

Section I

The Financial Services Authority

Introduction

Section I covers parts K1, U1, U2 and U3 of the syllabus, including the aims and activities of the FSA; its approach to ethical conduct and to the regulation of firms and individuals; how its rules affect the control structures of firms; and how its Conduct of Business rules apply to the process of advising customers.

There was, in the latter part of the 20th century, a strong assertion, in Western societies, of the rights of the consumer. Many people believe that, as commercial organisations have grown through mergers and acquisitions, they have become more remote from their customers and more concerned with their own financial results than with customer satisfaction. This is reflected in the emergence of both government-sponsored organisations, such as the Office of Fair Trading and the Competition Commission, and openly consumerist bodies such as *Which?*

Although some people believe that this trend to consumerism has gone too far – notably in the USA – there is a general acceptance that protection for the consumer is both necessary and appropriate.

One of the primary objectives pursued by most modern governments is an economic and legal environment in which a balance is established between the need for businesses to make a profit and the rights of customers to receive a fair deal. This has led to the regulation, to some degree, of most industries in the UK, but at the same time, the government recognises the right of companies to make a profit. Indeed, it recognises that it is essential that companies be permitted to make a reasonable profit; it would otherwise be

impossible to attract the investment that sustains the industries on which the UK economy depends.

These twin objectives of a free market for business enterprise and the protection of the consumer are among the principles on which the European Union is based, and it is not surprising to discover that these objectives have been promoted largely through European legislation – most of which impacts, either directly or indirectly, on the UK. The force of European law can be seen in most recent major developments in the regulation of UK financial institutions.

Perhaps because it deals with money – a vital common denominator both in the lives of individuals and in the national economy – the financial services industry has become one of the most regulated business sectors of all. Following the government's establishment in 1998 of the Financial Services Authority (FSA) as the single regulator of the financial services industry and the passing of the Financial Services and Markets Act 2000, there is no sign of a slowing down in the trend to greater supervision of the industry. Details of the nature and scope of the FSA as the regulator of the UK financial services industry are covered later in this section.

Although governments try to foresee problems and to introduce legislation as a means of 'prevention rather than cure', it remains true that most regulatory legislation in the past has been *reactive* rather than *proactive*, ie it has been passed in response to problems, rather than designed to foresee and prevent them. Legislation has often resulted from:

- ◆ particular scandals or crises: most recently, for example, the events surrounding the collapse of Barings Bank in the 1990s and the problems at Equitable Life. These have shown up the need for prudential control and for protection against mismanagement and fraud;
- ◆ an increase in consumers' financial awareness and a demand for a more customer-focused business approach: demands for a 'one-stop shop' approach to financial services sales was instrumental in the deregulation of banks and building societies over the past 20 years or so;
- ◆ the need to respond to changes in lifestyle: more relaxed attitudes to marriage and divorce in recent years have led to a strengthening of the rights of divorcees to share in former spouses' pension benefits; the introduction of civil partnerships for same-sex couples has extended the scope of some tax benefits and other financial and social benefits;

- ◆ developments in business methods: technological advance, in particular, has fuelled many changes in the last years of the 20th century and the early part of the 21st; this is particularly true for banks and building societies, whose customers now can, and do, carry out many of their transactions electronically;
- ◆ innovation in product design: rapid expansion has been seen in the ranges of certain products, particularly in mortgage business. This has made it more important than ever that a consumer should be provided with sufficient clear information about the features and benefits of the products they are buying;
- ◆ the increase in the number and complexity of financial products: this has made it necessary to provide customers with more information and advice.

Now, however, there is a strong move towards a culture of recognising and preventing problems before they arise, where possible, rather than simply picking up the pieces afterwards and allocating blame and punishment (although punishment has not been discarded). This approach is clearly illustrated by the Financial Services Authority's stated objective of moving to a more proactive stance and, in particular, its plans to base regulation on an assessment of the risk posed to consumers and to the economy by financial organisations and their products.

Government policy on the regulation of the financial services industry in the UK has, since the late 1970s, displayed what appears to be something of a paradox. There have been specific moves in what seem to be two opposite directions: in some areas, *deregulation* has been a key development; at the same time, many aspects of the industry have become more closely regulated. The aims of developments in all areas have been to benefit the consumer through greater choice, better service and stronger protection.

Deregulation was experienced mainly in the worlds of banking and building societies. Traditionally, banks had not been active in the mortgage market because government credit controls had severely restricted their lending activities, while building societies – operating under legislation that dated, in some cases, from as far back as the nineteenth century – were restricted to lending on mortgages and to offering simple personal savings products. But the world had moved on: the increase in home ownership was creating a huge demand for mortgages and customers were demanding a much wider range of products and services from their chosen financial providers.

The deregulation introduced in the 1980s was designed to remove these barriers, enabling institutions to broaden their services and to move into new markets. The relevant changes were introduced largely through the Building Societies Act 1986 and the Banking Act 1987. Increased competition was beneficial for customers who, in addition to having a much wider choice of both products and providers, saw a reduction in the cost of many products. The increased size and complexity of the financial marketplace, however, quickly revealed the inadequate protection afforded to customers by existing legislation. Many existing laws, such as the Prevention of Fraud (Investments) Act 1958, were quite inadequate to deal with what was now a much more sophisticated and competitive industry.

1.1 The Financial Services and Markets Act 2000

One consequence of the changes described in the Introduction was, in the 1980s and 1990s, a number of new pieces of regulatory legislation, including the Financial Services Act 1986, which included an element of self-regulation.

By the mid-1990s, however, it was becoming clear that the self-regulatory aspects of the system had not been wholly successful and that the overall structure of regulation was too fragmented for the increasingly integrated world of financial services. For example, many large banking groups – now providing a wide range of financial products and services – were regulated by the Bank of England and also by several other organisations relating to fund management, investments and marketing. This sometimes led to confusion over where regulatory responsibility lay. The collapse of Barings Bank in 1992 highlighted many of these anomalies, with both the Bank of England and the body then regulating stock market organisations (the Securities and Futures Authority) being criticised.

The first major step in the development of a new regulatory regime came in June 1998, when responsibility for the regulation of the UK banking sector was transferred from the Bank of England to a new single regulator, the Financial Services Authority (FSA). The next stage was achieved in December 2001, when the FSA assumed regulatory responsibility for almost all of the financial services industry. A wide-ranging new Act, the Financial Services and Markets Act 2000, gave effect to the new regulatory regime.

This Act provides the legislative framework through which the FSA is able to regulate the professional and business behaviour of all parts of the industry, from the largest institutions (including around 800 insurance companies and

600 banks) to individual employees and sole traders. It covers a wide range of matters, including solvency, capital adequacy, sales and marketing practices, prevention of crime, competence of managers and sales staff, complaints and compensation.

Two sectors of the industry that did not come under the wing of the FSA in 2001, however, were mortgages and general insurance. Regulation of mortgage sales continued on a voluntary basis, overseen by the Mortgage Code Compliance Board (MCCB), until their regulation under the FSA in October 2004. Similarly, general insurance continued to be the responsibility of the General Insurance Standards Council (GISC), until its regulation under the FSA in January 2005.

1.2 The FSA's objectives, role and activities

The role of the FSA is to oversee the regulation of the financial services industry in the UK. To carry out this role requires a staff of well over 2,000 and an annual budget of over £200 million. It involves the publication of a handbook so large that, as the Director of Policy of the Association of Independent Financial Advisers pointed out, a paper version would take up the entire shelf space in most financial advisers' offices.

The introduction of 'principles-based' regulation (and with it a set of revised and simplified conduct of business rules from 1 November 2007) is expected to lead to a reduction in the staff costs of the FSA.

The FSA is not a government department – it is a limited company – but it does have statutory powers, given to it under the Banking Act 1987, the Financial Services and Markets Act 2000 and other legislation. The FSA's board, which makes its policy decisions, is, however, appointed by the Treasury, which has overall responsibility for the UK financial services industry.

The FSA has also been given the following statutory objectives:

- ◆ *maintaining confidence in the UK financial system* (including financial markets, exchanges and regulated activities). The aim is to ensure that markets are 'fair, efficient and transparent';
- ◆ *promoting public understanding of the financial system* (including public awareness of the benefits and risks of different forms of financial transactions);

- ◆ *securing an appropriate level of protection for consumers*, but it should be noted that the FSA emphasises that it cannot provide 100% protection and an 'appropriate' level of protection may depend on:
 - the different level of risk that relates to different investments;
 - the different experience/expertise of different consumers;
 - the consumers' need for accurate advice and information;
 - the principle that consumers should take responsibility for their decisions;
- ◆ *reducing the scope for financial crime*, the three main areas that the FSA seeks to control being:
 - money laundering;
 - fraud and dishonesty, including e-crime;
 - criminal market conduct, such as insider dealing.

The performance of the FSA in regulating the industry will be judged against a set of 'principles of good regulation'. It must be seen to be:

- ◆ allocating its resources in the most efficient and economic way;
- ◆ ensuring that the costs of regulation are in proportion to the benefits;
- ◆ taking proper account of the responsibilities of those who manage authorised firms;
- ◆ facilitating innovation and maintaining industry competitiveness;
- ◆ taking into account the international character of financial services and the UK's competitive position;
- ◆ facilitating, and not having an unnecessarily adverse effect on, competition.

The FSA carries out its role by setting standards, developing rules and regulations, supervising their implementation, authorising firms and individuals, and providing guidance and training. These and other areas of FSA activity are covered in a range of *sourcebooks*, which make up the *Handbook*. The Handbook is broadly divided into five sections, each of which is described below. More details of relevant key aspects of sourcebook contents are given throughout Section 1.

1.2.1 High level standards

The 'High level standards' section of the FSA's Handbook covers:

- ◆ the threshold conditions;
- ◆ the statements of principle for approved persons;
- ◆ the 'fit and proper' test for approved persons;
- ◆ the principles for business;
- ◆ senior management arrangements, systems, and controls.

1.2.2 Business standards

Business standards are described in:

- ◆ the *Interim Prudential sourcebook*, which is concerned with the financial soundness of the various types of firm (such as valuation of a firm's assets and liabilities, its reserves, and financial reporting);
- ◆ the *Conduct of Business sourcebooks*, which address the standards applied to the marketing and sale of financial services products. In November 2007, a new conduct of business rules book (NEWCOB) was introduced. This is considerably shorter than previous rulebooks as it is centred on a principles-based approach. Some of the detailed prescriptive rules have been removed;
- ◆ the *Market Conduct sourcebook*, which concerns investment markets and is therefore primarily of interest to investment firms. It covers such issues as insider dealing;
- ◆ the *Training and Competence sourcebook*.

1.2.3 Regulatory processes

The third section of the Handbook covers regulatory processes, including rules and guidance for firms wishing to seek authorisation, and the FSA's enforcement powers. It also includes the Supervision manual, which sets out the way that the FSA will regulate and monitor the compliance of authorised firms.

1.2.4 Redress/specialist sourcebooks

The two remaining sections of the Handbook cover:

- ◆ *redress* (including investor complaints and compensation); and
- ◆ *specialist sourcebooks* (including arrangements for professional firms, such as solicitors and accountants, and the supervision of Lloyd's of London).

1.2.5 Status of provisions in the FSA Handbook

The Handbook consists mainly of 'rules' and 'guidance', and it is important to understand the difference between them.

- ◆ Most of the *rules* in the Handbook create binding obligations on authorised firms. If a firm contravenes a rule, it may be subject to enforcement action and, in certain circumstances, to an action for damages.
- ◆ The purpose of the *guidance* is to explain the rules and to indicate ways of complying with them. The guidance is not binding, however, and a firm cannot be subject to disciplinary action simply because it has ignored the guidance. It is helpful, however, for firms to know that, if they have acted in accordance with the guidance 'in circumstances contemplated by that guidance' (in the FSA's words), it will be presumed that the firm has complied with the relevant rule.

It would be impossible to explore every area in this text that is covered by the FSA Handbook. It will, however, cover the areas of greatest interest to financial advisers and mortgage advisers in sufficient detail to enable them to carry out their activities in an efficient, safe and well-regulated manner.

1.2.6 Principles for firms and approved persons

The FSA's regulatory regime is based on a set of 11 'Principles for Business', from which all of the more precise rules and regulations follow. They apply to the behaviour of firms and of the individuals who carry out the firm's activities and refer to:

- ◆ the *integrity* with which a firm must conduct its business;
- ◆ the *skill, care and diligence* with which a firm must conduct its business;

- ◆ *management and control*: a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems;
- ◆ *financial prudence*: a firm must maintain adequate financial resources;
- ◆ the proper standards of *market conduct* that a firm must observe;
- ◆ *customers' interests*: a firm must pay due regard to the interests of its customers, and treat them fairly;
- ◆ *communications with clients*: a firm must pay due regard to the information needs of its clients and communicate information to them in a way that is clear, fair and not misleading;
- ◆ the way in which a firm must manage *conflicts of interest* fairly, both between itself and its customers and between one customer and another;
- ◆ the *customer relationship of trust*: a firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely on its judgement;
- ◆ the adequate protection that a firm must arrange for *clients' assets* when it is responsible for them;
- ◆ the *relations with regulators* of a firm, which must deal with its regulators in an open and co-operative way, and must disclose anything which the FSA would reasonably expect it to notice.

These principles are the 'central core' on which the FSA's principles-based regulation is based.

There are seven further statements of principle for members of staff who are *approved persons* and are carrying out *controlled functions* (see Section 1.7.1 for a definition of approved persons and controlled functions). These principles specifically stress that approved persons must, while carrying out controlled functions:

- ◆ act with integrity;
- ◆ act with due skill, care and diligence;
- ◆ observe proper standards of market conduct;
- ◆ deal with the FSA and with other regulators in an open and co-operative way.

These principles are taken straight from the list of 'Principles for Business'.

In addition to these, there are three principles that apply to persons who are in positions of *significant influence* in a firm (ie those who carry out senior or supervisory functions). Such persons must:

- ◆ take reasonable steps to ensure that the business of the firm is organised so that it can be controlled effectively;
- ◆ exercise due skill, care and diligence in managing the business of the firm;
- ◆ take reasonable steps to ensure that the business of the firm complies with the relevant requirements and standards of the regulatory system.

1.2.7 Treating Customers Fairly

In order to ensure that these principles are translated into a practical, properly controlled regulatory regime, the FSA has established a very large body of rules, many of which are found in the sourcebooks listed in Section 1.2.2. A selection of the important rules affecting financial advisers and mortgage advisers is also included.

The establishment of rules and regulations can, however, carry with it one very serious drawback, which is that people and organisations make it their aim to comply with the letter of the law rather than to operate according to its spirit. There is also the danger that it is sometimes possible for firms to 'hide behind' the rules, using loopholes or technicalities to their own advantage.

The FSA quickly became aware of this potential drawback to their complex system of rules and has introduced an initiative known as *Treating Customers Fairly* (commonly referred to as *TCF*). The aim of the scheme, which is being taken very seriously by the FSA, is to develop a more ethical 'frame of mind' within the industry, leading to more ethical behaviour at every stage of firms' and individuals' relationships with their customers, who in turn should become more capable and confident regarding financial products. This is an important part of the move to a 'principles-based' form of regulation.

What exactly is meant by *Treating Customers Fairly*? Clearly, it depends on the definition of 'fair', but the FSA has declined to supply a definition, claiming that fairness is a concept that is 'flexible and dynamic' and that it can 'vary with particular circumstances'. Instead, firms will have to decide for themselves exactly what *TCF* means within their own context. What is clear is that the FSA intends that *TCF* will apply at every stage throughout the life cycle of financial

products, beginning with product design. All the stages that follow – including sales and marketing, advice and selling, and administration – must also be carried out with TCF in mind, and this carries through into all post-sales activities such as claims handling and, where necessary, dealing with complaints. The FSA has stressed that firms and employees must ‘embed the principle of Treating Customers Fairly into the firm’s culture and day-to-day operations’.

Despite failing to specify what ‘fairness’ entails, the FSA has given some guidance on the types of behaviour it would wish to see and has suggested a number of areas that a firm should consider. These include: considering specific target markets when developing products; ensuring that communications are clear and do not mislead; honouring promises and commitments that it has made; identifying and eradicating root causes of complaints.

Responsibility for the introduction of TCF lies with a firm’s senior management, which is required to ensure that TCF is ‘built consistently into the operating model and culture of all aspects of the business’.

Individuals who wish to get fully to grips with this new FSA initiative, and to demonstrate their commitment to the principles of TCF, can take an appropriate examination such as the *ifs* School of Finance’s Certificate in Regulated Customer Care (CeRCC).

One of the key issues that the FSA wishes to address is the extent to which customers are helped to understand the financial products they are buying. Firms are expected to be clear about the services they offer and about the true cost to the customer. It is vitally important, for instance that information is provided to customers in a way that is clear, fair and not misleading. Firms should always consider the ways in which the customer will assess their product against others in the market, and ensure that a fair comparison can be made. This means not only that product literature should be clear and appropriate to the expected financial sophistication of the customer, but also that the advice given should be of a sufficiently high quality to reduce the risk of mis-selling.

In summary, TCF is designed to deliver six ‘improved outcomes’ for retail financial consumers, which the FSA have described as follows:

- ◆ consumers will be confident that the firms they are dealing with are committed to fair treatment of customers;
- ◆ products are designed to meet the needs of properly identified customer groups;

- ◆ consumers are provided with clear information at all stages, before during and after a sale;
- ◆ any advice given is suitable for the customer, taking account of his circumstances;
- ◆ products perform as customers have been led to expect, and associated services are of an acceptable standard;
- ◆ there are no unreasonable barriers to switching product or provider, making a claim, or complaining.

By the end of March 2008, firms are expected to have in place appropriate management information systems to test whether they are treating their customers fairly. By the end of December 2008, they must be able to demonstrate to the FSA that they are consistently treating their customers fairly. This can be done by means of a review and report showing how they are delivering the six consumer outcomes described above.

1.2.8 Arrangements, systems and controls for senior managers

Senior managers must take responsibility for a firm's compliance with FSA regulations and there are three particular ways in which they are required to achieve this. The exact nature of the systems and controls used by a firm is left to its discretion but it must be able to demonstrate that these systems and controls are appropriate.

1.2.8.1 A clear chain of responsibility

Senior managers will be held personally responsible for the firm's activities but in many large firms it is not realistic for them to do everything themselves. They must, therefore, identify specific individuals within the firm to take responsibility for specific areas of activity. These individuals must be made aware of their areas of responsibility and records must be kept showing a *clear chain of responsibility*.

1.2.8.2 Systems and controls

A firm must implement *systems and controls* that are 'appropriate to its business'. These systems and controls must be clearly documented and

regularly reviewed. They will relate to a wide range of the firm's activities, including:

- ◆ chains of responsibility, delegation and reporting;
- ◆ compliance;
- ◆ assessment and reporting of risk (see also Section 1.5);
- ◆ reporting of other management information;
- ◆ competence and honesty of staff, particularly those who fill 'approved person' roles. Senior management should apply the 'competent employee' rule, ie employees must have the necessary skills to carry out the job for which they are employed.
- ◆ a strategy for controlling business risks and for recovering from serious problems such as fire or computer failure;
- ◆ adequate and readily accessible records (with backup) of systems and controls must be securely kept;
- ◆ an audit of the systems and controls must be made independently of the persons who normally operate them.

1.2.8.3 Whistle-blowing

Firms should have *whistle-blowing* procedures in place to enable employees to report serious inappropriate circumstances or behaviour within the firm, which they believe are not being addressed. Workers who wish to report their knowledge or suspicions regarding, for example, a failure by the firm to comply with legislation, have a right to protection under the Public Interest Disclosure Act 1998. The firm's procedures should assist staff and not hinder them in the whistle-blowing process.

1.2.8.4 The role of oversight groups

It is appropriate that all aspects of the activities of financial services institutions should be kept under review to ensure that the investments of both shareholders and customer are being handled safely and honestly and that the institution is abiding by all the relevant laws and regulations that apply to it, in the best interests of all its stakeholders. This oversight of an institution's business can take a number of different forms, of which three are described briefly here for illustration purposes.

1.2.8.4.1 Auditors

External auditors are concerned particularly with published financial statements and accounts. They are independent of the institution whose accounts are being audited; they are normally firms of accountants, and it is their responsibility to provide reasonable assurance that published financial reports are free from material mis-statement and are compiled in accordance with legislation and with appropriate accounting standards. They must conform to the professional standards of the Auditing Practices Board and the Accounting Standards Committee.

Internal auditors may be in-house members of staff, or the process may be out-sourced. Their basic task is to review how an organisation is managing its risks, to ascertain whether appropriate controls have been established, and to evaluate and suggest improvements to control and governance processes. They check that operations are being conducted effectively and economically in line with the organisation's policies, and that records and reports are accurate and reliable. It is not the responsibility of internal auditors to put controls and systems in place; that remains the responsibility of management. The role of the internal audit is to inform management decisions by identifying problems and recommending possible solutions.

1.2.8.4.2 Trustees

A trustee is a person (or in some cases an organisation) whose responsibility is to ensure that any property held in trust is dealt with in accordance with the trust deed for the benefit of the trust's beneficiaries. Examples of trusts can be found throughout the financial services industry. For instance, unit trusts are investment schemes set up under a trust deed and the trustees are the legal owners of the trust's assets on behalf of the unit-holders. Similarly, most occupational pension schemes are set up under trust: this is important for the security of members' benefits because it enables the pension assets to be kept separate from the employer's business assets. The rights and duties of pension scheme trustees are set out in the Pensions Acts of 1995 and 2004.

1.2.8.4.3 Compliance officers

Firms that are authorised by the Financial Services Authority should appoint a compliance officer to have oversight of the firm's compliance function, in other words to ensure compliance with all relevant legislation and regulations. Responsibilities of a compliance officer will include:

- ◆ production and publication of a compliance manual;
- ◆ maintenance of compliance records such as complaints register and promotions records;
- ◆ responding to and corresponding with the FSA on compliance matters;
- ◆ ensuring that staff meet FSA requirement as regards recruitment, training, supervision and selling practices.

1.2.9 The ‘fit and proper’ test for approved persons

The FSA has established a set of criteria for determining whether an individual is a ‘fit and proper’ person to be approved to undertake a controlled function. This refers to the need for individuals to be authorised under the terms of the Financial Services and Markets Act 2000 before they can undertake certain specified jobs or activities within the financial services industry. This is described in more detail in Section 1.7.1.

The criteria relate to a person’s:

- ◆ *honesty, integrity and reputation* which can be judged from a number of factors, including:
 - criminal record;
 - disciplinary proceedings;
 - known contravention of FSA (or other) regulations or involvement with companies that have contravened regulations;
 - complaints received, particularly about regulated activities;
 - insolvency, or management of companies that have become insolvent;
 - dismissal from a position of trust or disqualification as a director;
- ◆ *competence or capability*, in terms of meeting the FSA’s training and competence requirements (see Section 1.7.4);
- ◆ *financial soundness*, based on:
 - current financial position;
 - previous bankruptcy or an adverse credit rating.

1.2.10 The prevention of financial crime

The FSA is committed to reducing financial crime of all kinds, in particular:

- ◆ *market abuse* which is separated (under EU definitions) into two aspects:
 - *insider dealing*, where a person who has information not available to other investors (eg a director with knowledge of a takeover bid) makes use of that information for personal gain;
 - *market manipulation*, where a person knowingly gives out false or misleading information (for instance about a company's financial circumstances) in order to influence the price of a share for personal gain;
- ◆ *money laundering*, which is dealt with in Section 2.

1.3 The FSA's approach to regulating firms and individuals

Any financial services organisation carrying on business in the UK must be authorised by the FSA if it carries out **regulated activities** in relation to **regulated investments**. Regulated activities and regulated investments are defined in Sections 1.3.1 and 1.3.2. Similarly, individuals who carry out certain specified controlled functions also have to be authorised, as described in Section 1.7.1.

1.3.1 Regulated activities

The activities for which firms must be authorised were first listed in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, often referred to simply as the *Regulated Activities Order* or *RAO*. These activities include:

- ◆ accepting deposits;
- ◆ effecting and carrying out insurance contracts (including funeral plans);
- ◆ dealing in and arranging deals in investments;
- ◆ managing investments;
- ◆ establishing and operating collective investment schemes;

- ◆ establishing stakeholder pension schemes;
- ◆ advising on investments;
- ◆ mortgage lending and administration;
- ◆ advising on and arranging mortgages;
- ◆ advising on and arranging general insurance.

Permission is given in the form of a list of regulated activities that the firm is allowed to carry out; it also shows the regulated investments with which the firm is allowed to deal. The relevant section of the FSMA 2000 under which permission is granted is Part IV – as a result, this form of permission is often referred to as *Part IV permission*.

1.3.2 Regulated investments

The Regulated Activities Order 2001 (see Section 1.3.1) also defines regulated investments. They include:

- ◆ deposits;
- ◆ electronic money (e-money);
- ◆ insurance contracts, including funeral plans;
- ◆ shares, company loan stocks and debentures, and warrants;
- ◆ gilt-edged stocks and local authority stocks;
- ◆ units in collective investment schemes;
- ◆ rights under stakeholder pension schemes;
- ◆ options and futures;
- ◆ mortgage contracts.

The FSA defines two key categories of regulated investments: *securities* (such as shares, debentures and gilts) and *contractually based investments* (including life policies, personal pensions, options and futures).

1.4 Capital adequacy

A vital element of the work of any industry regulator is to ensure that the firms operating in the industry are prudently managed. The aim is to protect the firms themselves, their customers and the economy, by establishing rules and principles that should ensure the continuation of a safe and efficient market, able to withstand any foreseeable problems.

One of the key areas of prudential control for financial institutions relates to their *capital adequacy*. There are different rules for deposit-takers (eg banks and building societies), for investment firms and for life assurance companies.

1.4.1 Capital adequacy regulations for deposit-takers

Regulations about capital adequacy broadly state that institutions must have sufficient *capital* to make it very unlikely that deposits will be placed at risk. The meaning of 'capital' in this context is perhaps best illustrated by the fact that it is also sometimes referred to as *own funds*, ie the bank's own capital base, obtained from shareholders and related sources, as distinct from funds deposited by customers.

Although a bank's lending is generally financed by deposits, any losses made (for instance if a loan is written off because repayment cannot be obtained) should be borne by shareholders rather than by depositors. Minimum requirements for capital adequacy are set to protect a bank's depositors so that they do not lose money, whereas shareholders are expected to take risks.

The Basel Committee on Banking Supervision, a multinational body acting under the auspices of the Bank for International Settlements, first established an international framework for deposit-takers (ie principally banks) in 1988. This agreement, which – among other things – set out minimum capital requirements for banks, was commonly referred to as the *Basel Accord*. This has now been superseded by a new expanded Accord, commonly known as Basel II (see below), which became fully operational in 2007.

These minimum capital requirements are specified in terms of a bank's **solvency ratio**, which means that the capital required is denominated as a proportion of the bank's assets (ie mainly its loans), with appropriate allowances made for the perceived risk level of different assets.

The solvency ratio is defined as *own funds of the institution as a percentage of the risk-adjusted value of its assets*. (This reflects the very reasonable principle that

any losses made on traditional banking business – such as debts written off when borrowers default – should be carried by the institution’s shareholders and not by the investors whose deposits provide the funds that the institution lends out.) Current regulations require credit institutions to keep a solvency ratio of at least 8%. This means that their own funds must amount to at least 8% of their risk-weighted assets. In practice, institutions normally keep more than the required 8%.

‘Own funds’ means the bank’s paid-up share capital, plus any retained profits. The ‘risk weighting’ of assets is a process that is largely self-explanatory. Since the solvency ratio is designed, broadly speaking, to calculate how much an institution must hold to cover the risk of loss on its lending (its credit risk), each asset is categorised according to risk. The percentage contribution of the less risky assets to the risk-weighted total is less than that of the more risky assets, as in the following table of examples.

Figure 1: Example percentage contributions to a bank’s risk-weighted lending total

0%	Cash in hand and equivalent items.
20%	Loans to the European Investment Bank and to multilateral development banks. Also loans to governments (such as gilt-edged stocks in the UK) and local authorities.
50%	Loans fully secured by mortgages on residential property.
100%	Unsecured loans.

Under Basel II, the minimum capital requirements for credit risk remain broadly as described above, although there is more flexibility to reflect the business of individual institutions.

Capital requirements for *operational risk* are included for the first time in Basel II. *Operational risk* is the risk of loss from failed or inadequate internal processes, people and systems, or external events: this might include computer failure, a serious earthquake or staff fraud. The *basic approach* to calculating the capital required is to multiply the institution’s gross annual income (averaged over the past three years) by 0.15. Insurance held against the events happening *cannot* be offset against this. For large organisations with different business lines, a more sophisticated system (called the *standardised approach*) can be applied, using different multiplying factors for each line.

In addition to the traditional 'capital requirements' approaches, Basel II introduced a more robust system of supervision. This includes the requirement for banks to carry out 'stress tests' to ascertain the extent to which they would have sufficient capital if certain unexpected adverse economic conditions prevailed. These supervisory processes are backed by a set of disclosure requirements to ensure that banks publish sufficient information to enable market participants to assess a bank's risk profile and the extent of its capitalisation.

1.4.2 Capital adequacy for investment business

In the early 1990s it was recognised that investment firms that are not credit institutions should have the same freedom to provide services across the frontiers of the EU as is available to banks and other credit institutions. In order to achieve fair competition on investments, the Investment Services Directive (ISD) came into effect in 1996 and has now been superseded and updated by the Markets in Financial Instruments Directive (MiFID).

In conjunction with the ISD, a second directive – commonly known as the Capital Adequacy Directive (CAD) – was issued, setting out the requirements for capital adequacy of investment firms. The CAD established minimum capital requirements to cover market risks arising from debt, equity and related derivatives in the trading books of those credit institutions and investment companies that were subject to the provisions of the ISD. A new directive, the Capital Requirements Directive (CRD) has now been issued in conjunction with MiFID.

The CRD sets minimum capital requirements for investment firms. The actual level of capital required depends on the category of the firm, as follow.

- ◆ **Own account dealers**, who deal as principal on their own account, are required to hold capital of the equivalent of €730,000.
- ◆ **Matched principal brokers**, who deal as principals only to fulfil customers' orders, are subject to a smaller figure €125,000.
- ◆ **Broker/managers** are firms that deal in investments as agents, or act as investment managers on behalf of customers. Their capital requirement is €125,000, but this is reduced to €50,000 if they do not hold client money or assets.

- ◆ **Advisers/arrangers**, ie those who give investment advice or arrange investment deals, are also subject to capital requirement of €125,000, with a reduction to €50,000 if they do not hold client money or assets.

1.4.3 Solvency margins for life assurance companies

Determining whether a life assurance company is solvent is a more complex process than determining solvency for most other companies – more complex even than for other financial services companies such as credit institutions. This is because the liabilities of a life assurance company relate to payments that the company may or may not have to make at unknown dates in the future, eg as a result of a death claim on a life assurance policy. Determination of the current value of these future liabilities, based on estimates of future mortality rates and future interest rates, is the province of actuaries. Although the valuation liabilities – known in the Life Directive issued by the EU in 2002 as *mathematical provisions* – must continue to be assessed according to the professional judgement of the actuarial profession, the directive sets out principles designed to harmonise the sometimes very technical methods and calculations used.

The directive requires that a life assurance company must maintain an ‘adequate’ solvency margin at all times in respect of its entire business. The solvency margin is the excess of the company’s assets over its mathematical provisions (the discounted current value of its liabilities).

An ‘adequate’ solvency margin means a margin that is at least equal to that prescribed by the directive. The regulations are complex and the detail is beyond the scope of this text, but the basic rule is that, for policies that carry an investment risk (such as endowment assurances), the required minimum solvency margin is 4% of the mathematical provisions – in other words, the value of a life company’s assets must be at least 104% of the value of its liabilities. For policies with no investment risks (such as term assurance), the percentages are less. This reflects the fact that actuaries can be more confident about future mortality rates than about future yields on investments.

The ‘competent authorities’ in individual EU states (eg the FSA in the UK) can, in extreme circumstances, relax the rules on a temporary basis if they feel it is appropriate to do so. In early 2003, in the wake of a deep and continuing fall in the value of stock market securities, the FSA indicated that it would not take action against life assurance companies that had become, or were in danger of

becoming, technically insolvent under the 4% rule, provided that they could show that they were taking steps to rectify the situation. This would normally mean taking action to reduce their prospective liabilities, for instance by reducing the levels of annual bonuses and terminal bonuses on with-profits policies.

The directive also sets out the components of a company's solvency margin, including:

- ◆ paid-up share capital;
- ◆ statutory and free reserves;
- ◆ profit brought forward after dividends have been paid;
- ◆ cumulative preference-share capital and subordinated loan capital, but at only up to 50% of the solvency margin.

1.5 The risk-based approach

The FSA has made it clear that its approach will be radically different from that of earlier regulators. In particular, it will:

- ◆ employ a risk-based approach;
- ◆ aim to act in a proactive rather than a reactive way.

It also recognises that regulation has to be built on realistic aims and has stated that it will not aim to prevent all failure. The FSA stresses not only the responsibilities of firms' own management in this regard, but also the need for consumers to take some responsibility for their own decisions. This appears to be a tacit admission that there is a danger in the 21st century of consumerism going too far and eventually acting to the detriment both of providers and of consumers themselves.

The FSA claims that its new approach will 'integrate and simplify' the different approaches employed by its predecessors. Some practitioners and commentators, however, feel that simplicity has not been – and is unlikely to be – achieved.

The integrated approach is based on systems and controls that reflect the risk factors involved rather than the business sector from which the firm comes – reflecting the fact that many firms now operate across a wide range of product areas.

The FSA has listed the main risks that financial services consumers face:

- ◆ *prudential risk* – eg the risk of a firm collapsing because of allegedly incompetent management, as Equitable Life was in danger of doing;
- ◆ *bad faith risk* – the risk of loss due to fraud, misrepresentation, mis-selling or non-disclosure. There have been instances of advisers taking clients' funds and applying them for their own ends;
- ◆ *complexity/unsuitability risk* – the risk of a customer not understanding a product or not realising that it is not suitable for their needs;
- ◆ *performance risk* – the risk that investments fail to deliver hoped-for returns, as has been the case with some endowments used for mortgage repayment purposes.

The FSA aims to reduce prudential and bad faith risks, and possibly some aspects of complexity/unsuitability risk, but it is not responsible for protecting consumers from performance risk. This is reflected in the fact that the industry's consumer protection schemes do not, for example, protect investors who have lost money because of a fall in stock market prices. The FSA will, however, aim to educate consumers about opportunities, risks and potential rewards.

The FSA's risk-based approach seeks to identify risks that may prevent it from achieving its objectives, to assess those risks and to prioritise them. The risks may arise from a number of different areas, ie firm-specific risks, product-specific risks and macroeconomic risks.

Assessment of risk is a complex process, but the following illustration may help to clarify the FSA's approach (which is set out in more detail in its booklet *A new regulator for the new millennium*). Consider a firm-specific risk, for instance the risk of a particular firm collapsing. The overall level of risk is defined by the FSA as being a combination of *probability* factors and *impact* factors. This reflects the fact that the seriousness of a problem depends both on the chance of it happening and on the effects of it happening.

- ◆ *Probability factors* relate to the likelihood of a problem occurring and might be categorised under various headings:
 - *business risk* – such as the firm's business strategy, its capital adequacy, its accounts;
 - *control risk* – such as the quality of its management, internal systems and controls;
 - *consumer relationship risk* – such as marketing and advice practices.

- ◆ *Impact factors* relate to the effect on the economy, the industry or the customer if a particular event were to occur. This might include:
 - the likely effect of the collapse of the firm on the whole industry, or even on the economy;
 - the size of its customer base and the nature of the customer relationship (eg investors, borrowers);
 - the availability of compensation for loss.

This risk assessment process will be applied to all firms and will determine how closely supervised each firm will be. The FSA allocates each institution to one of four 'impact' bands: *Category A* is high risk; *Categories B and C* are medium risk; *Category D* is low risk. Initial investigations suggest that fewer than 1% of institutions fall into *Category A* (high risk), whereas the great majority are *Category D*. It has been estimated that, not surprisingly, high impact firms have, on average, about 65% of market share; the collapse of a large organisation clearly has greater overall impact than the collapse of a small one.

1.6 Discipline and enforcement

Although the FSA has said that it aims to be proactive rather than reactive in its activities, there will undoubtedly be occasions when it needs to investigate situations in which it believes that the regulations have been broken and it may need to discipline organisations or individuals.

The FSA is empowered to undertake *general investigations* into the business of authorised persons by looking at the business as a whole or at particular aspects of that business.

The FSA is also empowered to undertake *specific investigations* if it has specific suspicions about the activities or behaviour of an authorised person. The circumstances under which this might occur cover a wide range of situations including, for example, suspicion of an authorised person:

- ◆ contravening regulations;
- ◆ providing false information;
- ◆ falsifying documents;
- ◆ acting outside the scope of his or her Part IV permission;
- ◆ participating in money laundering;

- ◆ allowing persons who are not approved to carry out controlled functions;
- ◆ falsely claiming to be authorised;
- ◆ undertaking insider dealing or market manipulation.

The person who is appointed to carry out the investigation on the FSA's behalf has the power to:

- ◆ demand that the person being investigated or anyone connected with them:
 - answer questions,
 - provide information;
- ◆ demand that *any* person (whether or not they are being investigated or are connected with the person under investigation) provide documents. In the case of a *specific* investigation, *any* person can also be required to answer questions or provide information.

If there are reasonable grounds for believing that someone has not complied with the requirement to provide information or documents, the FSA can apply to a Justice of the Peace for a search warrant to enter a property and seize documents or take copies.

1.6.1 Enforcement powers

If the FSA is satisfied that it has discovered a contravention of its rules, it has a number of steps that it can take, depending on its view of the nature and/or the severity of the contravention. Some of these are described below.

- ◆ *Variation of a firm's permissions*: this may involve removal of one of the firm's permitted regulated activities or a narrowing of the description of a particular activity.
- ◆ *Withdrawal of approval*: the FSA might withdraw a person's approval to carry out some or all of the controlled functions that they currently carry out.
- ◆ *Injunction*: if a person has contravened a regulation, the FSA can apply for an injunction to prevent that person from benefiting from the action, for instance by selling assets that they have misappropriated.

- ◆ *Restitution*: similarly, if a person has benefited from a contravention of a regulation, the FSA can ask the court for an order requiring that person to forfeit to the FSA any profit made from the activity.
- ◆ *Redress*: if it can be shown that losses have been made by identifiable customers as a result of the contravention of a rule, the FSA may be able to obtain a court order requiring such losses to be made good. There may be other more appropriate ways for that customer to pursue such claims, however, for instance through the Financial Ombudsman Service or the Financial Services Compensation Scheme (see Section 3).
- ◆ *Disciplinary action*: if an approved person or an authorised firm is judged to be guilty of misconduct, the FSA has a range of options regarding the sanctions it might apply. These are:
 - to issue a private warning;
 - to publish a statement of misconduct;
 - to impose a financial penalty.

1.7 FSA Conduct of Business sourcebook

The *Conduct of Business sourcebook* is part of the FSA Handbook. It draws on the principles established in the FSA's 'Principles for Business' (and elsewhere) and sets out, in more detail, the rules by which approved persons must operate when carrying out their controlled functions.

1.7.1 Approved persons and controlled functions

Any person working in an authorised firm who carries out a *controlled function* must be approved by the FSA. *Approved persons* are always approved to carry out a specific controlled function or functions.

The concept of approved persons is designed to cover all areas of financial services and all types of functions, so some controlled functions will not apply in all areas. For completeness, however, the full list of controlled functions is set out below. They are subdivided into five categories.

1.7.1.1 Governing functions

Governing functions relate to those of the people who run the business, even those who do not necessarily do so on a day-to-day basis such as non-executive directors and sleeping partners including the:

- ◆ director;
- ◆ non-executive director;
- ◆ chief executive;
- ◆ partner (including those in limited liability partnerships);
- ◆ director of a unincorporated association;
- ◆ director of a small friendly society.

1.7.1.2 Required functions

The required functions are:

- ◆ *apportionment and oversight*. This function is usually dealt with by the firm's chief executive, who must allocate all key responsibilities to named individuals (directors and senior managers) within the firm, and must ensure that adequate controls over the firm's risks are implemented and maintained. However, this function does not apply to MiFID firms, which are subject to different requirements;
- ◆ *EEA investment business oversight*;
- ◆ *compliance oversight*;
- ◆ *money laundering reporting* (see also Section 2);
- ◆ *actuarial* (including the duties of the appointed actuary).

1.7.1.3 Systems and controls functions

The systems and controls functions relate to:

- ◆ finance;
- ◆ risk assessment;
- ◆ internal audit.

1.7.1.4 Significant management functions

The significant management functions cover the management of:

- ◆ designated investment business;
- ◆ other business operations;
- ◆ insurance underwriting;
- ◆ financial resources;
- ◆ settlements.

1.7.1.5 Customer functions

The *customer functions* cover client-facing roles such as those of:

- ◆ an investment adviser;
- ◆ a trainee investment adviser;
- ◆ a corporate finance adviser;
- ◆ a pension transfer specialist;
- ◆ an adviser on syndicate participation at Lloyd's;
- ◆ customer trading;
- ◆ investment management.

1.7.2 Advertising and financial promotion rules

A *financial promotion* is defined as an 'invitation or inducement to engage in investment activity'. This includes:

- ◆ advertisements in all forms of media;
- ◆ telephone calls;
- ◆ marketing during personal visits to clients;
- ◆ presentations to groups.

Financial promotions can be 'communicated' only if they have been prepared, or approved, by an authorised person.

There is a distinction between:

- ◆ *non-written financial promotions*, such as personal visits and telephone conversations; and
- ◆ *written financial promotions*, such as newspaper advertisements and those on Internet sites.

With the FSA's move to a more principles-based regime, the emphasis of financial promotions rules will be shifted to allow firms more discretion in marketing. Many of the detailed existing provisions, particularly product-specific rules, have been removed and replaced by requirements described in high-level terms. Senior management will have greater flexibility in their interpretation of the high-level standards, but it will be their responsibility to demonstrate that their financial promotions conform to the principles.

The overall principle is that financial promotions to retail clients and professional clients (see Section 1.7.5.1.1) must be fair, clear and not misleading. In the case of retail clients, this means specifically that information supplied must:

- ◆ be accurate: this includes the requirement not to emphasise potential benefits without giving a fair and prominent indication of the risks;
- ◆ be understandable by an 'average' member of the group it is aimed at;
- ◆ *not* disguise or obscure important terms or warnings.

1.7.2.1 Comparisons

Comparisons with other products must be meaningful, and presented in a fair and balanced way. MiFID firms are subject to additional requirements to detail the source of information and the assumptions made in the comparison.

1.7.2.2 Past performance

Past performance information must not be the most prominent part of a promotion. It must be made clear that it refers to the past, and it must contain a warning that past performance is not necessarily a reliable indicator of future results. Past performance data must be based on at least five years (or the period since the investment commenced, if less, but not less than one year).

1.7.2.3 Unsolicited promotions

There are particular rules about *unsolicited non-written* promotions ('cold calls'), as follows.

- ◆ They are permitted only in relation to certain investments, including packaged products, such as life assurance policies and unit trusts. They are not permitted in relation to higher volatility funds (which use gearing) or life policies with links to such funds, due to the increased investment risk involved. Cold calls are not permitted in relation to mortgage contracts.
- ◆ Unsolicited telephone calls or visits must not be made during unsocial hours, generally taken to mean between 9.00pm and 9.00am Monday to Saturday, and on a Sunday.
- ◆ The caller must check that the recipient is happy for him to proceed with the call.

1.7.3 Record keeping

The maintenance of clear and readily accessible records is vital at all stages of the relationship between financial services professionals, their clients and the FSA, from details of advertisements to information collected in factfinds, to the reasons for advice given and beyond. Record-keeping requirements for the different stages can be found at appropriate points within the *Conduct of Business sourcebook*, with details of what must be kept and the minimum period for which it must be retained.

There are many business reasons for maintaining good records. From a regulatory point of view, the most important reason is to be able to demonstrate compliance with the regulations. Records can be kept in any appropriate format, which includes storage on computer, although the rules say that records stored on computer must be 'capable of being reproduced on paper in English'.

Firms are expected to take reasonable steps to protect their records from destruction, unauthorised access and alteration.

1.7.4 Training and competence

The FSA's philosophy of regulation is to be proactive rather than reactive and there is little doubt that one of the major steps towards the achievement of this objective lies in achieving high levels of knowledge and ability among financial services staff. This is reflected in the importance that the FSA places on training and competence.

The FSA has published a Training and Competence sourcebook (as part of its overall Handbook) that requires firms to make certain commitments regarding the competence of all persons who are employed in controlled functions (see Section 1.7.1). It is particularly prescriptive in relation to three types of employees, for whom it sets out detailed training and competence rules:

- ◆ financial advisers and those who deal in, or manage, investments;
- ◆ supervisors of those advisers, dealers or fund managers;
- ◆ supervisors who oversee certain 'back-office' administrative functions, particularly within a product provider (eg supervisors of the underwriting or claims functions in a life assurance company).

These training and competence rules cover the following areas.

1.7.4.1 Training

Firms must, at appropriate intervals, determine each employee's training needs and must organise training that is both appropriate and timely. The success of the training in achieving its objectives must be evaluated.

1.7.4.1.1 Assessing competence

Employees must not be allowed to engage in carrying out any of the activities covered by these rules until the employer is satisfied that the employee has:

- ◆ achieved an adequate level of knowledge and skill to operate when supervised; and
- ◆ passed the relevant regulatory module of an appropriate examination.

Individuals must work under close supervision until they have been assessed as competent. Individuals must not be assessed as competent until they have:

- ◆ passed all modules of an appropriate examination; and

- ◆ demonstrated a consistent ability to act competently under minimum supervision.

Supervisors should have coaching and assessment skills as well as technical knowledge.

1.7.4.1.2 Appropriate examinations

Approved persons who carry out certain controlled functions are required to achieve a pass in an *appropriate examination* as demonstration of their competence. Lists of appropriate examinations for different functions are held by the Financial Services Skills Council (FSSC). The FSSC sets the standards for appropriate examinations: awarding bodies submit proposals for particular examinations; when these are accredited, they are added to the lists.

The *ifs School of Finance's* Certificate for Financial Advisers (CeFA[®]) and the Certificate in Mortgage Advice and Practice (CeMAP[®]) are examples of appropriate examinations for financial advisers and for mortgage advisers respectively.

1.7.4.1.3 Maintaining competence

As well as ensuring that employees become competent, firms must have definite arrangements in place for ensuring that they maintain that competence. Although there is no specified minimum for the time that should be spent on continuing professional development (CPD), employees should take steps to refresh and expand their knowledge and skills levels. Some practitioners suggest that around 50 hours per annum is appropriate.

Methods used may include training courses, private study, conferences or any other activity appropriate to the role and the needs of the employee.

1.7.4.1.4 Record-keeping

Firms must maintain records showing how and when employees' competence has been and is being assessed. All records relating to the training and competence of individual employees must be retained for at least three years after they leave the firm. For pensions transfer specialists, records must be kept indefinitely.

Typical records might include some, or all, of the following:

- ◆ details of prior competence;
- ◆ initial assessments;
- ◆ training courses, etc, attended;
- ◆ assessment by written examination or by observation;
- ◆ success in appropriate examinations;
- ◆ summary of meetings/discussions with supervisor.

1.7.4.1.5 Wholesale business

The T&C rules do not apply to firms transacting wholesale business with non-retail clients.

1.7.5 Specific rules for financial advisers

This section deals with a number of aspects of the relationship between a financial adviser and their clients.

1.7.5.1 Rules about the process of advising clients

1.7.5.1.1 Types of client

There are three defined categories of client, which can be broadly described as follows.

- ◆ *Eligible counterparty*: this category provides the lowest level of investor protection. It includes large financial institutions such as banks, insurance companies, investment firms, collective investment funds, and governments, where the counterparty requires a limited service, such as straightforward execution of transactions.
- ◆ *Professional client*: this category includes all the bodies that would otherwise be eligible counterparties, except for the fact that they require a higher level of service than would apply to 'eligible counterparty business', eg they require advice, in addition to execution of transactions. This category also includes other types of large clients, particularly 'other institutional investors whose main activity is to invest in financial instruments'. When dealing with professional clients, advisers

can assume an adequate level of experience and knowledge and an ability to accept financial risks.

- ◆ *Retail client*: this category provides the highest level of investor protection and comprises customers who do not fall into either of the previous two categories – especially, customers who might be described as ‘the person in the street’ and who cannot be expected to have anything more than a simple general understanding of financial services. It is expected that most customers will fall into this category.

1.7.5.1.2 Client agreement

All advisers are required to have a written agreement with the client, which sets out the basis of their business relationship. This requirement may be covered by the *initial disclosure document* (IDD – see Section 1.7.5.2.3).

All new clients must be provided with a written agreement before the adviser undertakes work for the client. At the client’s request, however, a client agreement can be provided immediately afterwards if, for example, the transaction has been conducted over the telephone.

A client agreement is not required if the customer has received one in the past and the terms on which business is transacted have not changed.

The client agreement will typically address the following key issues:

- ◆ the status of the adviser (see Section 1.7.5.2);
- ◆ the services offered by the adviser;
- ◆ the full name of the regulator;
- ◆ summary of the client’s responsibilities;
- ◆ details of complaints procedures;
- ◆ details of payment for the services provided;
- ◆ the firm’s authorisation in relation to the handling of clients’ money;
- ◆ the duty to disclose details of any ‘connected persons’ before transacting the client’s business with them;
- ◆ the locum arrangements to ensure continuity of service in the event of the adviser’s absence;
- ◆ whether or not professional indemnity insurance is held.

1.7.5.1.3 Discretionary investment management agreement

A *discretionary investment management agreement* is necessary when a client allows the firm discretion over investment choice, for instance where the firm is handling a portfolio of investments and can change or switch them without the client's individual agreement to every separate transaction.

In this case, the client agreement will have additional content. For instance, it will show the limits of discretion within which the firm can operate in its capacity as investment manager.

1.7.5.2 Status of advisers and disclosure of status

1.7.5.2.1 Polarisation and depolarisation

One of the significant concepts introduced by the Financial Services Act 1986 was polarisation, which meant that all advisers had to be either *independent* or *tied*, and that they must make their status clear to customers before giving any advice.

- ◆ *Tied advisers* advise on and sell the products of only one company (or group of related companies).
- ◆ *Independent financial advisers* (often known as *IFAs*) give advice across the whole financial services market and must select, not only a suitable type of product for the client, but also the most appropriate product provider.

By the end of the 1990s, however, it was becoming clear that the polarisation regime was no longer an ideal way of protecting the consumer against the danger of *commission bias*, ie the tendency of advisers to recommend those products that pay larger commissions.

In January 2002, the FSA issued a consultation paper ('Reforming Polarisation – Making the Market Work for the Consumer') that effectively signalled the end of polarisation by proposing that the status of advisers should simply be a matter of disclosure to the customer. A broader range of types of status is permitted, provided that customers are made aware of precisely what products are available, where they are being sourced from, exactly how the adviser will be remunerated and what the level of that remuneration might be.

The new regime, known as *depolarisation*, was fully operative from 1 June 2005, and is designed to make the process of buying financial products clearer. The two major innovations of the new system are:

- ◆ the change from two to three basic types of status for advisers (described below);
- ◆ a new way of determining and explaining the way in which clients pay for advice (see Section 1.7.5.2.2).

Under the new rules, advisers are permitted to operate in one of three categories:

- ◆ *whole-of-market advisers*, who can offer any generally available product in the market. In practice, because of the huge size of the marketplace, whole-of-market advisers will be allowed to select from a smaller 'panel' of product providers; this panel must, however, include a range of providers sufficient to reflect the spread of products available across the market. Whole-of-market advisers can describe themselves as *independent financial advisers (IFAs)* provided the client is offered the opportunity to pay for the adviser's services by fee rather than commission. (This requirement is designed to ensure that the advice offered by IFAs is not influenced by different rates of commission offered by product providers);
- ◆ advisers who offer products from a limited range of specified providers. This system is commonly known as *multi-tie* and allows advisers to use, for instance, one provider for protection policies, another for pensions and another for mortgages;
- ◆ advisers who are *tied* to only one provider (or a linked group of providers known as a *marketing group* – normally all subsidiaries of one organisation). This type of adviser will offer only products from that company or group.

Advisers are obliged to specify to their clients, before any business is discussed, the category in which they operate.

When first meeting an adviser, many clients will receive two disclosure documents that the FSA has branded as *key facts* documents. The first, *Key facts about our services*, is the initial disclosure document described in Section 1.7.5.2.3, and tells the customer about the type of advice offered and the range of products available. The second document, *Key facts about the cost of our services*, is commonly known as the *menu*, and is described below.

These documents are no longer compulsory for investment business, but they are still compulsory for mortgage business. Investment advisers may, however, choose to continue using them, as their use will demonstrate compliance with the consumer information rules.

1.7.5.2.2 The 'menu' approach

The document entitled *Key facts about the cost of our services* is designed to be given to the client at the beginning of any consultation that may result in the giving of advice. Use of this document will demonstrate compliance by explaining:

- ◆ the services provided by the firm;
- ◆ that different firms offer customers different options for meeting the cost of advice (ie fees or commission);
- ◆ whether the firm charges fees, takes commission or offers a choice between fees and commission;
- ◆ where the firm offers a fee-based option, what the fee will be;
- ◆ where the firm takes commission for a product it recommends, the amount of commission it will receive and how this compares with the market average for similar transactions.

Advisers who describe themselves as independent will have to be a *whole-of-market* firm (ie offer advice across the whole market or a specified sector of the market) and will have to offer (but not necessarily insist on) a fee-based option. Whole-of-market firms are technically supposed to select products from the whole range of product providers; in practice, however, they are permitted to select from a panel of companies, provided that they can show that the panel is representative of the whole market. Whole-of-market firms that are not independent will be remunerated by product commission only.

Advisers who are tied to a particular product provider are, of course, still required to give advice as to what they believe is the most suitable type of product for the client, based on the client's circumstances and needs. However, their advice must be limited to the product range offered by their provider. If the most suitable type of product is not one that is available from the provider to which they are tied, it is not permissible to recommend or sell the product from the provider's range that is 'next best'. If the provider does not offer a fully suitable product, it is permissible, though not mandatory, to recommend that the client seeks independent advice to obtain a suitable product.

1.7.5.2.3 Initial disclosure document (IDD)

In common with the 'menu', the initial disclosure document (IDD) is no longer compulsory for investment business, but it remains a good way of demonstrating compliance. The information contained in this document will generally include:

- ◆ the types of product offered;
- ◆ whether the products are sourced from the whole market;
- ◆ whether advice and recommendation are provided;
- ◆ whether payment is required for the service;
- ◆ details of ownership and regulation of the firm;
- ◆ how to complain to the company and, if not satisfied, to the Financial Ombudsman Service;
- ◆ how to obtain compensation from the Financial Services Compensation Scheme.

An IDD and the 'menu' are still required for mortgage business.

1.7.5.3 Suitability requirements

An adviser must not give advice to a client unless they have fully ascertained the client's personal and financial circumstances relevant to the services that the adviser has agreed to provide.

This process is carried out by the completion of a confidential client information questionnaire, commonly known as a *factfind*. There is no prescribed format for this document. The information gathered normally includes the following details about the client, spouse or partner, children and other dependants:

- ◆ *personal information*, ie name, address, date of birth, marital or relationship status, state of health;
- ◆ *employment details*, ie occupation, employer details, income and benefits, pension arrangements;
- ◆ *assets*, ie property, personal belongings, savings and investments, policies;
- ◆ *liabilities*, ie mortgage, other loans, credit cards;

- ◆ *expenditure*, ie household expenses, loan repayments, regular savings, holidays, luxuries;
- ◆ *attitudes and objectives*, including attitude to investment risk;
- ◆ *knowledge and experience of investment* relevant to the required product or service.

The *suitability rules* specifically require advisers to take all reasonable steps to ensure that the client understands the nature of any risks implicit in the product proposed. Examples are whether or not the customer's capital will be returned in full or whether or not the level of life cover is sustainable for the duration of the term without an increase in premiums. The extent of these requirements will depend on the client's experience and knowledge of the type of product under consideration.

Advisers must also determine the customer's *risk profile*: in other words, how much risk, if any, is the customer willing to take with his capital?

The information obtained through the factfind must be retained for a specified period of time, depending on the nature of the product recommended. These periods are:

- ◆ indefinitely for pension transfers/opt-outs and free-standing AVCs;
- ◆ five years for life policies, pension contracts and MiFID business;
- ◆ three years for all other products.

In practice, advisers will wish to retain the information in all cases for as long as they believe they may be required to justify the advice and recommendations given.

1.7.5.4 Suitability reports

Advisers must recommend the product or service that is most suitable for the client, based on the information supplied by the client and on anything else about the client of which the adviser should reasonably be aware. The recommendation must be solely in the best interests of the client and no account should ever be taken of the commission that might be payable to the adviser.

A *suitability report* explains why the particular product recommended is suitable for the client based on their particular personal and financial circumstances, his needs and priorities as identified through the fact-finding process and his

attitude to risk (both in general terms and in relation to the specific recommendations made). The report should also identify any potential disadvantages of the transaction for the client, such as any 'lock-in' period. It should be clear and concise and written in plain English.

Suitability reports are required for:

- ◆ life policies;
- ◆ pension policies;
- ◆ unit trusts and OEICs, investment trusts (where acquired through an investment trust savings scheme);
- ◆ pension transfers and opt-outs.

For most investment products, a suitability report should be provided as soon as possible after the transaction has been effected, and no later than the date when the cancellation notice is issued to the client (see Section 1.7.5.8).

For life policies, the report should be provided before the transaction is effected, unless immediate cover is needed, or the information is given verbally in which case a written report should follow as soon as possible thereafter. For pensions business, it should be provided within 14 days of the transaction being effected.

1.7.5.5 Execution only

Some transactions with customers may be carried out on an *execution-only basis*, which means that, rather than wanting an adviser to make specific recommendations, the customer instructs the adviser to effect a specific transaction on his behalf, detailing in full the nature of the product required.

For an execution-only transaction, the adviser's duty of care to fully explain the nature of the transaction and risks involved does not apply. The customer is acting entirely on his own responsibility.

Advisers who deal with this type of client should obtain the client's signature confirming that the transaction is execution-only. Similarly, where a non-execution-only client wishes to effect a transaction that contravenes any advice given, the adviser should require the client to sign to that effect.

It is expected that only a very small proportion of any adviser's cases would be on an execution-only basis.

1.7.5.6 Charges and commissions

The seventh of the FSA's 'Principles for Businesses' (Communications with clients – see Section 1.2.6) requires a firm to 'pay due regard to the needs of its clients and communicate information to them in a way that is clear, fair and not misleading'. This includes the need to ensure that a private customer is made aware of the direct or indirect costs of any financial products or services they may purchase, so that they are better able to make informed choices.

1.7.5.6.1 Disclosure of charges

When an adviser transacts designated investment business for a client, the basis or amount of the charges must be disclosed in writing before the business is transacted. The firm's charging basis may be explained in a written client agreement. Charges relating to packaged products will be set out in any 'menu' that is provided to the client (see Section 1.7.5.2.2) and in the *key features document* (see Section 1.7.5.7).

Where the client wishes to deal with the firm, and prior written disclosure would delay the transaction (for example, when the business is being arranged by telephone), the firm can make the disclosure verbally before the transaction is executed and provide written confirmation immediately thereafter.

If the product being recommended is a 'packaged' product, such as a life insurance policy, the adviser must disclose in cash terms the amount of commission that would be received. This information is normally included in the *key features document*.

1.7.5.7 Product disclosure

Advisers who advise on or sell packaged products (eg life policies, pension policies, unit trusts and investment trust saving schemes) must provide clients with written details of the *key features* of a product *before the sale is concluded*. Although it is the adviser's responsibility to provide the documents, the product providers usually prepare the papers. It is a requirement that *key features documents* should be of the same quality as the materials used for marketing purposes.

The format for supplying the information is specified by the FSA and cannot normally be changed by the firm. The rules on what must be included are very detailed, but, as a broad guide, a key features document will cover the following issues:

- ◆ the essential elements of the product;
- ◆ details of risk factors related to the product;
- ◆ whether the levels of income or capital might vary;
- ◆ the consequences of making the product paid-up;
- ◆ client-specific information relating to charges and their impact on what the customer may receive from the product (this includes projected maturity values both in gross terms and net of charges);
- ◆ any commission or equivalent that will be paid;
- ◆ details of where additional information can be obtained;
- ◆ information on any taxation implications on the encashment of the product either at its maturity date or before.

1.7.5.7.1 Risk disclosure

The FSA has often highlighted the risks that customers face when taking out complex retail products; for example, in its 2005 Risk Outlook it pointed to home reversion schemes, lifetime mortgages and long-term insurances with reviewable premiums.

Under their principles-based approach, the FSA requires that the risks associated with all financial products must be 'adequately' disclosed. The product provider is left to decide what risks are sufficiently significant to be disclosed for its own particular products. These 'most significant' risks should be covered in the Key Facts document in such a way that they are easily accessed and understood by the customer.

1.7.5.8 Cooling off and cancellation

Sometimes known as a *cooling-off notice*, the *statutory cancellation notice* reminds clients of their right to withdraw from the contract within a specified period of receiving the notice. This time period is most commonly 14 days and runs from the date on which the client *received* the cancellation notice. The notice must be sent by post direct from the product provider to the client.

The customer can withdraw from the contract at any time during the cooling-off period, without any commitment or loss, by returning the signed cancellation notice to the product provider.

Generally the customer will receive a full refund of any premiums paid if they cancel the contract during this period. The exception to this is where the customer cancels a lump-sum unit-linked investment where the money has been invested and the value of the investment has fallen. Under these circumstances, the customer is entitled to a refund of the reduced investment: no charges can be taken but an adjustment can be made to reflect the fact that the value of the lump sum has fallen. This risk should be explained to the customer *before* the contract is effected.

1.7.6 Stakeholder-type products

In 2001, the government asked Ron Sandler to:

- ◆ identify the competitive forces driving the retail financial services industry; and
- ◆ suggest policy responses to ensure that customers are well served.

The *Sandler report* suggested that there were three main reasons why the industry seemed to be failing to serve large portions of the population who have urgent and genuine financial needs. The government is particularly concerned about the so-called *savings gap*, ie the failure of many people to provide adequate funds for their retirement. The report cited:

- ◆ the complexity and opacity of many financial services products, alleging that people do not understand how the products work, what the inherent costs are and what the risks are;
- ◆ the failure of the industry to attract and engage with the majority of lower- and middle-income consumers;
- ◆ the inability of consumers to drive the market.

Sandler suggested the development of a suite of simple, low-cost, risk-controlled products that would appeal to a target audience comprising the less financially sophisticated. The phrase ‘stakeholder’ was coined to describe such products – indeed it had already been introduced with the concept of stakeholder pensions (see Section 3.6.3 of Unit 1) – although they are still commonly referred to, for obvious reasons, as Sandler products.

It was felt that a simpler sales regime would require less complex regulation, thereby reducing costs. In addition to this, more direct cost-reducing measures were suggested, including a cap on charges. After considerable heated debate about the appropriate level for charges, the maximum permitted annual charge for the investment products was set at 1.5% for the first ten years of the life of a product and 1% thereafter. For stakeholder pensions arranged prior to 6 April 2005, charges are capped at 1% throughout.

The suite of stakeholder products includes five types of product:

- ◆ a cash deposit product, similar to a cash ISA. The interest rate will be within 1% of the Bank of England base rate, and the minimum deposit is not more than £10;
- ◆ a medium-term investment product, related to collective investment schemes such as unit trusts and OEICs;
- ◆ a smoothed investment fund (a with-profits-type fund);
- ◆ the stakeholder pension;
- ◆ the Child Trust Fund.

Controlling the risk is also an important part of the process of attracting investors who may have been put off by the large stock market falls that have occurred from time to time. This is achieved by limiting the proportion of shares in the stakeholder unit-linked and with-profits products to 60% of the funds. The remainder must be invested in fixed-interest securities and cash.

A simplified selling model applies to these products, with the exception of the smoothed investment fund. The rules for this simplified selling process are included in the *Conduct of Business sourcebook*, and can be summarised as follows.

- ◆ The adviser must explain the nature of stakeholder products and must make it clear that only basic advice will be given.
- ◆ The sales process will be based on a series of short scripted questions in plain language.
- ◆ The assessment of whether a stakeholder product is suitable will be based only on information disclosed by the questions and will not involve a detailed assessment of the customer's needs but:
 - the customer's savings and investment objectives should be ascertained (eg saving for retirement, specific sum required, early access required);

- the customer's willingness to accept risk should be ascertained, as this may determine which product might be suitable.
- ◆ The process must be terminated at any stage if (i) the customer requests it, (ii) the adviser believes there is no likelihood of any stakeholder product being suitable, or (iii) it appears that the customer is unlikely to be able to afford a stakeholder product.
- ◆ An assessment should be made of the customer's other financial needs and priorities (eg family protection or the need to reduce a debt) and, if necessary, the customer should be clearly informed of the desirability of meeting the other priorities first.
 - If the customer appears to be 'significantly' in debt (eg unsecured debt repayments exceeding 20% of gross income), a stronger warning of the desirability of addressing the debt should be given.
- ◆ Additional rules apply to stakeholder pensions, which should not be recommended if the adviser believes there are better options for the customer (eg if the customer could contribute to an occupational scheme).

1.7.7 Regulation of mortgage advice

The FSA took over the regulation of mortgage advice and sales with effect from 31 October 2004.

The FSA's rules relate to loans taken out by individuals or trustees, which are subject to a first charge on the borrower's property. This includes not only mortgages but also other loans where the security is a first charge on residential property.

Second mortgages and other second-charge loans are not covered. The property must be in the UK and it must be residential to the extent that the borrower or their immediate family must occupy at least 40% of the property. This means the new regime will cover home improvement loans, debt consolidation loans and equity release schemes such as home income plans, but that buy-to-let mortgages will not normally be covered.

The rules cover lending, administration, advice and the arranging of loans. Banks, building societies, specialist lenders and mortgage intermediaries will need authorisation.

The sales process must distinguish between cases where advice is given and those where only information is given and a series of pre-determined questions is used as a 'filter' through which a client can narrow down the selection of mortgages. In the latter case, sales staff must ensure they do not stray into the area of giving advice.

Where advice is given, it must be based not only on a consideration of which mortgage best suits the client's needs, but also on the affordability of the scheme for that client. This might include, for instance, recognising the impact of any possible increase in interest rates on a variable rate mortgage. Determination of the suitability of a mortgage involves three stages:

- ◆ assessing whether a mortgage is, in itself, a suitable product for the client;
- ◆ assessing what type of mortgage is suitable (eg repayment/interest only, interest scheme, additional features);
- ◆ selecting the best mortgage and mortgage provider to meet the client's needs and circumstances.

Mortgage advisers, arrangers and lenders now come under the scope of the Financial Ombudsman Service and the Financial Services Compensation Scheme.

Mortgage advisers are outside the scope of MiFID, and the Mortgage Conduct of Business Rules continue unchanged.

The structure of the MCOB rulebook is as follows.

MCOB 1: *Application and purpose.* This explains the scope of the rules, ie whom they apply to and what types of mortgages.

MCOB 2: *Conduct of business standards:* general. This includes: the use of correct terminology ('early repayment charge' and 'higher lending charge'); the requirement for communications with customers to be 'clear, fair and not misleading'; rules about the payment of fees/commission; and the accessibility of records for inspection by the FSA.

MCOB 3: *Financial promotions.* This distinguishes between 'real time' promotions (by personal visit or telephone call) and non-real time (by letter, e-mail, or advert in newspapers, magazines, or on television radio or the internet). Unsolicited real time promotions are not permitted. Customers must not be contacted during 'unsocial' hours (9pm to 9am, and all day Sunday).

Non-real time promotions must include the name and contact details of the firm. They must be clear, fair and not misleading, and if comparison's are used they must be with products that meet the same needs. They must state that 'your home may be repossessed if you do not keep up repayments on your mortgage'. Records of non-real time promotions must be retained for one year after their last use.

MCOB 4: *Advising and selling standards.* It must be clear whether advice is based on the products of the whole market, a limited number of lenders, or a single lender. 'Independent' advisers must be wholly or predominantly 'whole of market'. Any mortgage recommended must be suitable for the customer and appropriate to his needs and circumstances; records to demonstrate this must be kept for three years. Special requirements apply if the mortgage will be used to consolidate existing debts.

On first making contact with a customer, an initial disclosure document (IDD) must be given, showing (in addition to name and contact details) the following information: whose mortgages are offered; details of any fee payable for the advice; the firm's FSA registration details; how to complain and details of the compensation scheme.

MCOB 5: *Pre-application disclosure.* This gives details of the illustration that must be provided at the point at which a personal recommendation is made and before an application is submitted to the lender. This must include the APR, the amount of the monthly instalment and the amount by which the instalment would increase for each 1% rise in interest rates.

The contents of an illustration are set out in the rules, and variations from the prescribed format are not permitted.

MCOB 6: *Disclosure at the offer stage.* If a mortgage offer is made, the lender must provide a detailed offer document. This is based on the information given in the mortgage illustration. The offer document must also: state how long the offer will remain valid; point out that there will be no right of withdrawal after the mortgage has been completed; include or be accompanied by a tariff of charges.

MCOB 7: *Disclosure at start of contract and after sale:* After the first mortgage payment is made, the lender must confirm: details of amounts, dates and methods of payment; details of any related products such as insurance; the responsibility of the borrower to ensure that (for interest only mortgages) a repayment vehicle is in place; what the customer should do if he falls into arrears.

Annual statements must be issued, showing: the amount owed and remaining term; what type of mortgage it is, and for interest only a reminder to check the performance of the repayment vehicle; interest, fees or other payments made since the last statement; any changes to the charges tariff since the last statement.

If a change is to be made to the monthly payment, the customer must be informed of the new amount, revised interest rate and date of the change.

MCOB 8 and 9: *Equity release*. Special rules apply to equity release in relation to advising and selling standards, and to product disclosure.

MCOB 10: *Annual percentage rate*. This describes how to calculate APR.

MCOB 11: *Responsible lending*. Lenders must put in place a written 'responsible lending policy', and must be able to show that they have taken into consideration a customer's ability to pay when offering a mortgage.

MCOB 12: *Charges*. 'Excessive' charges are not permitted. Early repayment charges must be a reasonable approximation to the costs incurred by the lender if borrower repays the full amount early. Similarly, arrears charges must be a reasonable approximation to the cost of additional administration as the result of a borrower being in arrears.

MCOB 13: *Arrears and repossessions*. Firms must deal 'fairly' with customers who have mortgage arrears or mortgage shortfall debts; this includes: trying to reach an agreement on how to repay the arrears, taking into account the borrower's circumstances; liaising with third party sources of advice; not putting unreasonable pressure on customers in arrears; repossessing a property only when all other reasonable measures have failed. Records must be kept of all dealings with borrowers in arrears.

Customers in arrears must be given the following information within 15 working days of becoming aware of arrears: the FSA information sheet on what to do when in arrears; the missed payments and the total of arrears including any charges incurred; the outstanding debt; any further charges that may be incurred unless arrears are cleared.

1.7.8 Regulation of general insurance

With effect from January 2005, the FSA assumed responsibility for regulating activities relating to general insurance and other protection products. This move was prompted in part by the need to implement the terms of the EU Directive on Insurance Mediation, which was designed to open and standardise the market for insurance intermediaries across the European Union. The new FSA regulatory regime does, however, apply to product providers (insurance companies) as well as intermediaries.

The new regime is similar to the existing regulation of long-term insurance contracts (ie life policies). Firms and individuals working in the areas of general insurance, protection, critical illness, long-term care and permanent health insurance have to be authorised through the same processes of permission and approval as apply to the rest of the industry.

Rules applicable to intermediaries who sell, administer or advise on general insurance are contained in a new FSA rulebook known as the Insurance Conduct of Business (ICOB) sourcebook. The ICOB rules are split into a number of sections, the contents of which are summarised below.

1.7.8.1 ICOB 1: The scope of the rules

ICOB 1 explains which firms the rules apply to and what types of activities are covered. The rules cover intermediaries who deal with retail customers and commercial customers for the sale of 'non-investment' insurance contracts (eg endowment policies are excluded).

1.7.8.2 ICOB 2: General rules

ICOB 2 covers rules on communications, which must be clear, fair and not misleading, and on inducements and record-keeping.

1.7.8.3 ICOB 3: Financial promotions

Advertisements must be clear, fair and not misleading. This means, among other things, that expressions of opinion should be fair representations, and it should be clear if the person quoted has a connection with the firm. It should be made clear if price quotations are estimates only and not precise figures, and any mention of reduced premiums should make it clear in what circumstances the reduction is available and what limitations are involved.

1.7.8.4 ICOB 4: Advising and selling standards

ICOB 4 is a particularly important section, dealing in some detail with the initial and ongoing relationship with the customer. The main elements are:

- ◆ *information on status*: this includes details of the firm's regulatory status (ie authorised and regulated by the FSA); whether products are offered from the whole market, a range of providers, or just one provider; details of how to complain, and details of compensation arrangements. This information can be provided in an *initial disclosure document (IDD)*. If both mortgage and insurance products are offered, information about both can be included in a *combined initial disclosure document (CIDD)*;
- ◆ *fees*: details of any fees charged by the intermediary must be disclosed before the contract begins, including any fees that may be charged later in the term of the contract;
- ◆ *suitability of advice*: when a personal recommendation is made, the contract recommended must be suitable for the customer's demands and needs. This must be confirmed by issuing a demands and needs statement, which details the customer's demands and needs and explains why the particular product recommendation has been made;
- ◆ *excessive charges*: charges must not be excessive in relation to charges for similar services offered by others in the market;
- ◆ *unsolicited services*: automatic renewal of contracts on behalf of customers must not be carried out unless the customer has given prior consent to this.

1.7.8.5 ICOB 5: Product disclosure

ICOB 5 covers the content of product information and when it must be provided. It is the intermediary's responsibility to provide product information to customers, but insurance companies regulated by the FSA must provide the intermediary with adequate information to enable the intermediary to do so. Details are included in ICOB 5 of the information that must be given to customers, particularly before and after a sale and on renewal. This includes information about the terms of a contract, price, cancellation rights and claims handling.

A policy summary must be given to all customers. It must include the '**Keyfacts**' logo, the main features of the policy, and any significant exclusions or limitations.

I.7.8.6 ICOB 6: Cancellation

ICOB 6 sets out the cancellation rights of retail customers. The cancellation rights themselves are offered by the product provider but intermediaries must be aware of them, since it is their responsibility to inform customers of their cancellation rights. For general insurance, the cancellation period is 14 days, while for pure protection contracts (eg critical illness cover) the period is 30 days.

If a customer cancels, the insurance company must return any sums paid to it within 30 days of cancellation. For general insurance contracts, the company can deduct any reasonable and genuinely incurred costs, including a charge for time on risk, but the company must not make a profit and the amount retained must not be capable of being interpreted as a penalty.

I.7.8.7 ICOB 7: Claims handling

If the intermediary acts on behalf of the insurance company in handling a claim on their behalf, the insurance company is responsible for ensuring that the rules are complied with. If the intermediary were to act on behalf of both the insurance company and the customer for whom he arranged the policy, that would be construed as a conflict of interest. In the event of a conflict of interest, it is necessary for the intermediary to tell the customer and ask for their consent to continue acting for them. If this is not possible, or the consent is not given, then the intermediary must withdraw from acting for one of the parties.

Unit 2

Test your knowledge and understanding with these questions

Take a break before using these questions to assess your learning across Section I. Review the text if necessary.

Answers can be found at the end of this unit.

1. Name the four statutory objectives of the FSA.
2. What is the difference between 'rules' and 'guidance' in the FSA Handbook?
3. How, according to the 'Principles for Business', must authorised firms behave in their dealings with the FSA?
4. What, according to the FSA, must be 'embedded into the culture and day-to-day operations' of authorised firms?
5. Whose rights are protected by the Public Interest Disclosure Act 1998?
 - (a) Borrowers who fall into arrears.
 - (b) Whistle-blowing employees.
 - (c) Bank/building society deposit account holders.
6. What are the two forms of market abuse defined by the EU?
7. Which of the following is NOT a 'regulated investment' under the Financial Services and Markets Act 2000?
 - (a) Works of art.
 - (b) Funeral plans.
 - (c) Insurance policies.
8. What is 'Basel II'?

9. 'The risk of losses from failed or inadequate internal processes, people and systems, or from external events.' What is this a description of?
10. What European legislation determines the capital adequacy requirements of investment businesses?
11. Name the four main types of risk that the FSA has identified as being faced by financial consumers.
12. In relation to the FSA's enforcement powers, explain the difference between 'restitution' and 'redress'.
13. The role of financial adviser is a 'controlled function'. Which category of controlled function is it?
 - (a) Required function.
 - (b) Management function.
 - (c) Customer function.
14. During what hours can an unsolicited sales call be made by a financial adviser?
15. What is an 'eligible counterparty'?
16. An adviser acts in a 'multi-tie' capacity. When recommending a product to a client, as whose agent is he operating?
17. An Initial Disclosure document must explain the circumstances in which the client can refer to the Financial Ombudsman Service. *True or false?*
18. An adviser has just sold a personal pension plan to a client. What is the minimum period for which the factfind and related information must be retained?
19. If the current Bank of England base rate is 4.5%, what is the minimum rate of interest that can be offered on a 'stakeholder' cash deposit scheme?
 - (a) 1.5%.
 - (b) 2.5%.
 - (c) 3.5%.
20. What is the maximum proportion of a stakeholder smoothed investment fund that can be invested in shares?

Answers

1. Maintaining confidence in the financial system; promoting public understanding of the finance system; securing an adequate level of protection for consumers; reducing the scope for financial crime.
2. Rules create binding obligations on authorised firms. Guidance provides assistance in understanding how to abide by the rules.
3. In an open and co-operative way, disclosing anything that the FSA might reasonably expect to be told.
4. The principle of Treating Customers Fairly.
5. (b) Whistle-blowing employees.
6. Insider dealing, where a person who has information not available to other investors makes use of that information for personal gain; and market manipulation, where a person knowingly gives out false or misleading information in order to influence the price of a share for personal gain.
7. (a) Works of art.
8. An international standard for the capital adequacy requirements of financial institutions.
9. Operational risk.
10. The Capital Requirements Directive (CRD).
11. Prudential risk; bad faith risk; complexity/unsuitability risk; performance risk.
12. Restitution refers to the FSA's power, with a court order, to require a person or firm to forfeit any profit made from contravening an FSA rule. Redress refers to the situation where identifiable customers have made a loss as a result of contravention of a rule and the FSA, again with a court

order, can require the loss to be made good.

13. (d) Customer function.
14. 9.00am to 9.00pm, Monday to Saturday (to an existing client).
15. An eligible counterparty is someone who is 'in the business', ie someone who transacts the same kind of business for his own customers as he is proposing to transact as a customer himself.
16. Because he is tied, he is acting as agent of the product provider.
17. True.
18. Five years.
19. (c) 3.5%.
20. 60%.