new definitions in the appropriate alphabetical position.

structured capital-at-risk product	a product, other than a *derivative*, which provides an agreed level of income or growth over a specified investment period and displays the following characteristics: (a) the *customer* is exposed to a range of outcomes in respect of the return of initial capital invested; (b) the return of initial capital invested at the end of the investment period is linked by a pre-set formula to the performance of an index, a combination of indices, a 'basket' of selected stocks (typically from an index or indices), or other factor or combination of factors; and (c) if the performance in (b) is within specified limits, repayment of initial capital invested occurs but if not, the *customer* could lose some or all of the initial capital invested.
structured deposit	a *deposit* paid on terms under which any interest or premium will be paid, or is at risk, according to a formula which involves the performance of: (a) an index (or combination of indices)(other than money market indices); (b) a stock (or combination of stocks); or (c) a commodity (or combination of commodities).