THE FINANCIAL SERVICES PRACTITIONER PANEL ANNUAL REPORT 2004/5

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CHAIRMAN'S FOREWORD

I am pleased to be introducing this Annual Report on behalf of the Financial Services Practitioner Panel (the Panel) for the period 2004/5. Its primary purpose is to create a document of record – as a function of our responsibility to the industry and also of our role in the wider Financial Services and Markets Act 2000 (FSMA) accountability framework – that summarises the work we have done since the beginning of 2004. We have also endeavoured to set out how well we consider the Panel has performed against its own objectives and in relation to the expectations of our major statutory stakeholders; regulated firms, the Financial Services Authority (FSA) and Her Majesty's Treasury (HMT).

2004/5 has, once again, been a busy and demanding time for the Panel. It has also been an eventful period for the FSA, regulation in general and the financial services sector as a whole.

The Report comments on the progress made on the major issues that were raised in our Annual Report last year, and also outlines the other key matters that have occupied our time since then. It goes on to identify what we see as our main priorities for 2005/6 and how we intend to tackle them. We would add that the views contained – including those of practitioners emerging from our survey – should be set against a backdrop of ongoing change and evolution at the FSA, the anticipated benefits of which have not yet fully materialised.

In order to make this Annual Report as relevant, accessible and reader-friendly as possible, we have chosen to concentrate on the strategic and cross-industry matters of interest. We have therefore not included detailed commentary on some of the sector-specific or more technical regulatory and directive-based initiatives; such as Market Abuse, Distance Marketing, MiFID and softing/unbundling. However, these issues have featured regularly on our agenda over the past year, and we have made our views known to the FSA executive and Board where appropriate.

The biggest undertaking during the last year was our survey of regulated firms, published in December 2004. Over 3,000 regulated firms took the time and effort to respond, for which we are most grateful. The end product is an informed, authoritative and enlightening portfolio of data and conclusions that will drive much of our focus in the year ahead. We are pleased that the regulator has taken the content of this research seriously, and the FSA's own Business Plan for 2005/6 – coupled with its International Regulatory Outlook document – is a mature response that seeks to address many of the findings that emerged from the survey. Underlying

this is the belief that strong, risk-based and proportionate regulation is a good thing for everyone – practitioners, consumers, the FSA itself and UK plc. The Panel will continue to push the FSA to deliver against its clear commitment to create a better regime and environment in which regulated firms can not only operate, but thrive.

We are particularly conscious of the burden of regulation on smaller firms and always take time to consider their needs. This is very much helped by the presence on the Panel of Ruthven Gemmell, Chairman of the Small Business Practitioner Panel (the SBPP), who ensures that their concerns are communicated to us at our meetings.

The Panel has also maintained a regular dialogue with the Consumer Panel to better understand their views – satisfied customers of the financial services industry are clearly of equal interest to both panels. We have worked closely with the Consumer Panel and the FSA on a project to put substance behind the principle of *caveat emptor* – this has been particularly helpful in developing a better understanding of different perspectives.

Most of the Panel's input to and discussions with the FSA are undertaken in private – this is the best way to stimulate constructive debate between the industry and the FSA senior management. That means, however, that much of our work and effect often goes unseen. We have actively reviewed how well we are operating, and will make changes where appropriate. These are likely to include being more proactive in setting our agenda and identifying issues of industry concern, the greater use of sub-groups to look in more detail at sectoral and technical issues and – where appropriate – taking the opportunity to make stakeholders better aware of the Panel's activities and views. Importantly, the reduction in the number of FSA consultations means that we now have more discretion to concentrate on those topics which are of most importance to practitioners.

Five members of the Panel have stepped down this year: Donald Brydon, former Panel Chairman; Michael Quicke and Roger Sanders – who have been excellent representatives of the smaller businesses sector – on relinquishing their joint chairmanship of the SBPP; Hector Sants; and Brendan Nelson. My sincere thanks to all of them for their commitment and time.

I have been pleased to welcome Nick Prettejohn, Alan Yarrow, Andrew Ross, Russell Collins and Luqman Arnold to the Panel. They all have substantial experience of the financial services marketplace and are already making a significant contribution to the Panel's activities.

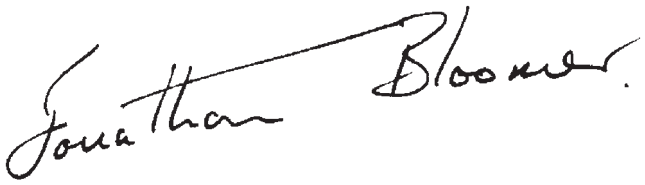
Finally, I would like to thank all my fellow Panel members, and our Secretariat support staff, for their expertise, efforts and enthusiasm during the preceding period. Our thanks also go to the FSA staff with whom we have engaged in regular, open and frank dialogue.

There has been a real change in the FSA's agenda: fewer CP's; and more focus on operational matters (for example, the review of the costs and benefits of regulation and of the enforcement regime). The Panel welcomes this and hopes that it will address the important concerns raised in our survey. The overall efforts to make the FSA easier for firms to do business with are particularly welcome, and the structural

distinction between wholesale and retail is a sensible and logical one which the FSA is confident will prove to have significant advantages.

The acid test will, of course, be the next round of the Panel's survey to be conducted in the summer of 2006. By that point, the industry will expect to see tangible evidence that the FSA is delivering against its recent commitments and that things are indeed moving in a positive direction.

I hope that you will take the trouble to read this Annual Report, and that you find its content informative, interesting and relevant.



Jonathan Bloomer

Chairman

2004/5 – THE PANEL'S YEAR IN REVIEW

Survey of regulated firms

A significant item of business for the Panel during 2004/5 was our biennial survey of regulated firms. Over 3,000 firms – of all sizes and types – took part in this research; making it not only wide-ranging in the nature of its opinion, but truly representative of the industry. The main purpose of the survey was to gauge and understand the views of the regulated community about the performance and impact of the FSA. The status of the Panel and the research's extensive coverage (conducted with the support of NOP Financial), mean that it is a genuinely independent, authoritative and influential study that is treated with the appropriate degree of respect and seriousness by the FSA. We were, however, careful to ensure that the industry's perceptions were presented in a fair, balanced and objective fashion given the changes already taking place at the FSA.

The Panel welcomes the improvements that the FSA has made in certain regards recently, including the reduction in the number of consultation papers being issued and the work it has done, and continues to do, to make the Handbook easier to use. We also welcome the greater reliance on market-led solutions, a more careful and pragmatic approach to the application of EU directives and the ongoing work to enhance the overall capability and approach of FSA staff. It is also fair to say that, in a number of categories, there were notable differences between the respective perceptions of wholesale and retail firms – with wholesale firms typically recording a higher overall degree of contentment than their retail counterparts.

However, the results of the survey show that the industry believes the current regulatory system places too great a burden on firms, is harmful to the development of new products and services and, therefore, may actually work to the detriment of consumers. Smaller firms, in particular, feel that the regulator gives little consideration to the impact of policy development and regulation on their businesses.

The costs of compliance are seen as the issue of greatest concern. Generally, firms complain about the level of investment required to ensure they are compliant and see these costs as continuing to increase still further in the future. Unsurprisingly, this is again particularly felt by smaller firms. Potential consequences of this will be reduced consumer choice, a negative impact on innovation and on the UK's international competitiveness.

While supportive of the FSA's efforts to reduce financial crime and to secure the right degree of protection for consumers, the industry feels that the FSA is too focused on consumers' interests, to the detriment of its other objectives. The survey reflects a

belief that – in comparison – the FSA does less to meet its objectives of maintaining confidence in and promoting understanding of the UK financial system.

There was a general feeling that the FSA does not give sufficient priority to international issues and, as a result, does not take a lead on matters concerning international regulation but positions itself in a more reactive and responsive way. The implementation of EU directives within the UK is often seen as over-zealous.

As the FSA is the regulator of the financial services industry – its 'policeman' – it may be unrealistic to expect that a large proportion of regulated firms will ever give very high satisfaction scores. That said, as previously observed, the notion itself of strong and effective regulation continues to be supported by the vast majority of practitioners.

In that context, it was pleasing to note that overall satisfaction with the relationship between the FSA and individual firms had increased slightly over the preceding two years. However, any action that the FSA takes to further improve these relationships may well struggle to have a significant impact on overall satisfaction while the majority of practitioners expect compliance costs to rise inexorably. The survey suggests that there is also a need for the FSA to further improve its understanding of the businesses it regulates, and there remains a pressing call for it to enhance its ability to provide guidance to firms in a timely, consistent and helpful manner.

The Panel will continue to push for the implementation and assimilation of the key points arising from the survey, both as high-level issues of principle and in the context of our representations on specific regulatory developments.

Costs of regulation project

The most immediate outcome of the Panel's survey was the decision by the FSA to jointly mandate an in-depth study into costs, and their associated benefits.

This project – the scope of which was announced in February 2005 – will be undertaken in partnership with the Panel. It is a crucial piece of work. The Panel were very keen to be co-joined in its governance, and the FSA's agreement to this demonstrates the willingness on both sides to produce something that has the necessary degree of practitioner input and experience. The research is being undertaken in a way that should provide a reliable basis from which to identify areas where the pressures imposed by the costs and burdens of regulation might be relieved. Our equal representation in the ongoing oversight arrangements will help ensure that it is conducted in a manner which practitioners would support and where the conclusions and recommendations will have the desired credibility. The work will – rightly – pay particular attention to the way that costs bear most heavily on smaller firms, and will also endeavour to look at how costs in the UK compare with other relevant international marketplaces.

The effect on smaller firms is all the more important since, following the statutory commencement of regulation for mortgage and general insurance intermediation, more than 95% of firms regulated by the FSA would be generally regarded as small; i.e. those that do not have a dedicated relationship manager.

The task of identifying, calculating and analysing costs and their impact will not be at all straightforward – there are many levels, layers and drivers – some direct, some less so. We therefore hope that those firms selected to assist with establishing the hard data will do so enthusiastically and without bias.

HMT 2-year review of FSMA

In last year's Annual Report, the Panel welcomed the HMT announcement regarding the scope and timing of the so-called 'N2+2 Review'. In particular, we had previously been pleased to note that many of the Panel's earlier submissions regarding the terms of the review were taken on board. The review had 3 main strands – the impact of FSMA on competition, the Financial Ombudsman Service (FOS) and its interaction with the FSA, and the boundaries of regulation.

We followed the progress of the review closely – the findings from which were made public in December 2004 – and contributed our views where appropriate and necessary. Moreover, the Panel has taken a keen interest in considering and pursuing the outcomes and actions arising from it in discussion with the relevant HMT, FSA and FOS staff.

One particular issue that we have recently raised directly with HMT is the desire to allow the FSA greater freedom to endorse guidance produced by trade associations. Part of the FSA's continuing review of the Handbook, and as a function of its general approach to regulation, is likely to be the reduction in the amount of detailed FSA guidance that exists. This is welcomed, and is consistent with the move towards a more principles-based approach. But it is nevertheless important that practitioners have access to sufficient assistance to help them understand and fulfil their compliance obligations, and in a way that does not place additional or unreasonable burdens on the FSA's own Contact Centre and supervisors. A number of trade associations stand ready to produce information in order to plug any such gaps but, in the absence of clear approval from the FSA, the value and credence of this material is significantly undermined – the Panel hopes that this is an area where greater discretion may be permitted in the future.

We believe that good progress has already been made on strengthening the relationship between the FOS and the FSA – both now appear to have a far better understanding of each others' respective responsibilities and difficulties. The Panel supports the intention to handle 'wider implication' cases in a more defined way and with greater discipline, along with raising awareness in and making the overall FOS decision-making processes and safeguards more transparent. We hope that these improved arrangements will mitigate the wholly undesirable prospect of the FOS finding against a firm even though it had seemingly acted in compliance with the prevailing FSA rules (although we acknowledge that certain FSA provisions are couched in general terms, with no absolute safe harbours).

On a more general note, we shall continue to meet regularly with the Chief Ombudsman – with whom we have an open and productive relationship – on FOS-related issues that are likely to emerge in the coming year; such as the ongoing volume of mortgage endowment complaints and the approach to cases arising from

the sale of simplified stakeholder products. One initiative that the Panel (and, we understand, the FOS itself) is keen to support and engage in further is the trade association-led project to create an annual knowledge bank of normal industry practice adopted by regulated firms during the preceding 12 months – while not without its challenges, it could serve as a valuable resource to help inform and manage the expectations of practitioners, consumers, the FSA and the FOS, on the merit of future mis-selling claims or investigations.

Cost Benefit and Market Failure Analyses (CBA/MFA)

Also flowing from the HMT review of FSMA, the FSA has stated publicly that it is putting measures in place to improve the way that Cost Benefit and Market Failure Analyses are undertaken. This is a particularly important area that is, of course, linked to the wider issue of costs and regulatory burdens. A long-standing concern on the part of the Panel – which was supported by the results of our survey – is the sense that CBA are often not sufficiently robust; with costs typically underestimated, and the anticipated benefits overstated. We accept that CBA forecasts are sometimes difficult to make with the desired degree of accuracy – hence the need for a subsequent audit in light of experience.

Messrs McCarthy and Tiner have made clear to us that the FSA will not exercise its discretion to make new policy unless there is tangible evidence of market failure and that regulatory intervention would have a positive influence. The proposal to include a defined focus in CBA on the impact for smaller firms is also a welcome development. In addition, we support the signalled intention to conduct *ex post* assessments to explore whether CBA proved – in practice – to be broadly accurate in their earlier analyses of financial implications and the advantages to the marketplace that these would generate.

Linked to this is the way that the FSA introduces EU directives into UK regulation. We acknowledge the subtle distinction that exists between the emotive terms of super-equivalence and gold-plating. The Panel also accepts that, in certain circumstances, the application of EU directives in such a way is not totally unwarranted or unpopular with practitioners. There are occasions where it may be perfectly appropriate to maintain the high standards of conduct and compliance to which the UK aspires. However, there are other times where the basis on which the FSA brings (or intends to bring) such directives into effect is – in our view – far less justifiable. The part played by HMT must, of course, also be taken into account in this regard.

The FSA's internal processes are now more geared towards a critical evaluation of, and a genuine senior-level challenge to, the imposition of any international provisions in a way that may be damaging to the UK's competitive position. The Panel welcomes this, but will remain vigilant. Separately, we intend to build a closer relationship with the FSA on the prioritisation and coordination of its international work – if the industry can assist the FSA to better influence the development of international policy and legislation, this will help mitigate concerns arising at the point of UK implementation.

Arrow

The Panel welcomes the FSA's review of the structure and application of the Arrow framework relating to its supervision and thematic work. The success of Arrow is key to achieving a truly risk-based approach to regulation. In particular, Donald Brydon, the previous Chairman of the Panel, wrote to Sir Howard Davies (the then-FSA Chairman) in May 2003 with the industry's suggestions to enhance and simplify the process. It would appear that many of these suggestions are now receiving due and active consideration as part of this review.

We are particularly pleased to see that the FSA is exploring the possibility of providing an incentive for those firms that maintain demonstrably robust systems and controls – in other words, an element of regulatory dividend. This could, for example, take the form of a suitably lighter-touch supervisory oversight and/or greater reliance placed on a firm's senior management.

The Panel supports the development of a more collaborative, 2-way relationship between the FSA and the firms it supervises, and the more intelligent use of management information. However, to facilitate this, further developing the overall knowledge and skill of FSA staff must also be a top priority for the FSA, along with taking steps to ensure greater continuity and consistency of approach.

The ongoing development of the FSA's internal tool for assessing the risk to consumers of firms' products – the Product Risk Framework (PRF) – remains an issue on which the Panel takes a keen interest. In particular, the way in which the PRF sits alongside Arrow and how it will be used and applied in practice by supervisors. It must not become a product-regulation mechanism by the back door.

Enforcement

During this year, the Panel took the view that it should – in due course – take a detailed look at the FSA's approach to, and processes for conducting investigations and pursuing enforcement action against regulated firms. However, it was not appropriate to commence this until a number of high-profile disciplinary issues had been concluded (on which we make no comment). That is now the case.

We have welcomed the FSA's decision to formally review its arrangements in this regard – led by David Strachan, reporting to a sub-group of the FSA Board – and are already engaged with the FSA as this initiative progresses. In this context, the Panel is informed by practitioners' views about the FSA's enforcement framework arising from our own survey – having confidence in the fairness and transparency of the process being the key points. We also intend to open an ongoing dialogue with the new Chairman of the FSA's Regulatory Decisions Committee (RDC).

One aspect that the Panel is particularly keen to explore further is the principle of negotiated settlements – whether in individual cases or involving multiple firms. This appears to be becoming a far more common method of case-disposal on the part of the FSA, and we would like an opportunity to consider the benefits, risks and general appropriateness of this at greater length.

Treating Customers Fairly and other retail-focused strategies

Treating Customers Fairly (TCF) is an initiative that the Panel broadly welcomes and supports. We do believe that treating customers in the right way leads to sustainable business success and high customer satisfaction. The challenge will be to articulate, embed and apply TCF in a suitably pragmatic and proportionate way. We have been regularly involved in the development of the FSA's thinking on TCF – both as a full Panel and through representation on the FSA working groups – and will continue to take an active role.

The Panel was particularly concerned that the early iterations of TCF were too negative and stereotypical in their perceptions of industry behaviour, and failed to give appropriate credit for much of the good work that had already been done by the industry to raise standards. Similarly, we did not feel that the way in which the concept of consumer responsibility applied had been adequately considered or given the necessary prominence.

Since then, the Panel has been encouraged about how things have moved on. But there remains much more to be done by the FSA if TCF is to receive the support and backing from the industry that is essential. Issues such as the way in which the FOS will seek to apply TCF, the nature of expectations on firms' senior management, and achieving the desired balance between prescription and principles (the proposed case studies are key to this) remain to be concluded. There must also be absolute clarity that the output of TCF will not be enforced retrospectively or become a separate and additional layer of regulation over-and-above what already exists.

The Panel feels strongly that it is not possible to consider TCF in isolation from the principle of *caveat emptor* (buyer beware). The responsibilities that consumers themselves must take for their investment decisions – an obligation that remains enshrined in the FSMA legislation – should not be overlooked by the FSA. We have been working with the Consumer Panel and the FSA on whether it would be possible to develop a working definition of what this principle might mean in practice, and how it should sit in relation to the obligations that are incumbent on regulated firms. We have been encouraged by the positive nature of those discussions and the progress that has been made to date. Practitioners and consumers might never reach complete agreement, but the Panel believes that there is an opportunity to create some workable ground rules.

The wider issue of consumers' appreciation and understanding of risk – highlighted by a recent Treasury Select Committee report – is a debate on which the industry also stands ready to contribute with a view to establishing an agreed and workable solution. However, the proposition that all products should be risk-labelled is one that carries certain fundamental dangers and difficulties, and will require particularly careful and thorough consideration.

Finally, the Panel has had a regular involvement in the wider Financial Capability strategy, being led by the FSA. One plank of this work that will be particularly important to the success of the overall initiative is that of generic advice. There are many competing imperatives at work that the FSA will need to consider carefully if the right outcome is to be reached. These include the extent to which – and how – the existing advice infrastructures (i.e. regulated firms) could or should be utilised to provide generic advice, and the development of suitable accreditation and redress mechanisms. If demand can be established, there would be an understandable wish

to reach the widest possible range of consumers, but ensuring an adequate level of consistency and quality of service will also be critical.

On a general note, there is currently a preponderance of high-level strategies, working groups and think-tanks that are in train and on which the Panel is represented. Some are FSA-driven, some are not. The most recent of these is the Treasury Select Committee Financial Services Forum on restoring long-term market confidence. Quite often, the role and activities of these initiatives will overlap. They must be pursued on a suitably joined-up basis, and meaningful and valuable output will be essential if the industry's ongoing support is to be secured.

Financial crime

The Panel considers that there has been steady and encouraging progress on the issue of fraud and money laundering during the latter half of 2004. Prior to that, much industry goodwill had been lost because of the large expense involved in the prevention of money laundering and financial crime, with little demonstrable evidence of effective action or tangible success. The FSA must maintain the current impetus and see the drive towards a more coherent, proportionate and straightforward overall approach as an ongoing priority.

There is broad support for the FSA's efforts to clarify and make the identification issue less complicated and problematic. The Panel finds it hard to accept that customers do not regard the current requirements as anything other than burdensome and without significant merit. Although simplification would incur a degree of initial cost and re-training, practitioners remain of the view that this would be a price worth paying.

We would also add that the day-to-day application of the various provisions by FSA supervisors is vital. Ensuring that the issue of financial crime is properly incorporated in the Arrow framework will help determine the level and type of risk-based attention that is required in specific circumstances. Placing an appropriate and realistic degree of expectation on firms' senior management will be another key component.

The Panel's effectiveness and profile

The Panel believes that it is functioning adequately and making a good contribution. There is always room for improvement and, to that end, we recently held a stocktake session to think about how we could put our resource and expertise to maximum effect, and be sure that we are adding full value. In doing so, we must however take care not to duplicate the excellent work that is undertaken by the trade associations.

The senior management at the FSA are fully committed to engaging with the Panel in an open and collaborative manner and, since the structure change that took place in April 2004, there are encouraging signs that this message is starting to filter down to the policy-makers. We believe that the key to getting the most from the Panel is to speak to us at a suitably early stage in the development and thought process – when the regulator's views are unlikely to be so well-formed – and to do so in a constructive spirit. We are pleased to say that there have been a number of examples in recent

months where FSA staff have done just that, and where the overall end-product benefited as a result. The Panel does not see itself as being an adversary of the FSA, and nor does it wish to be viewed as a mere procedural hurdle. We want to help the FSA reach the best possible outcome – for all parties – and take this opportunity to encourage its staff to use us to their best advantage; not because they have to, but because they see and understand the benefits of doing so.

The time that busy members are able to devote to Panel affairs is inevitably limited. We therefore intend to be more proactive in setting our meeting agendas in order to concentrate on the things that matter most to practitioners, and where our views will have greatest impact on the regulatory regime as a whole. Naturally, this is likely to mean that we shall spend proportionately more of our time on high-level, strategic and cross-industry issues (which is also reflected by the substantive content of this Annual Report). At the same time, the Panel will convene sub-groups – where appropriate – to discuss individual or sector-specific initiatives with the FSA in more depth. The fact that there are now fewer new policy initiatives and consultations emanating from the FSA means that we have a greater degree of freedom and flexibility to manage our time, and structure our operations, accordingly.

Finally, it is of course important that industry stakeholders – in particular, regulated firms and trade associations – know a sufficient amount about our role and activities to be confident that the Panel is indeed doing its job in representing practitioners' interests. We therefore intend to ensure that the visibility and profile of the Panel is sufficient to achieve this – including strengthening our links with trade associations, and the selective use of press releases and speaking opportunities.

OUR WORKPLAN FOR 2005/6

As we have indicated earlier in this Report, the Panel intends to concentrate the bulk of its time on the issues that we believe are most important and where our influence is likely to have greatest overall benefit for industry and most impact on the shape and application of the FSA's regulatory framework. Over the next 12 months, our priorities will therefore be linked more closely to the FSA's own aims and objectives as set out in its Business Plan and Budget for 2005/6.

When the FSA's Business Plan was issued in January 2005, the Panel stated publicly that this document represented a positive reaction to practitioners' continuing frustrations and concerns. While the overall cost of the FSA will increase, it is important that this is viewed and assessed in a properly strategic manner. The key for the Panel is that the FSA's expenditure and priorities for the coming year appear now to be better focused on the things that regulated firms consider to be the most significant; and which we believe would ultimately have greatest advantage for practitioners, consumers and the operation of the marketplace in general.

The Panel intends to play its part in monitoring progress and working with the FSA to help it meet these goals. We have decided that the best way to do this is to align ourselves to the key initiatives and commitments in the FSA's Business Plan for 2005/6 and to break these down under a series of high-level themes applying to all firms – large and small. This will also give the Panel a structured basis on which to prioritise its workload, track developments and – in a year's time – report on how the FSA has done and our own role in helping move these matters forward.

The Panel's Workplan for 2005/6 is set out overleaf. It is not necessarily exhaustive or definitive, and we shall keep the urgency and importance of particular issues under review as we go along. Financial services is a dynamic business – new and unexpected matters will undoubtedly arise during the course of the year. We need to be sufficiently flexible to adapt and refocus our efforts and resource as required.

Retail Markets issues

– Treating Customers Fairly

– Financial Capability

– Rights and responsibilities of firms and consumers (caveat emptor)

– Helping Consumers Get a Fair Deal (point-of-sale disclosure provisions)

– TSC Financial Services Forum

– Consumers' understanding of risk

Costs/burdens of regulation

– Costs of regulation project

– Approach to Cost Benefit and Market Failure Analyses

– FSA value for money and performance against budget

– FSA, FOS and FSCS levies and fees

– Treatment of smaller firms

FSA effectiveness and operation

– Panel survey of regulated firms (commencing in early 2006)

– Review of FSA enforcement processes

– Review and application of the Arrow framework

– The FSA success-measures project

– Financial crime and money laundering

– Product Risk Framework

– Coordinating and influencing the international agenda

– Overall quality of FSA staff

Handbook improvement and provision of guidance

– Handbook Review Project

– Handbook Development Project

– General provision of guidance by the FSA (Contact Centre and Relationship Managers)

– Endorsement of trade association material

– Processes for consulting on and making formal guidance

Capital Markets issues

– MiFID

– BASEL

– Solvency 2

– International Accounting Standards

– Integrated Regulatory Reporting

International Competitiveness

– Market Abuse Directive

– Distance Marketing Directive

– Transparency Directive

– Credit for Consumers Directive

– Instances of super-equivalence and gold-plating

– Services Directive

Marketplace dynamics

– Depolarisation and distribution models

– Sale of simplified stakeholder products

– Mortgage and general insurance intermediation

– Complaint handling and operation of the FOS

– Soft commission and bundled brokerage services / conflicts in analysts' research

– With-profits

ANNEX 1
Background to the Panel

Objectives

The Practitioner Panel was established in November 1998, comprising senior figures from a cross-section of the financial services industry, to provide a high-level body available for consultation on policy by the FSA and which is able to communicate to the FSA views and concerns of the regulated industries. It has a statutory basis under Section 9 of FSMA.

"*The Panel sees its main role as being that of a 'constructive critic' of the Financial Services Authority*"

The Panel considers that it has six core objectives:

1. **Monitor the overall effect of the FSA's activities on the industry**
2. **Assess the FSA's effectiveness, as seen by practitioners, against its statutory objectives and the principles of good regulation**
3. **Communicate industry concerns to the FSA**
4. **Help maintain market confidence, by promoting a suitably risk-based and proportionate regulatory regime**
5. **Provide practitioner views to the FSA on specific regulations**
6. **Promote international competitiveness of the UK marketplace**

These objectives should be viewed in the context of the FSA's four statutory objectives and the principles of good regulation (as set out in FSMA), and of its three strategic priorities – promoting efficient, orderly and fair markets; helping retail consumers achieve a fair deal; and improving FSA business capability and effectiveness.

The Panel believes that these are the characteristics of a properly functioning financial services sector and of effective regulation. We also recognise that practitioners' interests are best served by ensuring clients' prosperity and financial awareness/capability. We believe that a clear distinction must be drawn between wholesale and retail issues – and the various types and size of firm operating within those markets.

Further information on the role and work of the Panel can be found on its website: www.fs-pp.org.uk.

Membership

The current members of the Panel are:

Jonathan Bloomer, Group Chief Executive, Prudential plc (Chairman)

Roy Leighton, UK Chairman, Calyon SA (Deputy Chairman)

Alan Ainsworth, Deputy Chairman, Threadneedle Asset Management

Luqman Arnold, former Chief Executive, Abbey

Matthew Bullock, Group Chief Executive, Norwich and Peterborough Building Society

Russell Collins, Head of Deloitte UK National Financial Services Practice

Clara Furse, Chief Executive, London Stock Exchange

Douglas Gardner, Chief Executive, AWD

Ruthven Gemmell, Partner, Murray Beith Murray (Chairman of the Small Business Practitioner Panel)

David Hardy, Chief Executive, LCH Clearnet

Nick Prettejohn, Chief Executive, Lloyd's of London

Andrew Ross, Chief Executive, Cazenove Capital Management

David Verey, Chairman, Blackstone Group, UK

Alan Yarrow, Vice Chairman, Dresdner Kleinwort Wasserstein

Members of the Panel are appointed by the FSA, normally based on a recommendation by the Panel Chairman following canvassing of the relevant trade associations. The appointment of the Panel Chairman is also approved by HM Treasury.

ANNEX 2

FSA Annual Report 2003/4 – extract (www.fsa.gov.uk/annual)

The FSA does not include its formal response to the Practitioner Panel's Annual Report in the hard copy version of its own Annual Report. Instead, this response is available in electronic format only, on the FSA website – www.fsa.gov.uk/annual. We have therefore chosen to reproduce the extract from last year's FSA Annual Report in order that these important comments may reach the widest possible audience.

The shaded section below is taken from the FSA's Annual Report for 2003/4 and relates to last year's Panel Annual Report issued in March 2004.

Appendix 6: Accountability

The FSA's response to the Practitioner Panel's Annual Report for 2003

In their Annual Reports, the [Practitioner, Consumer and Small Business Practitioner] Panels comment on a number of aspects of our work. We welcome the Panels' support for particular aspects of our work and policies. In these responses we focus on those topics on which the Panels express concern or criticism. We look forward to continuing our dialogue with the Panels on all these subjects over the coming year. In the text below we show the Panel's comment in italics, followed by the FSA's response.

FOS/FSA relationship

The role of the Financial Ombudsman Service (FOS) and its relationship with the FSA has caused unease among practitioners for some time. The Panel has repeatedly pointed out the concern over the FOS's quasi rule-making abilities and the often blurred line of demarcation between the FOS and the FSA. In particular, the scope of the FOS to define such concepts as risk without a full public consultation of the sort undertaken as a statutory obligation by the FSA, as well as the absence of a practical appeal mechanism against FOS decisions, have been the source of much anxiety. The resulting uncertainty, in the Panel's view, further undermines market confidence, as well as firms' ability to manage their business risks effectively. In addition, the Panel would like greater assurance that practitioners do not face double jeopardy – specifically, where a firm may have complied with FSA rules but despite that is subsequently found 'guilty' by the FOS.

The Panel intends to continue holding regular discussions with the relevant senior officials at the FOS and the FSA, with whom we enjoy an open and productive relationship, to consider how our concerns might be addressed. In the meantime, we welcome the news that HM Treasury's N2+2 Review will explore in detail how the FOS and the FSA work together. This will include the circumstances in which the FSA may itself take wider regulatory action rather than rely on

individual determinations by the FOS, possibly by building further on the existing Memorandum of Understanding between the two organisations. However, we are conscious of the limitations of what can be done without primary legislation.

As the Panel points out, we and the FOS are reviewing how we deal with complaints to the FOS which may have 'wider implications'. The review will also consider whether there should be an appeal mechanism against FOS decisions. We will publish a joint consultation paper in the second quarter of this year, and plan to complete the review in the fourth quarter.

In response to the Panel's specific point about double jeopardy, the Financial Services and Markets Act 2000 (FSMA) does not require an ombudsman to take decisions on the basis of whether an FSA rule has been breached. However, relevant FSA rules are one of the factors that an ombudsman takes into account in deciding what is 'fair and reasonable' in the circumstances of a particular case. Decisions on changes to primary legislation are, of course, a matter for Government.

International competitiveness

Rising compliance costs and the increasing burden of regulation in the UK generated by domestic regulation and governmental initiatives, as well as EU financial services legislation, are perceived by many practitioners to pose a serious threat to the international competitive standing of the UK financial services market. There are also concerns in the industry over the FSA front-running EU regulation and gold-plating EU directives in the transposition process. Together, this could create an unnecessarily onerous regime that could damage UK markets relative to their European neighbours.

Maintaining the competitive position of the UK is one of the principles of good regulation outlined in FSMA. The Panel has urged the FSA to uphold this principle by keeping this point at the very forefront of its policy-making decisions. The FSA must have proper regard for the UK's international competitiveness and include this consideration in all regulatory initiatives.

With political and regulatory initiatives toward a common European financial services market gathering pace, the threat of financial services companies moving their core operations elsewhere should not be underestimated. We hope that the FSA's new Regulatory Policy Committee is alive to this issue, and the Panel shall itself continue to keep the point under review.

We agree that the FSA should have regard to the competitive position of the UK's financial services industry when making policy decisions. Our Regulatory Policy Committee (RPC) has already agreed that when implementing European directives we should not impose super equivalent requirements unless a demonstrably convincing case can be made for them on the basis of our statutory objectives and principles, including cost benefit analysis (CBA). The RPC requires policy proposals to be set in an international context, does not wish to pursue domestic policy changes if action could more effectively be taken at EU/international level, and considers whether proposed changes would place the UK in an anomalous or uncompetitive position.

Considerations of international competitiveness do influence our policy decisions. For example, in response to industry concern that our proposals on softing and bundling could damage the international competitiveness of the UK fund management sector, we commissioned research on the position in some other European jurisdictions. The results of this research influenced our eventual decision.

In our contribution to discussions and negotiations on emerging EU legislation, we take into account the impact of proposals on the competitiveness and structure of the UK market. For example, we consulted widely with all relevant industry sectors on the likely impact of the Markets in Financial Instruments Directive, and agreed which topics we should focus on as UK priorities.

We welcome the conclusion in the 2003 report by the Centre for the Study of Financial Innovation on London's competitiveness as a financial centre, that international firms active in London prefer the regulatory regime here to that in New York, Paris and Frankfurt. In the World Economic Forum's 'Global Competitiveness Report 2002-03' (which covers all sectors, not just financial services), the UK had the ninth lowest burden of regulation (of 80 countries), comparing favourably with the USA and several other developed countries. Under the heading 'the extent of bureaucratic red tape' the UK had the eighth lowest burden, again comparing favourably with the USA and several other developed countries.

Cost of regulation

In last year's Annual Report, the Panel highlighted strong practitioner concerns over the cumulative cost of regulation and its impact on regulated firms – an issue that also featured prominently in the findings of the Panel's 2002 survey of regulated firms. The past year has shown that industry anxieties over this problem have not lessened. In fact, they may have grown stronger, due to the deluge of regulation ahead of the 2005 target completion date of the EU's Financial Services Action Plan (FSAP).

In a closely related matter, the Panel has repeatedly voiced its concerns over the operational complexity and associated cost of the entire regime – another issue that featured in our Annual Report last year but continues to be relevant. The annual incremental rise in the overall cost of compliance to financial firms operating in the UK is widely regarded as a serious threat to their ability to compete.

The Panel has made a number of suggestions to the FSA to address these matters. For example, it is necessary to prioritise the international and EU agenda so that both the FSA and market participants are able to devote sufficient resources to the implementation of the EU's FSAP. Also, the interfaces between the UK, EU and the US should be addressed to minimise political and commercial obstacles that might prevent a cost-effective common financial services market. We would support any initiative to conduct an in-depth survey to better understand the source and size of compliance costs and to evaluate the effect of regulation on the competitiveness of UK firms. In addition, the Panel would like to see the FSA explore the merits and logistics of applying a 'regulatory dividend' – for example, as an incentive for firms fostering an inherently sound compliance culture and infrastructure, a suitably lighter-touch supervisory approach could be applied. The ARROW process should, over time, yield this result.

By the FSA's own admission, the costs of the regulatory regime to the industry have risen since it assumed its full powers, and the absolute quantity of regulation has also increased. The FSA must look at these facts and compare them with the benefits to be gained by allowing market forces to prevail. The Panel welcomes the news that such an analysis will be conducted as part of H M Treasury's N2+2 Review.

We acknowledge the considerable impact on the financial services industry of the changes arising from both EU legislation and domestic regulatory reform. Decisions on the substance and phasing of EU measures are, of course, taken by the EU institutions, not by the FSA. In a speech in October 2003 the FSA Chairman warned of the likely cumulative effect on regulated firms of the FSAP implementation programme, which was likely to be particularly heavy in 2004 and 2006. He called for firms' senior management to take this very seriously. Adequate time should be allowed for all relevant areas of firms e.g. compliance staff, legal, IT, to prepare for implementation. Senior management should review the appropriateness of their strategy in the light of EU legislative change, whether their activity is UK-focussed or spread more widely across the EU. He also called for EU legislation to be introduced in a phased and measured way, giving firms a realistic timeframe to prepare and plan. He advocated the introduction into the EU legislative process of CBA and effective challenges, to ensure that proposed policies are proportionate. In our discussions on forthcoming legislation in the various EU fora, we continue to argue the case for this approach.

In deciding which domestic policies to take forward, and when, we take into account relevant EU and international developments. For example, we recently decided not to publish new rules on firms' disclosures of conflicts, pending further work to prepare for implementation of the Market Abuse Directive. And we agreed to delay a number of policy changes until the content of the Markets in Financial Instruments Directive is finalised. In some areas – for example, reforming insurance regulation – our domestic objectives can be achieved only through an international approach, in this example, via the EU and the International Association of Insurance Supervisors. One reason for the pace of regulatory reform since N2 is that some aspects of the regime we inherited were inadequate. In particular, as is widely accepted, the framework for insurance regulation had not kept pace with market developments and with changes in regulation of other sectors.

Where possible, we seek to rely on market forces rather than regulatory intervention. Our recent decision on softing and bundling is one instance where we look to the market to find a solution, rather than imposing our requirements. In other cases we have held back from regulatory intervention on the grounds that market forces should be able to achieve the desired result. For example, we decided not to regulate short selling but rather to rely on transparency provided by the market itself.

As the Panel notes, as part of the N2+2 reviews we are, with the help of external advice, looking at our approach to CBA. Another strand of that review is work, led by the Office of Fair Trading (OFT), on the impact on competition

of the financial services legislation. We are working closely with the OFT and their advisers on this project.

In applying our risk-based approach we take into account the quality of firms' internal controls. For example, where we have confidence in a firm's internal audit function, we would normally expect to rely on its conclusions, rather than commissioning a report from external skilled persons. In our review of the operation of ARROW we will consider the scope for extending this approach.

Quality of cost benefit analysis

The FSA is required by the FSMA to conduct cost benefit analyses (CBA) ahead of its policy initiatives, to demonstrate that new provisions are necessary and proportionate. Generally speaking, the Panel welcomes this; CBA can be a valuable tool in determining the likely effectiveness, impact and necessity of a regulatory initiative.

However, the Panel has some concerns over quality and process. For example, CBA are often produced relatively late in the process, at which point there may be pressure to prove that benefits exceed costs. The Panel would prefer to see CBA conducted early to help form the policy, not after to justify the decisions made. We also believe that certain costs are often unrepresentative or not included at all, and that there is a disregard for the total cost of regulation and the industry's ability to absorb the incremental price of rule changes. It is also important that potential areas of consumer disadvantage, such as a reduction in choice, and the possibility of unintended consequences are properly and fully taken into account.

Following our representations, the Panel has been delighted to learn that the FSA has recently launched a concerted attempt, under the aegis of the Regulatory Policy Committee, to conduct CBA earlier in the policy development process. We were also pleased to hear that, as part of the N2+2 Review, the regulator will seek to design a means of analysing costs and benefits retrospectively, to assess whether the actual effects of regulation turned out as expected. The FSA is also committed to exploring a means of examining the cumulative impact of regulation.

As the Panel acknowledges, cost-benefit considerations are now built into our policy thinking at an earlier stage. Our internal processes now require that, before we embark on policy development or rule-making, we determine whether a market failure exists which requires a policy solution (or whether there is a non-economic rationale for intervention), and that if rules or general guidance are appropriate, we give early consideration to their costs and benefits. As part of the N2 + 2 work we are reviewing, with the help of external experts, our CBA methodology and our processes for linking CBA and policy formulation. The consultants are also developing a methodology that may be used as required for carrying out 'ex-post' CBAs and for conducting reviews of the cumulative effect of regulation. We are also planning a project, following on from the work Europe Economics did for us in early 2003, to survey the source and size of firms' compliance costs.

Each of our consultation papers includes our estimate of the costs and benefits of our proposals and invites comment from firms, trade associations and others. We acknowledge the time commitment involved for firms who wish to respond on these points: however, we have not always had the specific feedback on likely costs that we had hoped for. We will continue to discuss with the Panel how we could work better with the industry to improve the data on costs which we take into account in making our decisions.

The ARROW process

In principle, the industry is very supportive of the ARROW process and believes it is the appropriate approach for a fair and effective risk-based regulatory framework in the UK. Since it is a highly complex and relatively untested process, being implemented for the first time, the Panel has monitored informally firms' reaction to ARROW and fed some of the key issues back to the FSA.

In particular, we consider that there should be an improved mechanism for delivering the FSA's ARROW conclusions to firms before being finalised – at the very least, to allow a review for factual accuracy. Moreover, there should be more clarity on what needs to be achieved by firms to lower their risk rating. This is especially relevant to address firms' concerns that the ratings are based principally on size, irrespective of the quality of their control systems and infrastructure. According to practitioners, the process would also benefit from a clearer prioritisation of actions in the risk mitigation plan to help firms decide how best to allocate their resources. To add further value, benchmark feedback on other firms' ratings would be welcome to provide context to the FSA risk ratings in relation to actual risk exposures.

The FSA must appreciate that the ARROW process is based on its own assessment of the risks firms present to its statutory objectives. This may cause disagreements between practitioners, who face real commercial pressures, and the FSA, over the relative importance of concerns raised by ARROW and over the proposed risk mitigation tools.

We welcome the fact that the FSA has been very open to the Panel's views on ARROW and has stated publicly that it intends to address a number of these points to improve this evolving process. These points include the issue of size-based bias, the benchmarking of risk ratings and the prioritisation of actions in the risk mitigation plan.

We have described in our Business Plan for 2004/05 the main aims of the review of our implementation of ARROW, which is now under way. This review will cover the issues referred to above. In a pilot study being conducted as part of this review, we have built in the opportunity for firms to review the factual basis of our risk mitigation letter.

In a pilot study being conducted as part of this review, we have built in the opportunity for firms to review the factual basis of our risk mitigation letter before it is issued. We agree that the risk mitigation plan we propose should clearly identify the urgent and important issues so that the firm is clear as to our priorities.

A firm's potential impact on our statutory objectives is necessarily linked to its size: however the 'size-based bias' is corrected by the other dimension of the ARROW mechanism – the probability of an event occurring. For example, in assessing the likelihood of a problem occurring in a firm, we take the strength of the firm's internal controls into account.

Improving our application of the ARROW model is a priority for us in 2004. Part of this is an intensive programme of staff training and coaching, designed to ensure that staff adopt a genuinely risk-based approach in day-to-day supervision. We are also working to improve our allocation of resources, to ensure that they can be moved more quickly to areas of greatest risk.

Consumer education and responsibility

The FSA is obliged by statute to protect consumers. However the FSMA also states that consumers must take some responsibility for their own actions. Practitioners accept that the latter will only be possible if at least a basic level of financial literacy and awareness among consumers can be assumed. Hence, the Panel strongly supports the FSA's efforts to boost consumer education with appropriate initiatives. At the same time, we would also urge the FSA to better articulate what it believes the principle of consumer responsibility should mean in practice.

Generally, the Panel prefers for the focus to be on consumer education and transparency measures wherever possible, rather than more costly direct regulation. Better-educated consumers would require less protection and assist in the promotion of more effective competition between financial services providers. However, we do recognise that consumer education initiatives will not change public awareness overnight and will take significant time and effort to produce the expected results.

Too much emphasis on over-regulation, consumer protection, reviews of disclosure and selling practices, and Government-imposed product designs pose a serious threat to the competitiveness of UK firms. It is worth considering at what point the regulator, in seeking to protect consumers, actually starts to damage competition and innovation, so disadvantaging the very people whose interests it is seeking to safeguard.

Amongst other things, the FSA may wish to consider engaging more with practitioners in partnership initiatives for the education of consumers, and routinely including a suitable consumer education budget in relevant individual policy proposals.

Recent FSA announcements of stepping up its activity in the area of consumer education and, in particular, the creation of the Financial Capability Steering Group(FCSG) in late 2003 are steps in the right direction. The Panel would be happy to provide the FCSG with whatever support and input might be appropriate.

We agree that consumers have an important part to play in making the financial services market more efficient. In a speech in March 2004 the FSA Chairman summarised the respective responsibilities of firms, regulators and consumers for promoting and maintaining a fair and efficient financial services market. He explained the need to improve consumers' capability to take responsible decision. We are working to ensure that the principle of consumer responsibility is

reflected properly in our day-to-day decisions. Our consumer education work should put consumers in a better position to discharge their particular responsibilities. Following a suggestion by the Chairman of the Practitioner Panel we have begun a series of discussions jointly with the Practitioner and Consumer Panels on how the concept of consumer responsibility should be applied in practice. We hope this will be a useful contribution to the difficult balance we need to strike in this area.

We welcome the Panel's support for our initiative on financial capability and their offer of input. As our Business Plan for 2004/05 makes clear, this work is a major priority for us.

Sandler products

The Panel last year warned of the problems embedded in the current approach to the proposed stakeholder investment products, or Sandler products. Donald Brydon, then-Chairman of the Panel, took the opportunity at the FSA's Annual Meeting in July 2003 to highlight practitioners' potential vulnerability to mis-selling complaints, even if they were compliant with the Sandler provisions and the FSA conduct of business regime. As a consequence, distributors might have to retain pre-Sandler suitability and fact-finding processes – with the associated costs, but without the prospect of economic benefit.

Moreover, the creation by HMT of the Sandler suite of products did not follow the route usually taken by commercial organisations, of defining demand and the appropriate customer-base ahead of product design and pricing. The back-to-front process of designing stakeholder products ultimately put the FSA into an unenviable and difficult middle ground. In addition, providers, especially smaller firms, may well be reluctant to develop and manufacture such products given the inevitably tight margins imposed by the proposed charging restrictions.

Echoing the Panel's concerns, the Financial Services Consumer Panel and the Chairman of the FSA, Callum McCarthy, both voiced their reservations over Sandler products; in particular, over the inherent dangers in selling equity-based products without full (or any) advice. In an interview in November 2003, Mr McCarthy questioned whether a simplified purchase system for products with a heavy equity component would provide appropriate consumer protection – one of the FSA's four statutory objectives. The FSA are currently carrying out further consumer research and the Panel keenly awaits the outcome of this work.

As the Panel is aware, Treasury are responsible for the specification and design of Sandler products, including decisions on the charge cap. Our responsibility is to consider whether, given Treasury's decisions on these matters, a simplified selling process can be devised which is consistent with our statutory objectives – in particular, consumer protection and consumer awareness. We have carried out two major consumer research projects this year to check the effectiveness of an advice process based on filter questions. We are now broadly satisfied that a simplified process could deliver an appropriate degree of consumer protection, although some work remains to be done on the detail. Our consultation on the new process was launched in June, and will close in mid-September.

Prohibition of insurance against regulatory fines

In July 2003, the FSA published a CP of miscellaneous amendments, CP191. Included in this document were details of a proposal to prohibit authorised persons from entering into, arranging, claiming or making a payment under a contract of insurance that would pay all or part of a financial penalty imposed by the regulator.

The Panel expressed strongly its view that the nature of this proposal reflected an inappropriate and disproportionate response from the FSA. We are not persuaded that the scale of the perceived problem warrants such a prescriptive approach.

The FSA's decision-making arrangements, through the Regulatory Decisions Committee, are relatively untested and there remains a lack of full confidence in this system amongst practitioners. It should also be recognised that evaluating the degree of respective culpability between an individual and their firm – for the purposes of determining the ultimate target of enforcement action – is often a difficult task, with much scope for argument. Moreover, we reject outright the suggestion that an individual or firm might deliberately misbehave (or perform to a lower standard) in the knowledge that insurance was in place to cover any subsequent fine. Irrespective of the size of any financial penalty, the Panel would suggest that it is the threat of adverse publicity, professional and reputational damage that serves as the greatest deterrent.

One of the points that we have continually pressed is for the FSA to better harness market forces and have greater faith in the industry's willingness and ability to regulate itself and develop sensible and suitable solutions. This is an example where the Panel believes the overall circumstances of the perceived problem would have benefited from the FSA taking a more risk-based approach.

We were disappointed to learn that, following the formal consultation process, the FSA decided to press ahead with the proposals broadly along the lines previously set out. The Panel remains unconvinced that there was sufficient support (less than a third of respondents were in favour) to justify the FSA's decision to do so, or that it represented a true reflection of industry opinion on this matter.

We continue to believe that the rules we have made on insurance against fines are a sensible and proportionate way to avoid the risk that insurance might undermine the deterrent effect of fines. We thought it sensible to take action before this became a major issue, when the cost and disruption of doing so would have been greater. We originally also consulted the Practitioner Panel on a second proposal, which would have banned firms from indemnifying their own employees against the cost of fines. However, we decided not to go ahead with this proposal because of concerns expressed by the Panel. We have not suggested that any individual firm might deliberately misbehave or perform to a lower standard in the knowledge that insurance was in place, but we nevertheless believe that insurance does potentially undermine the deterrent effect of fines.

The FSA Board was conscious of the strength of the Panel's views on this issue when it took its final decision, following public consultation. In reaching policy decisions we take into account the merit of the arguments put to us. The strength of industry (or, in other cases, consumer) opinion and the number and balance of responses received is something we note, but that in itself cannot and should not be the deciding factor.

Soft commissions and unbundling

With regard to the proposals in the FSA's CP176 on Soft Commission Arrangements and Bundled Brokerage Services, which was driven in part by the recommendations on transparency in the Myners Report, the Panel expressed to the FSA some concerns over the draft CBA. The Panel did not take a strong position on the broad desirability or undesirability of softing or bundling, but recognised that softing is the more controversial issue.

Generally there has been agreement with the FSA's stance on the softing of non-research services, however, the Panel believes that on the question of the bundling of research a market-driven approach may be the best solution. An overly prescriptive, rules-based regime, in the Panel's view, would not correspond with the FSA's principles-based regulation.

Panel members also felt that there was insufficient recognition of the risks from possible unintended consequences and their impact on UK firms' international; competitiveness. This could include wide-ranging structural change within the investment industry, and the likely increase in the cost of research (which would impact small firms in particular).

An announcement is expected from the FSA shortly on the outcome of the consultation exercise. The Panel awaits this development with interest to see the extent to which its own views, and the views of many others from within the industry, have been taken on board.

We have considered carefully the views put to us during the consultation process, and announced our proposals on soft commissions and unbundling on 7 May. We remain clear about the outcomes to be achieved, and look for the following outcomes:

- fund managers have stronger incentives to make efficient decisions about trade execution and the purchase of ancillary services such as investment research; and
- fund managers are fully accountable to their clients for those decisions, and the consequent expenditure of their clients' funds.

To deliver these outcomes, we see three complementary changes as necessary:

- the range of goods and services that fund managers can buy with their clients' funds through commission should be limited to execution and research;
- fund management clients should be given, through enhanced disclosure, clear information about the respective costs of execution and research paid for on their behalf by their manager, and the overall expenditure on these services; and

- fund managers should be encouraged to seek, and brokers to provide, clear payment and pricing mechanisms that enable individual services to be purchased separately. We believe that such mechanisms will facilitate better decision-making.

We have been persuaded through the consultation process that there is scope for market-led solutions to contribute to delivering the outcomes we seek. The consultation response from the Investment Management Association suggested that a new system of 'comparative disclosure' would deal adequately with the market failure, at less cost than the rebate proposal. We have decided to allow the industry an opportunity to develop this disclosure proposition further, as part of the solution.

It is important that through improved disclosure, institutional customers such as pension fund trustees get the information they need to put pressure on their managers, as appropriate, over the control of costs. However, we believe that disclosure by itself is unlikely to be an effective solution for investors in retail funds, who may lack the knowledge to understand it and are unlikely to be able to muster sufficient pressure to use it as a lever for change. So we will look carefully at the arrangements for retail fund governance to see if there are ways in which retail consumers' economic interests can be better served, and to reinforce the principle that fund managers should act in their customers' best interests.

We have decided to set the industry a challenging timetable to achieve our objectives. We acknowledge that it will take time to develop, implement and assess the effectiveness of a fully-functioning disclosure regime. However, we intend to assess the industry's progress towards a workable and adequate regime at the end of 2004. Our action beyond that point will depend on the results of that review. If we judge that disclosure is not going to support our desired outcomes, we will reconsider regulatory intervention, including implementation of the rebate proposal in CP176.

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