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Polarisation

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Summary

Polarisation as a concept in investment advice was introduced by the *Financial Services Act 1986* regime. It was argued then that consumers were confused, they could not distinguish between products 'produced' and marketed by their advisers and products recommended entirely on merit following a search of the market. After the Act firms had to choose between selling the products of a single product provider, or advising clients on the full range of products available on the market. Firms which chose the latter option were described in the legislation as 'independent intermediaries'. The Act had a significant effect on the structure of the market for financial advice, and in particular promoted the class of advisers known as 'independent financial advisers', all of whom are independent intermediaries.

From the outset polarisation constrained the sale of financial services products, restricting both the form of distribution channels and the availability of products and therefore there was a tension within the rules as to whether the restrictions on competition which the rules created was justified by corresponding benefits to consumers or which could not be obtained in less restrictive ways.

In 1998, the Director General of Fair Trading started a review of the polarisation rules. The Financial Services Authority commissioned a study into their impact and, after much debate 'polarisation' has been dismantled from December 1st 2004. This note sets out the progress of this reversal.

1. Polarisation: background

Polarisation is a concept which was developed as out of the regulatory regime set up under the *Financial Services Act 1986*. The rule is not contained in the Act itself, but in the rulebooks issued by the regulators.

The key principle can be explained by referring to the *Core Conduct of Business Rules* which were originally issued by the regulator the Securities and Investments Board (SIB).

> Rule 4 on polarisation required that where advice is being given on packaged products (which include life assurance type products, such as pensions, and unit trusts) a firm must either be an independent intermediary or it must be a product company (or an associated company of a product company). If the firm is a product company, it may only advise customers on the products of its own company. If the firm is acting as an independent intermediary, it must act as an independent intermediary when it advises customers. This may sound circular, but the rule needs to be read with rule 17, standards of advice on packaged products, which required that:
>
> 17(3) Where a firm is acting as independent intermediary, it must not advise a private customer to buy a packaged product, or buy a packaged product for him in the exercise of discretion, if it is aware of a generally available packaged product which would better meet his needs.

This requirement is part of the obligation to provide 'best advice'. Clearly the capabilities and resources of independent financial advisers vary, as do the ways in which they charge for their services (usually either fee-based or by taking a commission). Many people nevertheless prefer to buy financial products in circumstances in which independent advice is available. This gave independent financial advisers (IFAs) a marketing advantage which helped counteract the disadvantages they faced in competing against the product companies and tied agents of product companies, which include many of the biggest banks and insurance companies.[1]

Polarisation was initially justified on the grounds that consumers were at risk of harm from not knowing on whose behalf those who offered them financial advice were acting. It only applied where specific advice was given to the consumer, and only to 'packaged investment schemes'. It meant that when an investor bought this type of product with advice he would either be given advice from an independent financial adviser (who would give advice on all the available investment products) or he would be advised by a company representative (working directly for a product company) or an appointed representative or tied agent (who would not be an employee of the product company, but was only permitted to sell that product company's range).

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1 This account over-simplifies the way that polarisation works in practice. A number of means have been developed within the current rules which soften the concept slightly. In particular, firms are able to buy in the products of other providers and re-brand them as their own. Moreover, many independent advisers sell from a panel of pre-vetted providers rather than searching across the whole market for each sale.

2. Office of Fair Trading scrutiny

The Office of Fair Trading (OFT) had a responsibility to report to the Treasury under the *Financial Services Act 1986* on the effect on competition of the initial rules of the regulatory bodies. The Director General also had a continuing duty to keep the rulebooks under review under s.122 of the Act, and to report to the Treasury if he found any of those rules to be significantly anti-competitive.

The OFT had believed that polarisation when first introduced, together with other features of the regulatory regime, was significantly anti-competitive:

3.11 Under the terms of the Financial Services Act, the Director General was required to give the Secretary of State for Trade and Industry his views on whether the rules of SIB, including the polarisation rules, were likely to restrict, distort or prevent competition to any significant extent before SIB became fully operational.

3.12 The then Director General concluded in his report on the rules of SIB in March 1987 that polarisation, combined with financial regulation, the cost of compliance and the costs of the compensation and complaints procedures for IFAs would significantly distort competition. He believed that the extra costs would reduce the number of IFAs. Because polarisation meant that there was no intermediate category of adviser, there would be an increase in the influence of the representatives of product providers.

This would lead to a reduction in the information available to consumers on competing products.

3.13 The Secretary of State did not agree with the views of the Director General. He delegated authority to SIB and the rules, including the polarisation rules, were issued in 1987.[2]

In August 1999, the Director General delivered a report on polarisation to the Treasury. He found that polarisation was having an adverse effect on competition:

2.15 The polarisation rules restrict or distort competition to a significant extent by preventing some innovation in retail markets. These effects are outweighed in the case of life assurance and personal pensions by the competition between providers generated by the number of IFAs in the market and by the protection that the rules give to the consumers of these products. This protection arises both from the clear lines of responsibility for regulatory control of advice and the continuing need for consumers to receive independent advice on these products. The significant effects on competition are not outweighed to the same extent for advice on other packaged investment products where consumers do not enter into such long-term commitments and a larger proportion of products are sold direct to the public. It is sufficient that before giving advice on non-life products advisers should be required to

[2] Ibid. paras 3.11-13

make their clients aware of any ties with providers that they may have entered into.[3]

He therefore recommended that polarisation should cease to apply to unit trusts, but should continue to apply to insurance-based packaged products, on the ground of their greater complexity. He also proposed a number of ideas for further consideration by the regulator. The Director General's report went to the Treasury.

3 para 2.15

3. London Economics study for the Financial Services Authority (FSA)

Before a decision was announced on the OFT report by the Treasury, the FSA (the successor body to the SIB) commissioned its own study on polarisation from consultants London Economics which was then made public for comments in July 2000.

London Economics' study was based on 'interviews with providers and advisers, consumer research, extensive background research on market trends, and detailed consideration of the underlying economic issues, to build up a comprehensive body of evidence on the effects of the regime and possible changes to it'.[4] This evidence was then used to conduct a cost-benefit analysis of four possible alternative scenarios to the current regime. The current regime was also evaluated to provide a benchmark, as were a couple of minor variations. The structure of the scenarios drew on the work of the OFT, and the advice of the FSA, and was adjusted during the life of the study to make sure that unworkable proposals were not considered. The four main scenarios were:

- **Redefinition of polarisation for all products.** In this scenario, firms could choose to be independent, tied, or multi-tied, with clear disclosure of both status and interest.
- **The Director General of Fair Trading's (DGFT) recommendation.** In this scenario, collective investment schemes are removed from the ambit of polarisation.
- **Minimum standards exemption**. In this scenario, simplified packaged products (CAT ISAs and stakeholder pensions) would be removed from the ambit of polarisation.
- **Retaining the essentials of polarisation.** In this scenario, providers operating tied distribution are allowed to introduce the products of other providers to fill gaps in their product range.[5]

The study agreed with the Director General's finding that polarisation did have anti-competitive effects. On the other hand it also found that the rules had reduced consumer detriment to the extent that they had helped clarify the status of financial advisers, that is, whether advisers were independent or not. It warned that any changes would need to ensure that this clarity was not lost.

Three of its scenarios appeared to offer improvements to competition without having undesirable effects on consumers. It was not attracted to the recommendation of the Director General (removing polarisation from collective investment products only):

This scenario may reduce the effectiveness of competition, and it also has the potential to increase consumer detriment for collective

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4 *Polarisation and financial services intermediary regulation: A review for the Financial Services Authority*, Report to the Financial Services Authority by London Economics, July 2000

5 p. 1

investment products, since it allows advisers to use different statuses whilst advising on investment products that are close substitutes.[6]

From an economic perspective, it favoured the most radical of the scenarios, 'redefining' polarisation for all products:

Although such a change would bring both direct costs to the FSA and compliance costs for regulated firms, there would be worthwhile competition benefits, with increases in product volumes and reductions in prices for consumers. Meanwhile, there is unlikely to be much increase in consumer detriment. In the IFA channel, this is because independent status remains protected, and few current independent advisers would choose to abandon this status. In the tied channel, other regulatory protections (the 'as good as' provision) remain in place, and the importance to providers of protecting their brands is likely to prevent firms from buying-in poor quality products. There may be benefits in the bancassurance channel, where there is substantial potential for falls in consumer charges to reflect the low expense levels.[7]

In all its analysis, the study was mindful of the general desirability of not making changes which would reduce the availability of independent advice, given that polarisation appeared to have both beneficial (reducing consumer detriment) and harmful (anti-competitive) effects.

The key analytical consideration is therefore whether polarisation can be changed in such a way as to have little impact on the size and independence of the IFA channel. The evidence suggests that most IFA customers value independence highly and would be unlikely to switch to a multi-tied channel if this became available. The evidence also suggests that IFAs are in a somewhat distinct market segment from tied agents, and this is reinforced by IFAs' different contractual relationship with their client. We conclude therefore that the IFA channel would not diminish significantly if multi-tied agents came into the market. However, the evidence is not conclusive and this is an area of risk.[8]

The FSA's analysis of responses to the study showed a mixed picture:

No overall consistent picture emerged from the responses submitted. Some large institutions favoured substantial change, others did not. Several submissions conveyed the sentiment 'It's not broke so don't fix it' and some respondents struggled to understand the need for the review. Those supporting some changes to the polarisation regime tended to focus their arguments on the scope for improved competition to the benefit of consumers.[9]

The most popular of the scenarios with respondents was gap filling; the least popular, the de-polarisation of collective investment schemes only.

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6 p. 2
7 p. 2
8 p. 2
9 *Reforming polarisation: First steps*, Financial Services Authority, January 2001 [CP 80] Annex B p 1

The majority of respondents, highlighting where detriment arises under the four LE scenarios, assert that consumers will be confused by the changes. If polarisation is relaxed in any way, many respondents are concerned it may not be possible to achieve meaningful status disclosure and a few saw distribution costs rising, as a scramble for distribution would occur.[10]

The FSA's own Consumer Panel made a detailed response, which indicated that it was too early to decide what the most appropriate solution is and that more research would be needed before it would be safe to change the current system.[11] The FSA's own Competition Unit also addressed some points raised by the responses:

• whatever decision is made on polarisation, clarity of status rules will help prevent consumer detriment that may arise from consumers wrongly assuming that any tied adviser reviews the whole market;

• IFAs have not drawn a large number of less well-off people into their channel. Whether, over time, more people enter this channel as real incomes rise and/or IFAs start targeting the less well off, are considerations. It may be that most such consumers will continue using the tied channel. If this is the case, there is expected to be less chance that they will be sold a poor value product from an intermediary tied to more than one provider firm. So while preserving the status quo may tend to protect consumers who use the IFA channel, it would do little for other consumers; and

• there are contradictory arguments about how market structure would change if radical rule changes were made. This might reflect genuine uncertainty or a degree of vested interest. Adjustments from the present structure of the market might not be smooth, but marked by aggressive gambits by major players.[12]

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10 Annex B, pp 4-5
11 Annex B, p. 6
12 Annex B, p 6

4. FSA proposals: first stage

The FSA made recommendations on polarisation to the Chancellor of the Exchequer at the beginning of November 2000. It recommended that sales of products which are subject to minimum standards - CAT-marked ISAs and the new stakeholder pensions - as well as direct offers to the public (including those from fund supermarkets) should be taken outside polarisation in time for the introduction of stakeholder pensions in April 2001.[13] It also recommended further consultation on more fundamental changes to the polarisation rules, although it did not set out the precise solution envisaged.[14]

The Treasury accepted the FSA's suggestions promptly, although expressed some disappointment that it was not possible to make faster changes to the regime:

The retail investment industry has been on notice of potential change in this field for over two years now. I am also keen to make progress on the Government's agenda for encouraging saving and responsible financial planning. To do this we need a reliable and reputable retail financial marketplace. Modernising polarisation has an important part to play here. So I am naturally disappointed that preparation for full reform will take some while longer to achieve - though I recognise that doing the thorough integrated task you describe will be the best way of developing consensus to deliver a durable result. I hope you will take any opportunities to move faster that may open up as the project moves forward.[15]

The FSA argued that the original aim of protecting consumers no longer justified the distortion to competition which the polarisation rules causes. This view is based on changes to the markets which have happened since the introduction of polarisation:

The FSA has examined polarisation in the context of its statutory objectives, in particular consumer protection and consumer awareness. It is not concerned solely with the competition aspects of polarisation.

The FSA has taken account of the previous regulators' justification for polarisation when it was introduced in 1988 - i.e. on consumer protection grounds, despite its potential to distort competition. The most important issue for the FSA has been whether there is a case for maintaining polarisation unchanged on consumer protection grounds. It has concluded that there is not for the following reasons:

i) the regulatory environment has changed substantially since polarisation was introduced. Regulators have introduced a range of measures including status disclosure, commission disclosure, and a training and competence regime;

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[13] CAT standard ISAs are now not being included in the first round of changes; polarisation will therefore continue to apply to these products

[14] 'FSA says fundamental change to polarisation will benefit consumers and the industry', Financial Services Authority press release PN/135/2000, 8 November 2000

[15] Letter from Melanie Johnson to Sir Howard Davies, 8 November 2000 in Annex A of FSA CP 80

ii) the FSA has further measures in hand to improve transparency and disclosure. Plans for the publication of comparative information next year are well advanced. A discussion document setting out how product information disclosure might be improved, so as to allow consumers to make better informed decisions, will be published soon. Work is in hand to improve status disclosure further to deal with the absence of polarisation.

iii) consumer detriment arises not only from the purchase of inappropriate products but also through the failure to make appropriate financial provision. Improved access and choice allied to better disclosure will serve consumer interests better.

iv) the UK is unique in imposing a structural constraint on distribution arrangements and other countries have not found it necessary to introduce a system like polarisation to protect consumers. In the future, the current polarisation regime could become increasingly inconsistent with EU developments

v) an important role remains for genuinely independent advice to consumers and the FSA believes it will be possible to maintain a robust and healthy IFA sector whilst also trying to improve competition within the tied sector.[16]

To prepare for the first stage of reforming polarisation, a consultation paper was issued on the removal of CAT-marked ISAs, stakeholder pensions and direct offers from polarisation.[17] As a result of that consultation the scope of the reforms was narrowed and will now only apply to stakeholder pensions and direct offers.[18] The changes were introduced slightly before the actual introduction of stakeholder pensions in April 2001.

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[16] 'FSA says fundamental change to polarisation will benefit consumers and the industry', Financial Services Authority press release PN/135/2000, 8 November 2000

[17] *Reforming polarisation: First steps*, Financial Services Authority, January 2001 [CP 80]

[18] When these products are sourced from another provider they will be referred to as 'adopted packaged products'. The selling firm will be responsible for the advice given at the time of sale while the product provider will be responsible for the product terms themselves and the subsequent administration.

5. Reactions to the first stage

The Director General of Fair Trading welcomed the announcement from the FSA:

'The polarisation rules limit competition more than is necessary for investor protection. The FSA agrees with the OFT that there are better ways to ensure informed consumer choice.

'The market for financial products has changed since the rules were adopted twelve years ago. For example, some clearer and simpler products have come onto the market.

'I support the FSA's view that improving information about products and statutory disclosure of the seller's status can promote informed and wider choice while meeting the goals of investor protection. It is right to consult on how far the relaxation of polarisation should go.'[19]

The Association of Independent Financial Advisers expressed a number of doubts about both the scope and the detail of the FSA's proposals:

AIFA welcomed the fact that restrictions will initially be eased only on a limited range of products; that the IFA community will be under no pressure to multi-tie; and that the FSA is concerned to minimise the risk amongst consumers with plans for greater disclosure of status, but AIFA is still not convinced that the benefits of polarisation for investors have been fully appreciated.

AIFA Chairman, Lord Hunt of Wirral, said

"The potential for investor confusion has been underplayed and there will be a heavy cost of compliance in monitoring rules on status disclosure which consumers will have to bear. We are relieved that IFAs will not be pushed toward multi-ties and we will continue to resist their introduction. Whilst there is a welcome commitment to greater disclosure, the current regulations deliver complete clarity over the vital difference between the status of the IFA and the tied agent. The changes proposed today, even with additional disclosure requirements, would dilute this clarity.

AIFA has consistently argued that the investor now increasingly understands the difference between independent advice and products sold via tied agents."[20]

Other commentators were divided on the merits of the new proposals. There are question marks for example about the decision to allow direct offers to be free of polarisation so quickly, and there are also concerns about the second stage, for which there were already indications that the FSA might be minded to adopt the more radical of the mooted reforms. Some were concerned that any change would be likely to jeopardise the strength of the IFA sector, which they saw as a vital

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[19] John Vickers, in 'Polarisation review', Office of Fair Trading press release 44/00, 8 November 2000

[20] 'FSA changes could confuse investors', AIFA press release, 8 November 2000. See also the AIFA's response to the FSA's more detailed plans, on www.aifa.net

source of advice for consumers, whilst others thought that the defence of polarisation owes more to the protection of vested interests than of the consumer:

The government and the Financial Services Authority, the chief City watchdog, teamed up on Wednesday to announce their long-awaited decision on rules covering advice and sales of everything from life assurance to unit trusts. For the rest of the week, financial advisers, banks and consumer representatives spent their time shouting at each other.

The cause of the flaring tempers is the decision to do away with the "polarisation" of advice, which positions independent advisers at one extreme and "tied" advisers, who can sell only the products of the company they work for, at the other. Now, there is to be a middle-ground. So-called "multi-tied" advisers will be able to sell their own products alongside those of a few competitors.

So, is this good news for the consumer?

The government, the FSA and the banks insist it is. A move away from polarisation is a move away from unnecessary red tape, they say. Promoting multi-ties is a vital way of promoting consumer choice.

If their views hold sway (and they might not, because there is to be a period of consultation before any changes are introduced), your legwork could certainly be reduced. A visit to the bank to withdraw some cash could save you a trip up the road to buy a fund from your independent financial adviser and a meeting with the insurance broker to buy motor insurance.

Making it easier, of course, does not mean making it better. In spite of assurances from the scheme's supporters that the consumer can only win, the Consumers' Association remains sceptical. "Polarisation was never perfect, but we are very concerned that multi-ties will add confusion and the opportunity for bad advice," a spokesman said.

Their argument is compelling. At present a tied agent will offer only one company's products. An independent financial adviser should give you full market access. If you want choice, choose an IFA. If you don't, buy from a tied agent.

But IFAs have their critics, too. Some say many IFAs are already multi-tied agents in all but name. "For economic reasons, IFAs are already confined to routeing your business through a few partner financial services companies," says Michael Maslinski at banking consultancy Maslinski Lawrence. [21]

Another columnist in the same paper argued strongly that polarisation should never have been introduced and should be discarded:

All those years ago I had two main reasons for arguing against the polarisation principle. First, it was a compromise which emerged from a committee made up largely of life company bosses. It was justified as preventing the public from being confused. But its real purpose, in my

[21] 'New-style advisers predict wider choice', *Financial Times*, 11 November 2000

opinion, was to sort out conflicts between life companies which depended on independent brokers and others which used direct sales forces.

Secondly, polarisation was clearly anti-competitive. The Office of Fair Trading said so at the time. My own concern was that the rules banished from the financial services sector what has become the standard business model in retailing: that own brands are sold alongside a selected range of independent brands. In particular, the retail banks would be encouraged to set up their own investment subsidiaries and cease selling the products of Fidelity, Scottish Widows, Perpetual and all the other independent houses. As a result, the quality and value delivered to the mass market would decline. [22]

[22] Barry Riley, 'At last the 1987 show: 'Polarisation' is on its way out - and not a moment too soon', *Financial Times*, 18 November 2000

6. FSA proposals: second stage

In mid 2001, the FSA commissioned a number of research projects to help inform its work on polarisation:

- Charles River Associates was asked to look at the evidence for the influence of commission-based remuneration on advisers ('commission-bias'). An elaborate research exercise using statistical analysis of very large data sets and new market research data was designed to see whether there is reliable evidence for such bias, which is often alleged.[23]
- Cap Gemini Ernst & Young looked at how independent financial advisers select product providers, and in particular the use IFAs make of panels of providers. Panels are typically chosen at intervals either in-house or by external consultants as sources of 'best advice' quality products for a firm's IFAs to use. Some IFAs have principled objections to the use of panels.[24]
- A series of consumer research projects sought to find out what consumers currently understand about financial advice, the status of advisers, and how advisers are remunerated. They sought to find out what effect polarisation and the way in which advisers are remunerated has on consumer behaviour in looking for advice. They also investigated how consumers would respond to more complicated disclosures of information about status.[25]

In addition the FSA looked at the customer base of IFAs, remuneration practices in the tied sector and international comparisons.[26]

On 14 January 2002, the FSA published its second round of proposals.[27] The FSA's chairman said:

'This is a significant liberalisation package to enhance consumer choice by breaking the shackles that polarisation puts on competition and innovation.

Our aim is to secure long-term improvements for consumers through greater access to advice and greater choice in the financial products available to them.

The extensive research we have carried out as part of this review demonstrates that the regime we inherited now represents a major market distortion and has simply not delivered sufficient consumer benefits to justify maintaining it. So we propose that it should be abolished, and new enhanced disclosures should be introduced to

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23 Charles River Associates, *Polarisation: research into the effect of commission based remuneration on advice*, Financial Services Authority, [December 2001]

24 Cap Gemini Ernst & Young, The Financial Services Authority Polarisation Research: IFA Use Of Panels, Financial Services Authority, [September 2001]

25 *Polarisation: Consumer Research: Report of research studies carried out by IFF Research Ltd, ORC International Ltd, NOP Research*, Financial Services Authority, January 2002

January 2002

26 See CP 121, Chapter 3 for more details

27 *Reforming polarisation: Making the market work for consumers*, Financial Services Authority, Consultation Paper 121, 14 January 2002

ensure that consumers are clear about the different types of adviser available to them.'[28]

The FSA proposed to remove the polarisation rules altogether. In their place would come stronger requirements on firms to disclose to consumers the nature of the advice on offer, backed up by efforts to make consumers more aware of this market. Product provider firms would be free to invest in adviser firms, with the aim of creating better-capitalised advice firms. The concept of 'independent' advice would be linked specifically to fee-based advice: advisers who are remunerated on commission will no longer be able to describe themselves as independent.

The FSA listed the weaknesses which it had found in the system that polarisation had fostered:

- competition currently operates, via the commission system, to secure IFA distribution power for product providers, which is to the detriment of consumers
- consumers' behaviour, in response to the signals given by polarisation, shows that the regime has not in practice delivered good value for many middle-market consumers
- the remuneration systems for both tied advisers and IFAs give an incentive to sell a product, and in some cases that product may be unsuitable for the consumer
- too few consumers are making (adequate) provision for their financial future and, in particular, for retirement
- the bundling together of the cost of advice and the cost of the product prevents consumers gaining a proper understanding of the role of advice and its cost
- the regulatory system itself may put impediments in the way of consumers who might be minded to shop around[29]

The FSA predicted that if these proposals were to be introduced, the advice market would be characterised in future by the following participants:

- provider firms which continue to offer only their own products and are free to distribute through the tied, independent and direct channels
- provider firms which choose to increase the range of products they offer by adopting products from other provider firms. They are free to distribute through tied, independent and direct channels;
- distributor firms which distribute and advise on the products from a range of different providers; and
- independent advisers responding to the continued demand for independent advice[30]

The FSA also sought views on whether there is scope for establishing a two-tier system for adviser qualification, with 'less intensively qualified advisers' able to advise on a limited range of less risky investments.

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28 Howard Davies in Financial Services Authority press release, *Consumers put first in proposed major reform of financial advice*, PN/003/2002, 14 January 2002

29 CP 121 p5

30 CP 121 p6

7. Reactions to stage two

The consultation paper provoked a fair amount of criticism within the industry and a great deal of debate. Since the plans will affect a wide range of firms, with different interests, reactions varied. Lord Hunt, chairman of the Association of Independent Financial Advisers, said:

It is extraordinary that the FSA is proposing to remove a cornerstone of consumer protection to solve the problem that tied agents can only offer a limited range of products. A simple system is being replaced by a free-for-all and the FSA admits it does not know what the future shape of the market will look like.

Instead of building on what polarisation has achieved, the FSA's proposals to dismantle the strict polarised environment will send the industry into a serious bout of reorganisation and chaos, as providers look to form new relationships with advisers. How will this be beneficial to the consumer? The FSA's own research shows that most consumers perceive independent advice as the best. But they have come up with proposals which by their own admission could reduce the number of independent advisers. This is totally illogical.[31]

The National Consumer Council was reported to have welcomed the announcement: 'The current polarisation system doesn't work at all well for consumers who are on low incomes'.[32] However, it warned about adding to the complexity of the advice system which might confuse consumers. Writing in *Money marketing*, Andy Haste of Axa Sun Life argued that the proposals could benefit IFAs despite some of their fears: 'With the market set to become more competitive, IFAs are better placed than ever to sell themselves on the basis of service, value and transparency, whichever option they choose'.[33]

Some have questioned whether wholesale reform is an appropriate response to the research data that the FSA gathered. John Ellis of the LIA is quoted as saying: 'I do not think the FSA research into commission bias is conclusive. It is mainly qualitative not quantitative research. It looks like political manoeuvring to me'.[34] Peter French of Troy French says: 'The FSA's proposals will result in reduced independent financial advice, public confusion about advice and increased costs of that advice'.[35] However, David Lascelles of the Centre for the Study of Financial Innovation observed: 'The combination of better information and sharper competition, both of which should follow from the abolition of polarisation, can do more to ensure that the consumer gets

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[31] AIFA press release, *Depolarisation - Industry Chaos and Consumer of Confusion says AIFA*, 14th January 2002 The AIFA has since made detailed responses to the FSA in a number of themed documents.

[32] 'Financial advisers attack regulator's plans for shake-up', *Financial Times*, 15 January 2002

[33] 'The positive potential', *Money marketing*, 24 January 2002

[34] 'Cut against the bias', *Money marketing*, 24 January 2002

[35] 'Count the cost of turning back the clock', *Money marketing*, 31 January 2002

the right products at the right price than the most fastidious rulebook'.[36]

The Financial Services Consumer Panel, a statutory advisory panel which puts the consumer viewpoint to the FSA, has described the proposals in CP 121 as 'inadequate', and has criticised among other points the plan to require that independent advice can only be remunerated by defined fees.[37] The Panel said:

There are two central issues at stake:

- First, the availability of accessible advice is crucial in getting the best deal for consumers. Currently there is a "gap" in the supply of advice, particularly for low and middle income consumers. This needs to be tackled by the FSA. The Panel itself is talking with advice agencies to consider what more can be done in this area, and will report back further to the FSA on its findings.
- Secondly, the FSA cannot rely simply on the market to create the best system for consumers after depolarisation. It must put extra rules and procedures in place to make sure the consumer is protected. For instance, suitability requirements might need to be strengthened to ensure that consumers are always offered products that meet their individual needs. Moreover, rules would need to be put in place to ensure competition. Consumers will need to be informed of the effect of tied arrangements on the range of products on offer; they will need to appreciate that, by shopping around between tied and multi-tied firms, they may be able to obtain better value-for-money.[38]

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36 'Rolling back the rules', *Financial Times*, 15 January 2002

37 'The Panel does not see any logic in the proposal to require independent financial advisers to enter into a defined payment agreement while allowing tied agents and distributor firms to charge commission. We think that equivalence in the market could be achieved by giving consumers the right to choose whether to pay by commission or by a defined payment irrespective of the channel of delivery.' *Financial Services Consumer Panel response to Consultation Paper 121: Reforming Polarisation: Making the market work for consumers*, April 2002 p3

38 Financial Services Consumer Panel press release, *Market reforms won't work without more consumer advice and protection*, 7 May 2002

8. Stage 2 Changes

In November 2002 the FSA decided that polarisation was to end with detailed proposals to follow in 2003.

In January 2003 the FSA published its proposed rule changes to abolish polarisation from the remaining areas of regulated business. In its document – *Removing Polarisation: Removing the Barrriers to Choice* – it stated that:

Our approach

1.3 Removing the polarisation restrictions will mean that, in future, firms will be able to sell not only their own products (if they produce any) but will also be able to sell the products of any other provider. But there will be no limit on the number of providers whose products can be sold. Firms advising customers will be obliged to recommend the most suitable product from the range on which advice is being given. In this way, and as now, those firms holding themselves out as giving advice across the whole market will be expected to recommend those products they consider the most suitable of any that are generally available. Other firms, however, will be expected to recommend the most suitable from those products which the firm has available within its range.

1.4 We wish to secure clear accountability for the advice given to consumers. We put forward a proposal recently in Consultation Paper 159: *Appointed Representatives – extending the current regime* (CP159) that, as now, appointed representatives for investment business should have a single principal where advice is given to consumers. It will be possible for an appointed representative (AR) to gain advantage of the liberalisations we propose in three ways. An AR can do this through its current principal (where that principal adopts others' products), by changing to another principal which does have an extended scope of products, or by obtaining authorisation in its own right so that it can distribute products of a number of providers. In the case of introducer appointed representatives, who will not be advising customers or arranging transactions, we propose that they should be free to have links with a number of companies, rather than be confined to a single principal.

1.5 Firms that continue to offer advice across the whole market may wish to continue to hold themselves out as 'independent'. So we are proposing clarifying the circumstances in which the use of the term 'independent' (or any comparable term) will not breach the requirement to be considered clear, fair and not misleading. This rule will be to the effect that the firm both advises across the whole market and offers customers the opportunity to pay by fee for advice.

1.6 Firms will be required to make it clear to consumers what type of service that firm is able to offer them. Therefore, we have developed a new initial disclosure document which is designed to give consumers relevant core information in an easily digestible form.

1.7 In addition, we propose to abolish the 'better than best'1 rule which currently has the effect of imposing an arbitrary limit on investment in firms. Abolition will be accompanied by safeguards through:

• disclosing to consumers in an initial disclosure document any connection with a product provider;

• requiring loan finance or share purchase to be on commercial terms; • reporting to us where significant volumes of business are placed with a single provider;

• prohibiting providers from setting any implicit or explicit business targets for firms in which they invest;

• the continued application of the rule prohibiting the giving of an unfair inducement (COB 2.2.3 R); and

• reminding consumers in the suitability letter of any connection the firm has with a provider where the firm is recommending one of that provider's products.

1.8 We announced on 28 October 2002 that we were not proposing to pursue

development of the 'defined payment system' canvassed in CP121. Instead, we are developing the so-called 'menu' approach as the means of introducing more transparency into the cost of advice. We will publish a separate CP on the menu as early in 2003 as possible.

1.9 We have reviewed the position of indirect benefits against the background of the removal of the polarisation restrictions. We have decided that, with the exception of a firm selling only its own products, the guidance on the receipt of indirect benefits should apply across all firms. The basic prohibition of inducements (COB 2.2.3 R) continues to apply in all cases, of course.

1.10 We are proposing no changes to the arrangement for fees paid by firms and meeting the cost of compensation.

1.11 We do not propose to remove the polarisation restrictions until we have also concluded consultation on rules for the 'menu'. Then, we propose that firms who wish to take advantage of the removal of the polarisation restrictions can do so providing they are at the same time in a position to comply with the new obligations that go with it. And we propose a transitional period of six months at the end of which all firms need to be in compliance with the new rules. We will consult on appropriate transitional rules when we consult on the 'menu'.[39]

Under the FSA proposals:

- firms currently restricted to selling just one company's products to customers will in future be able to offer their customers more choice;
- firms which wish to continue to hold themselves out as 'independent' can do so provided they both advise from across the market and offer their customers the option to pay by fee;

[39] Op cit pp 4-5

- abolition of the polarisation regime means that firms must clearly explain to consumers what the scope of advice or service they are offering is. This will be achieved through a new specific initial disclosure document; rules about disclosure in advertising and on stationery, all firmly backed up by a consumer education campaign.

The approach was summarised as the 'menu' plan and was expounded most fully in the FSA's Consultation paper 04/3 entitled 'Reforming Polarisation: A menu for being open with consumers. The role of the menu and its place in the regulatory scheme are set out in chapter two.

The menu document

2.5 The menu is a concise document that, with some exceptions, all types of adviser firms in the depolarised world will be required to give to private customers when they first seek advice on packaged products. The menu aims to disclose clearly and simply to consumers the cost of advice in dealing with, and the services provided by, a particular firm. It is aimed at getting consumers to appreciate that it is they who ultimately pay for the advice, regardless of the payment method. The menu will include, where relevant, the average rate of commission charged for each product group across the market (the 'market average').9 By arming consumers with this information, we hope that they will have a better understanding that advice costs can vary between firms and be better equipped to shop around, compare costs across the market and/or negotiate with their adviser.

2.6 The document will not actually be called the menu; it will be entitled '**A guide to the cost of our services'** so that the title will tell consumers what it is about. The document will be 'key facts' branded to draw it to the attention of consumers as something they should read and take notice of.

2.8 Within the menu, firms will be required to disclose how they are paid in terms of the maximum commission that they would retain and/or their fee rates.

2.9 Firms will be required to give private customers a copy of their menu at the same time as they provide their initial disclosure document (IDD), which is also 'key facts' branded. CP166 contained a proposed requirement that, when approached for advice on packaged products, a firm must give a private customer an IDD. This would make clear whether advice on the products of a single provider, or on the products of a limited number of providers, or from across the whole market (or a sector of that market) was being offered. The IDD would also invite customers to ask for a copy of the list, or 'range', of particular products on which they would be offered advice. The menu will correspond to the particular IDD and range offered by the firm. The IDD and the menu, therefore, will carry some of the most important information about the firm, its charges and services, and help the customer to decide whether to use that firm or adviser.

2.10 The firm will also give the customer its terms of business at this early stage in

the advice process.

2.11 These three documents ['menu', IDD and terms of business]will together provide private customers with enough information to explain with whom they are dealing, the type of advice on offer and the likely cost of that service. The launch of the menu will be accompanied by consumer education initiatives that will aim to get across the importance of 'key facts' branded material, together with key depolarisation and disclosure messages.[40]

Generally, a firm will be required to give private customers a menu when it first makes contact with them with a view to providing advice on packaged products. It will also be required to provide a menu to any private customer who requests one, regardless of whether they are seeking advice at that time, or not. It is the activity of providing advice on packaged products that generates the need for a menu rather than the type of firm. Firms giving telephone based advice are subject to slightly different requirements. Here firms will be able to conclude the contract over the telephone if the customer has given explicit consent to defer receipt of the documents and the firm sends out the documents as soon as possible after the conclusion of the sale.

There are three exceptions to the requirement to provide a menu.

- Firms are not required to give customers a new menu if they have already provided one in the past, and the information in it remains valid.
- Firms are not required to provide a menu if they are providing advice only on non-mass market products that are not in one of our specified product groups and they are charging for their services on a commission-paid basis only. This is because the menu would be 'empty' and would not provide any prescribed standard information about the products they were actually offering. It should also be noted that firms selling non-mass market products are not required to provide a menu, but they do have the option of providing customers with separate information on their payment arrangements One commonplace example where this exception might apply is likely to be when firms are asked by an employer to advise employees on group personal pensions
- Firms are not required to provide a menu if they have a nondiscretionary investment agreement with a customer, and this agreement provides for (i) the firm to be paid by fees, (ii) the firm to provide whole-of-market advice on packaged products, and (iii) the firm to give advice on securities, as well as packaged products.

The third exemption is intended to cover firms, such as stockbrokers, whose principal business is not the provision of advice on packaged products, but which may nevertheless provide such advice from time to time. In such cases, it is usual for customers to enter into an agreement under which the firm agrees to invest a sum of money for a customer on a fee-paid basis.

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40 Op cit chapter 2 at http://www.fsa.gov.uk/pubs/cp/cp04_03.pdf

The new menu disclosure document - 'keyfacts about the cost of our services' - was introduced with depolarisation from 1 December 2004. Only firms that choose to depolarise from 1 December 2004 must provide their clients with menus. However, from 1 June 2005 all firms need to comply with the new depolarisation and disclosure rules. They must then provide their clients with menus using the charging rates current at that time.[41]

[41] http://www.fsa.gov.uk/industry/menu.html

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