The Regulatory Environment

1. Introduction

1.1. Chapter overview

This chapter is an important one as it provides the framework for all of the following chapters. It will give you a picture of the regulatory environment of the UK's financial services industry.

In particular, it explains the legal (or statutory) provisions of the Financial Services and Markets Act 2000 (FSMA 2000, or simply, the Act), as revised by the Financial Services Act 2012 (FSA 2012), and the power it grants to the FCA and PRA to make **rules** that govern the behaviour of both firms and individuals working within the financial services industry.

As well as giving powers to the FCA and PRA, FSMA 2000 made it an offence for a firm not to be authorised when carrying out regulated activity. The chapter also looks at the roles of other regulatory bodies, such as the Bank of England, the Financial Ombudsman, Her Majesty's Treasury and the Financial Services Compensation Scheme.

1.2. Learning outcomes

On completion of this module you will be able to:

Introduction to financial markets

- LO 1.1.1 - Explain the features of the financial markets
- LO 1.1.2 - Explain the role and impact of financial institutions
- LO 1.1.3 - Explain the role of the government in the financial markets

European Union (EU)

- LO 3.1.1 - Explain the legal status of EU directives and regulations within the UK
- LO 3.1.2 - Explain the role and powers of the European Securities and Markets Authority
- LO 3.1.4 - Explain the purpose and scope of the Undertakings for Collective Investment in Transferable Securities (UCITS) Directives
- LO 3.1.5 - Explain the purpose and scope of the European Market Infrastructure Directive

Regulatory environment

- LO 3.2.1 - Describe and distinguish between the roles of the Financial Conduct Authority (FCA), Prudential Regulation Authority (PRA), Bank of England, Financial Policy Committee (FPC) and HM Treasury
- LO 3.2.6 - Explain the function of the Information Commissioner's Office (NOTE: the rest of this objective is covered in Chapter 6: Other Regulatory Requirements)
- LO 3.2.2 - Explain the different roles of the FCA and the PRA for dual-regulated firms

The Financial Conduct Authority

- LO 3.3.1 - Explain the role and statutory objectives of the FCA
- LO 3.3.2 - Explain and distinguish among the blocks of the FCA Handbook
- LO 3.5.18 - Explain the FCA's approach to temporary product intervention
- LO 3.6.1 - Explain the risk-based approach to supervision and the enforcement and disciplinary powers of the FCA

The general prohibition

- LO 3.2.3 - Explain the scope of the Financial Services and Markets Act 2000 (as amended by the Financial Services Act 2012)
- LO 3.2.4 - Explain the scope of the Regulated Activities Order 2001 (as amended) in terms of specified activities and specified investments

2. Introduction to Financial Markets

2.1. The City of London

The City: then

It is 6.00am on a winter's morning and a team of sailors draw up alongside Cheapside wharf. They begin the process of unloading their cargo. Out come animal skins and precious stones from the Baltic which they hope to sell in the markets that line the river. A good day's trade will pay for the costs of the venture, although the crew will see little of the profit; the merchants who hired the ship and pay the wages will be the ones receiving a handsome return on their investment. They will need to, as they themselves borrowed the money to take on this enterprise. The crew can, however, hope for a well earned bonus if they complete their job well and in good time.

The City: now

It is 6.00am and a trader arrives at her desk. She switches on her screens and scans the information feeds for news of overnight trading in Tokyo. She will begin dealing at 8.00am but for now must decide upon her strategy; the level of interest rates, the confidence of consumers, market trends and volatility - all will influence her opinion. A successful decision now will reap rewards when the bank makes annual bonus payments.

Hundreds of years and a technological revolution separate the crew from the City trader, but the fundamentals of their jobs have remained the same: using other people's money to finance trade.

The markets of Cheapside have long since gone, but the City of London is still full of financial markets; the London Stock Exchange, ICE Futures (formerly known as the International Petroleum Exchange) and NYSE.liffe - the London International Financial Futures (and Options) Exchange - are just some of the many markets where trading still takes place.

2.2. Features of financial markets

Markets

A market is a place where people seeking to trade with one another are brought together. While we all have experience of markets for food and clothes, financial markets are concerned with the raising and trading of capital.

Some people have money (or **capital**) and want to lend it, and some people need capital and want to borrow it. In the financial markets lenders and borrowers come together and, assuming they can find each other, are ‘matched up’. In today's global financial markets simple loans between borrowers and lenders make up only a small part of the activity. Complex transactions require sophisticated deal-making procedures and the financial markets continue to develop in order to meet this challenge.

Lenders

Individuals

Individuals lend in one of two ways: conscious and unconscious savings.

Conscious saving is, for example, depositing cash in a bank account.

Unconscious saving occurs when individuals employ the services of fund managers, and pay premiums into insurance and pension companies. Fund managers use their expertise to lend/invest this money in order to create a portfolio of financial assets.

Companies

Cash-rich companies will often lend money both in the short-term money markets and in the long-term bond markets.

Borrowers

Individuals

Individuals often need to borrow money. They may use credit cards for short-term finance or perhaps take out bank loans for medium-term purchases, like cars and home improvements. In the long-term, house purchases are funded with mortgages.

Companies

Companies require short-term cash to pay for their supplies and other short-term needs. Longer-term borrowing is used to fund expansion and growth, such as factory buildings or overseas expansion.

Governments

Governments earn money through taxes and spend money on public services. Often, governments spend more than they earn so they need cash to make up for the shortfall. The shortfall in the UK is referred to as the Public Sector Net Cash Requirement (PSNCR).

Foreign exchange

Sometimes lenders may have a particular currency to lend, e.g. sterling, but borrowers require a different currency. The foreign exchange market enables people to change the currency they have for the currency they need.

Retail vs. Wholesale

The retail market is one that involves the private individual or private client. It includes retail banking, pensions, general and life insurance and collective investment schemes.

Wholesale

The wholesale market involves institutional clients, such as pension funds, charities and insurance companies. It involves large trades in more specific investments.

Retail

The retail market is one where the client has the least knowledge and experience, so is heavily regulated, whereas in the wholesale market the participants are considered more knowledgeable, so less protection – and fewer restrictions – are applied.

2.3. The role and impact of financial institutions

Financial institutions

There are many professionals in the financial services industry who provide support to the markets in the form of expertise or capital.

The roles of some of these professionals are detailed below:

- **Investment banks**: undertake a range of security related activities on behalf of their clients. Activities may include the following:
  - Trading as principal: buying and selling shares for their own account
  - Broking: dealing on behalf of clients
  - Market making: quoting prices to other market participants
  - Research: providing analysis on investments and their potential
  - Corporate finance: advice and execution related to the raising of capital by companies
  - Mergers and acquisitions: takeover advice
  - Fund management: investing client funds to maximise returns
- **Retail banks**: provide a high street presence primarily for accepting deposits and giving loans. Many have now extended their service line to include pensions, life assurance and share dealing services.
- **Building societies**: fulfil a similar role to retail banks but adopt a different legal structure. Building societies are established as **mutual** societies. This means they are owned jointly by all of their savers and borrowers and do not pay returns to shareholders. Many former building societies have converted into banks in order to access a greater range of financing sources.
- **Insurance companies**: provide two types of insurance: general and life policies. General insurers provide cover against motor accidents and house fires etc, whereas life companies provide, amongst other things, investment vehicles that pay out on death.
- **Fund managers**: offer wealth management services to a broad range of clients. Generally fund managers construct and manage portfolios of investments on behalf of institutional clients, such as pension funds, charities and insurance companies. However, fund managers may also offer their services to wealthy private clients or manage packaged products and market them to the general public.
- **Pension funds**: managers of pension funds perform functions that overlap with those of other fund managers. The funds themselves consist of assets under the control of legal guardians, known as **trustees**. Pension funds control a large proportion of UK shares.
- **Stockbrokers**: trade in investments on behalf of their clients.
- **Custodians**: offer safekeeping and administration services in relation to investment portfolios.
- **Credit card companies**: provide short-term, informal and flexible finance to the public.
- **Third party administrators**: offer administration services for other institutions, such as pension funds and insurance companies.
- **Industry trade bodies**: professional bodies that represent the interests of their members, such as:
  - The Chartered Financial Analyst Society
  - The Association of Private Client Investment Managers and Stockbrokers
  - Chartered Institute of Bankers

  - Investment Management Association
  - Chartered Institute for Securities and Investment

- **Fund supermarkets**: typically websites providing a convenient way of accessing collective investment schemes. Each 'supermarket' will offer a wide variety of funds by a wide variety of providers in one online place. However, different 'supermarkets' will offer a different range of goods and services and cost will vary greatly from one to another.

Investment distribution channels

Direct investments

An investor wishing to invest in particular products is obviously at liberty to make a direct investment in the product they choose by contacting the product provider or the product provider's agent.

Take an individual who wishes to invest in a pension, for example. They could contact a pension provider directly and set up their pension. The investor is using their own knowledge and experience of the market to inform their choice, which may or may not be a good thing. This is an example of execution only business.

Financial advisors

More likely, however, the individual would contact a financial advisor to give advice on the products available and assist the investor in the associated administration.

Independent financial advisors (IFAs)

Some advisors are independent financial advisors and are permitted to give advice on any product on the market.

In our example the IFA would be permitted to give advice to the investor on a pension provided by any pension fund. The investor is now benefiting from the experience of someone who has knowledge of the investments available, so possibly has a better insight into the best choices available.

Appointed representative

Other advisors are tied to a particular provider, or group of providers. In this case, the advisor – referred to as a tied agent or appointed representative – would only be able to give advice on the pensions provided by the provider they are tied to.

In our example, the investor seeking a pension would still benefit from the knowledge and experience of the advisor, but the scope of their advice would be limited to who the advisor represents.

2.4. The role of the government

Introduction

Governments have more recently taken a back seat when it comes to involvement in the financial services industry in most developed, and even developing, nations. Their involvement is typically from the point of view of consumer protection and education, and the combating of financial crime. Historically, governments have been much more active in controlling interest rates and trading in the money markets. However, there is an equally important holistic role of creating economic stability and promoting growth through their economic and industrial policies, as well as their impact through taxation and social welfare.

Economic and industrial policy

Economic and industrial policies are large scale policies that affect the economy and those within it as a whole. They have the ultimate goal of establishing low unemployment and low interest rates to create a constant and sustainable growth. More recently, however, they have been focused on recovery.

Economic policy

Economic policy in the UK is set and implemented jointly by the Government itself and the Bank of England. The ultimate goal is stability within the economy.

The UK Government targets inflation primarily as part of its economic policy. It has set a benchmark of 2.0% and all other policies are set to maintain this. The Government's fiscal policy, controlling Government spending and taxation, plays a role in this, as does the Bank of England's monetary policy, controlling the base rate of interest. The balance of payments will also play a role in this policy. All of these will be discussed in more detail in the economics section.

Industrial policy

Industrial policy, also referred to as supply side economics, has played a lesser role. In the UK there has been a very general focus on key themes such as international competitiveness, innovation, competition, and skills. More recently, the importance of technology and its role in industry has been recognised. However, it has been very much a light touch and we have seen industry in the UK slipping in its contribution to the Gross Domestic Product since the 1970s.

Critics of this light touch suggest a more active approach; recommending a move away from central control through legislation and regulation, and towards a more self-reliant and entrepreneurial focus. They also recommend strong government leadership is required in the creation of a long-term strategy to promote industry where there are opportunities, and reward it where there is success.

Regulation

The UK Government, via the Her Majesty's Treasury (HMT), has a direct impact on the financial services industry in the drafting and writing of financial law. The most significant piece of legislation to affect the current financial environment was the Financial Services and Markets Act 2000 (FSMA 2000), as amended by the Financial Services Act 2012 (FSA 2012), which empowered the Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (PRA) to be the regulators for the UK financial markets. The FCA and its regulations will be covered in depth later on, but FSA 2012 set the FCA four objectives that it was required to achieve through its role as regulator:

One strategic objective:

- Ensure the relevant markets work well

Three operational objectives

- Consumer protection: Ensuring an appropriate degree of protection for consumers
- Integrity: Protecting and enhancing the integrity of the UK financial system
- Competition: Promoting effective competition in the interests of consumers

It is worth noting that in April 2010 a new Financial Services Act gained Royal assent, and changed the second objective (public awareness) to financial stability.

Taxation

Taxation affects the financial services industry both through any corporate tax system within the country and through the personal taxation on investors. Other influences are taxes, such as stamp duty on the purchase of shares, value added tax (VAT) on the services that the financial institutions provide and windfall taxes in times of large profits. More recently we have seen a bonus tax of 50% on all discretionary payments above £25,000. The UK Government, in controlling the tax system within a country, wields great influence over the industry in this area.

Social welfare

Social welfare sometimes goes under the term social policy. Social policy takes into consideration social services and the welfare state. In general terms, it considers issues involving:

- Policy and administration of social services, including policies for health, housing, income maintenance, education and social work
- Needs and issues affecting the users of services, including poverty, old age, health, disability, and family policy
- The delivery of welfare

In the UK a great deal of this is funded and controlled through the Government or Government initiatives and funded through taxation and national insurance contributions.

3. European Union

3.1. Introduction

The European Union (EU) was established by the Treaty on European Union (Maastricht, 1992), although the project of creating a Union has a long history, and was first mooted at the European summit of 1972.

The Union is both a political project and a form of legal organisation.

The major objectives of the EU are to promote:

- Economic and social progress
- Sustainable development
- An area without internal frontiers
- Economic and monetary union

3.2. The Lamfalussy approach

The Lamfalussy approach is based on the recommendations of the Committee of 'Wise Men', chaired by Baron Alexandre Lamfalussy. It comprises a four-level procedure that speeds up the legislative process. It divides the legislation into high level framework provisions and implementing measures.

3.3. The European Commission

The European Commission is the driving force behind the EU legislation and directives. It is responsible for the implementation, management and control of the common policies adopted by the European Council - the regular meetings of the Heads of State or governments of the European Union Member States.

In performing their role, the Commission's goal is to create harmonisation in legislation among the member states and to prevent member states from taking policy measures which would unduly benefit their own economies at the expense of other EU countries.

The three new European supervisory authorities are:

- The European Securities and Markets Authority (ESMA)
- The European Banking Authority (EBA)
- The European Insurance and Occupational Pensions Authority (EIOPA)

3.4. The European Securities and Markets Authority (ESMA)

The European Securities and Markets Authority (ESMA) took over the responsibilities of the Committee of European Securities Regulators (CESR) in 2011. It is made up of the regulators of the securities markets from throughout the EU. The regulators on the committee are referred to as competent authorities. The FCA is a competent authority.

ESMA contributes to the safeguarding of the stability of the financial markets while ensuring the integrity, transparency, efficiency and orderly functioning of securities markets in Europe, as well as enhancing investor protection. In general, ESMA will work at a high level setting standards, while day-to-day supervision will continue to be carried out by national supervisory authorities.

The main powers of ESMA are:

- Delegating acts: setting out details needed to comply with the laws, for example setting out information necessary to gain authorisation
- Implementing acts: setting out processes required to implement the laws in the member states, for example standard forms, templates etc.
- Giving technical advice to the European Commission when developing legislative proposals
- Drafting subordinate acts. Subordinate acts take two forms:
- Overseeing a consistent approach to the implementation and enforcement of EU legislation
- Launching investigations into non-compliance, either at the request of the Commission or on its own initiative

3.5. The European Systemic Risk Board (ESRB)

The European Systemic Risk Board (ESRB) will monitor the entire financial sector to identify potential problems.

3.6. Financial Services Action

The Financial Services Action Plan (FSAP) consists of EU directives and regulations.

The FSAP has three specific objectives:

- To create a single EU wholesale market.
- To achieve open and secure retail markets.
- To create state of the art prudential rules and structures of supervision.

3.7. EU Regulation vs. EU Directives

Regulations are the most direct form of EU law - as soon as they are passed, they have binding legal force throughout every Member State, on a par with national laws. They are different from directives, which are addressed to national authorities, who must then take action to make them part of national law.

Directives can be implemented by primary legislation, or by the more recent tendency of delegated legislation under section 2(2) of the European Community Act (1972).

3.8. Markets in Financial Instruments Directive (MiFID)

The most important single policy of harmonisation of the financial regulations has been MiFID. Financial regulators are now required to impose these harmonised rules on their member state firms. The directive states rules that need to be followed by firms from 1 November 2007.

3.9. Undertakings for Collective Investment in Transferable Securities (UCITS)

Background

In 1985 the EEA announced the implementation of a directive regulating collective investment schemes throughout the EEA. This was the UCITS directive. We are currently on the fourth incarnation of the UCITS directive.

UCITS III

UCITS III is split into two parts:

Management Directive increases the scope of management companies' activities that can be passported to include discretionary management, safekeeping and fund administration.

The directive also aims to protect investors by ensuring that management companies are suitably capitalised, and that they have appropriate measures in place for risk management and reporting.

It introduced the simplified prospectus, designed to provide investors with a shortened 'core' version of the current prospectus, but does not replace the actual prospectus.

Product Directive expands the range and type of financial instruments that are permitted within UCITS funds, in particular allowing investment in derivatives for investment as well as for existing risk reduction purposes and investment in other funds.

UCITS IV

UCITS IV came into effect in July 2011. The intention of this amendment is to promote greater efficiency in pan-European management of funds and is likely to cover the following areas:

- Management company passport – a management company located in one country will be able to set up and run a fund in another
- Supervision – a management company will be subject to the supervision and regulation of the country where it is based
- Notification procedure – quicker, more simplified regulator-to-regulator communication
- Key investor information – product brochures to be simpler than the existing 'simplified' prospectus
- Mergers – a standardised framework governing both domestic and cross-border mergers between funds
- Master-feeder structures – allow funds to build economies of scale across borders

UCITS criteria

In order for a scheme to be allowed to operate and promote itself on a pan-European basis it must meet the criteria laid down in UCITS:

- The scheme must apply for permission (a **passport**) from its home state regulator to operate in other EEA member states

- The scheme must be open-ended
- The scheme may not be invested in any instruments or asset classes prohibited by the directive, such as immovables (property), gold or commodities

3.10. The European Market Infrastructure Regulation (EMIR)

This Regulation came into force on 1 April 2013. It requires anybody who has entered into a derivatives contract to report and manage the risk of their derivatives positions.

EMIR imposes three new requirements on those who trade derivatives:

1. To clear OTC derivatives that have been declared subject to the clearing regulation through a central counterparty (CCP)
2. To put in place risk management procedures for those OTC derivatives that are not centrally cleared
3. To report derivatives to a trade repository

All three obligations apply to financial counterparties. The clearing and risk management obligations apply to certain non-financial counterparties while the reporting obligation applies to all of them.

A financial counterparty is any investment firm, credit institution, insurance or reinsurance undertaking, UCITS or UCITS manager, institution for occupational retirement provision or alternative investment fund managed by an alternative investment fund manager.

A non-financial undertaking is any other undertaking established in the EU.

A non-financial counterparty (in relation to a particular class of derivative) is one whose position has exceeded the threshold set for that class of derivatives by the Commission.

4. The regulatory environment

4.1. FSMA 2000

The Financial Services and Markets Act 2000 (FSMA 2000) - drafted by the Treasury - created the framework for regulation in the UK financial services industry. FSMA 2000 is still law, though it has been significantly amended and modified by the Financial Services Act 2012 (FSA 2012).

FSMA 2000 created a single regulator for the entire industry. This single regulator was called the Financial Services Authority (FSA).

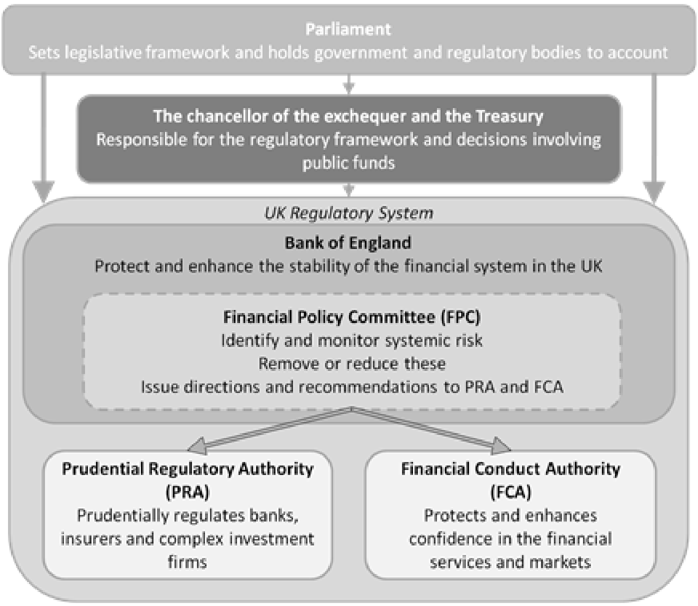
The FSA was roundly criticised in the aftermath of the 2008-9 financial crisis as having taken too much of a 'micro-prudential' view of its regulatory responsibilities, i.e. focusing on individual firms at the expense of the health of the overall financial system (the 'macro-prudential view').

The FSA 2012 overhauled the UK financial regulatory system by disbanding the FSA and establishing a new system of more specialised and focused regulators:

- A new macro-prudential regulator, the Financial Policy Committee (FPC), established within the Bank of England
- A new prudential regulator, the Prudential Regulation Authority (PRA), established as a subsidiary of the Bank of England
- A new conduct of business regulator, the Financial Conduct Authority (FCA), focusing on wholesale and retail markets and delivering better levels of protection to consumers

This new framework has been mostly welcomed, particularly as it allows a specific emphasis on promoting financial stability and an enhanced focus on macro-prudential as well as micro-prudential regulation.

The new framework is summarised in this diagram:



4.2. The Financial Conduct Authority (FCA)

Under FSA 2012 the FCA took over the bulk of the FSA's responsibilities in April 2013. It is funded and structured in a very similar way to the old FSA – via levies upon regulated firms. The FCA aims to become more of a proactive force than the FSA for enabling the right outcomes for consumers and market participants. It sets and enforces clear expectations for firms and market participants whilst taking a proportionate approach to regulation. In doing so, it adapts to the needs of different consumers and market participants.

4.3. The Prudential Regulation Authority (PRA)

The Prudential Regulation Authority (PRA) has been established for regulation of financial institutions (i.e., banks) that manage significant risks on their balance sheets. The PRA is an operationally independent subsidiary of the Bank of England, complementing the creation of the FPC. The PRA is a focused prudential regulator, with responsibility for the prudential supervision of banks, building societies, insurers, friendly societies, credit unions, Lloyd's of London and its managing agents, and certain significant investment firms – totalling, approx 2,200 firms.

The core objective of the PRA is in ensuring the safety and financial soundness of the firms that it regulates. The PRA seeks to achieve this via a combination of regulations, and a robust application of those regulations including intensive supervision. The PRA takes a risk-based and judgement-based approach to its new role.

The Government has made clear that the 'light-touch' regulatory regime of the FCA was insufficient to meet the needs of the financial marketplace. The PRA seeks to challenge the management of firms where appropriate, liaising with both the FCA, and also international regulators in areas beyond the UK's geographical scope.

4.4. Dual regulated firms

The FCA and PRA have separate authorisation functions, but a single administrative process for dual-regulated firms. Firms that are dual-regulated will apply to the PRA for authorisation. The application will be considered by both the PRA and FCA, following one of two processes:

- Consent: The FCA gives or refuses consent to the PRA. If the FCA does not give consent, the PRA can refuse the application
- Consult: For certain permissions, the PRA must consult the FCA. The PRA must consider the response of the FCA, but need not be bound by it

When considering the application, the FCA concentrates on conduct, the PRA upon prudential supervision. Both regulators have their own threshold conditions. Dual regulated firms have to meet both sets of conditions.

4.5. The Financial Policy Committee (FPC)

The Financial Policy Committee (FPC) has been established within the Bank of England, with responsibility for **macro-prudential** regulation, that is regulation of stability and resilience of the financial system as a whole. The FPC enjoys the authority to give directions, make recommendations and offer advice to institutions responsible for day-to-day oversight and policy (such as the PRA and FCA). It also has the power to intervene to ensure appropriate action is taken where needed to ensure stability.

Membership of the FPC consists of the Governor of the Bank of England (BoE), acting as chair, together with three deputy BoE governors. There are also two BoE executive directors, the chairman of the FCA, four non-Bank members, and a non-voting representative of the Treasury. The role of the FPC is to assist the BoE to achieve its objective in regard to financial stability, and it also takes enhancing economic growth into account in making its decisions.

4.6. The Financial Ombudsman Service (FOS)

The system for the consideration of complaints against its firms by customers involves consideration of the complaint by the firm itself first and, if the customer is not satisfied, independent investigation by the Financial Ombudsman Service (FOS).

Investigation involves both a mediation stage and a possible (depending on the type of client) subsequent determination stage by the Financial Ombudsman.

The FOS can make awards for a range of reasons including financial loss, pain and suffering, damage to reputation and distress or inconvenience.

Complaints against authorised firms relating to a regulated activity fall under the 'Compulsory Jurisdiction' of the FOS.

Unauthorised firms can also submit to the 'Voluntary Jurisdiction' of the FOS by entering into a contract with the FOS as a voluntary participant.

4.7. The Financial Services Compensation Scheme (FSCS)

The Financial Services Compensation Scheme (FSCS) was established to provide compensation where authorised persons and appointed representatives are unable to satisfy claims against them due to insolvency. It is jointly overseen by the FCA and the PRA.

4.8. The Tax and Chancery Chamber of the Upper Tribunal (TCCUT)

The Tax and Chancery Chamber of the Upper Tribunal (TCCUT) is an independent body run by the Ministry of Justice.

The Ministry of Justice is responsible for upholding justice, rights and democracy. Its responsibilities include running the courts, improving the justice system, human rights and information rights law, policy on running elections and modernising the constitution.

If a firm/individual is unhappy with the decisions or judgements made by the FCA or the PRA, it may refer this to the TCCUT. The Tribunal will rehear any enforcement or authorisation cases where the firm/individual and the regulator have not been able to agree the outcome.

This makes the regulator more accountable for its actions and allows for fair treatment of firms and individuals regulated within the financial markets.

A final decision by the Tribunal can be appealed in the Court of Appeal and then the Supreme Court, but only if it relates to a point of law.

4.9. The Bank of England

The Bank of England is responsible for the supervision of banks and money market institutions; this role is carried out by the PRA, which is a subsidiary of the Bank. However, the Bank retains certain key responsibilities for itself:

- Setting interest rates

- Printing bank notes
- Overseeing systemically important financial system infrastructure, such as payment systems
- Maintaining stability in the financial system by acting to deal with fluctuations in liquidity and providing emergency liquidity in times of emergency
- Maintaining a broad overview of the system as a whole
- Acting as 'lender of last resort'
- Appointing the chairman of the Panel on Takeovers and Mergers

In relation to interest rates, decisions are taken by the Bank's Monetary Policy Committee (MPC). The MPC meets on a **monthly basis** and sets rates in order to meet the government's inflation target based on the Consumer Prices Index (CPI).

The inflation target is set each year by the Chancellor of the Exchequer. The Bank implements interest rate decisions by regulating the rate at which it lends to other banks and financial institutions.

4.10. The Information Commissioner's Office

The Data Protection Act

The basic principle of data protection is that the public should know or should be able to find out who is carrying out processing of personal data and for what purposes the processing is being carried out.

To satisfy this principle, the Data Protection Act 1998 (DPA) places obligations on 'data controllers' (anyone who decides how and why personal data - information about identifiable, living individuals - is processed), including requiring them to register with the Information Commissioner.

The Act allows individuals to request access to information being held about them by a firm/organisation. The individual may be charged a maximum of £10 for access to their records (£2 in the case of credit reference agency records). This request is submitted to the firm/ organisation, which must normally respond to it within 40 days.

Where breaches of the DPA occur, the Information Commissioner can:

- Enter premises and seize documentation **without** a court warrant
- Issue enforcement notices requiring data controllers to take remedial action to remedy breaches
- Instigate criminal proceedings

If the Information Commissioner considers that a data controller is in breach of any of the data protection principles, it can serve an enforcement notice. If the data controller fails to comply with the enforcement notice, they are committing an offence and can be fined up to £500,000.

Principles of data protection

Anyone processing personal data must comply with the eight enforceable principles of good practice. They state that data must be:

- **Fairly and lawfully processed.** Data may not, therefore, be processed unless consent has been granted by the subject of the data, or the processing is required in order to comply with legal obligations

- **Processed for limited purposes.** Where data is considered sensitive, for instance, ethnic origin or religion, additional requirements are imposed to handle this data. This principle also ensures that firms cannot use information for other marketing purposes or sell information to third parties
- **Adequate, relevant and not excessive.** This principle ensures that no more data than is strictly necessary is held on a person considering the circumstances
- **Accurate and up to date.** Personal data should be accurate and kept up-to-date
- **Not kept longer than necessary.** It is a requirement that data should be regularly reviewed and deleted when appropriate to do so
- **Processed in accordance with the data subject's rights.** Appropriate technical and organisational measures must be taken to ensure no unlawful processing of personal data
- **Secure.** Personal data must be stored in a safe and secure location
- **Not transferred to countries outside the EEA without adequate protection**

5. The Financial Conduct Authority

5.1. FCA statutory objectives

The FCA's strategic objective is to ensure relevant markets work well.

It achieves this strategic objective through three **operational objectives**:

- Securing an appropriate degree of protection for consumers
- Protecting and enhancing the integrity of the UK financial system; and
- Promoting effective competition in the interests of consumers

As well as its stated objectives, the FCA will:

- Focus on the conduct regulation of all firms, covering the range of their dealings with retail customers, through to their activities in wholesale markets. It will regulate about 33,000 firms in total, including those prudentially supervised by the PRA
- Be responsible for the prudential supervision of all firms not prudentially supervised by the PRA
- Supervise trading infrastructure including the investment exchanges and over-the-counter (OTC) markets and monitor firms' compliance with the market abuse regime
- Have criminal powers to investigate and prosecute insider dealing
- Take on the FCA's responsibilities as the United Kingdom Listing Authority (UKLA)
- Be responsible for overseeing the Financial Ombudsman Service (FOS), the Money Advice Service (MAS) and (jointly with the PRA) the Financial Services Compensation Scheme (FSCS)

General powers

The FCA has been granted a wide range of powers under FSMA 2000. These powers include:

- **Authorisation**: authorising firms to undertake regulated activities, approving individuals to undertake controlled functions and recognising investment exchanges and clearing houses
- **Supervision**: investigating authorised firms and approved individuals
- **Enforcement**: taking enforcement action against authorised firms and approved individuals
- **Sanctions and disciplinary action**: imposing disciplinary measures on authorised firms and approved individuals
- **Rule making**: making general rules to govern authorised firms

5.2. The FCA Handbook: S138 FSMA 2000

S138 FSMA 2000 grants the FCA the power to make general rules governing regulated firms and individuals.

The FCA will only make rules and provisions if they are deemed to be 'necessary or expedient' to protect the users of services of authorised firms or of their appointed representatives carrying on regulated activities.

Structure of the FCA Handbook

The FCA rules have been collated into a central source known as the **Handbook**. The Handbook has been divided into seven main **blocks**, each block dealing with different aspects of regulation.

Each block contains a variety of **sourcebooks** (or **manuals**) that provide more detail on particular aspects of compliance. Five of these blocks, and the sourcebooks within, are relevant to your syllabus:

- Block 1: high-level standards. These include the rules on senior management arrangements (**SYSC**), the statement of principles for businesses (**PRIN**), the minimum standards for becoming and remaining authorised (**COND**), training and competence rules (**TC**), the statements of principle and code of practice for approved persons (APER) and the fit and proper criteria for approved persons (**FIT**)
- Block 3: business standards. These include the conduct of business rules (**COBS**), the code of market conduct (**MAR**) (to prevent market abuse), requirements relating to client assets and client money (**CASS**)
- Block 4: regulatory processes. The rules relating to supervision (**SUP**) and decision procedures and penalties (**DEPP**)
- Block 5: redress. Dispute resolution (complaints procedures) (**DISP**) and the compensation scheme (**COMP**)
- Block 6: regulatory guides. The enforcement guide (**EG**)

FCA's temporary product intervention rules

When creating new rules for the Handbook, the FCA needs to go through a lengthy process of discussion and consultation with all stakeholders before issuing a policy statement containing the new rules.

One of the powers given to the FCA by the Financial Services Act 2012 is the power to make temporary product intervention rules (TPIRs) where the delay involved in complying with the requirements for public consultation would prejudice the interests of consumers.

The FCA has stated it will use TPIRs in cases where a product is in “serious danger” of being mis-sold. The TPIRs will allow the FCA to take action, including restricting the use of certain product features and requiring that a product not be promoted to some or all types of customers. In the most serious cases, the regulator will be able to use the rules to prevent a product being sold altogether, such as in instances where complex or niche products are being sold to the mass market. The rules will be made before consultation and will last for no longer than 12 months. During this time the FCA will either consult on a permanent remedy or will work to find another way to resolve the problem.

TPIRs sit alongside other regulatory tools, such as general rules (including non-temporary product intervention rules), guidance, variations of permission and supervisory and enforcement action. The choice of which approach is used in any particular situation will be made based on the facts of the case.

The regulator has published a non-exhaustive list of scenarios under which the TPIRs could be applied:

- Products that would be acceptable but for the inclusion or exclusion of particular features
- Products where there is a significant incentive for inappropriate or indiscriminate targeting of consumers
- Markets where firms restrict their product range or access to their product range in ways designed to increase profitability by restricting consumer choice, reducing competition, or creating barriers to search, switching, or entry

- Products which may bring about significant detriment as a result of being inappropriately targeted
- In particularly serious cases, a product may be considered inherently flawed – for example, a product that has such disadvantageous features that the majority of consumers, or specified types of consumer, are unlikely to benefit

Outcomes-focused approach

An outcomes-focused approach means placing greater reliance on principles and high level rules as a means to achieve the regulatory aims, and less reliance on detailed prescriptive rules. The FCA's aim is to focus more clearly on the outcomes regulators want to achieve, leaving more of the judgement calls on how to achieve those outcomes to the senior management of the firms.

This does not mean the FCA is a purely principles-based regulator. In certain areas it continues to rely on detailed rules and prescriptive processes in order to ensure adequate consumer protection or to adequately implement EU legislation.

Rationale behind outcomes-focused regulation

Past experience in regulation suggests that prescriptive standards have been unable to prevent misconduct. The ever-expanding rule books, designed to prevent misdemeanour, have not stopped further mis-selling, market misconduct or any other detrimental activity.

An outcomes-focused approach is seen as better as it will:

- Allow for regulation that focuses on outcomes rather than prescription, which is more likely to support development and innovation
- Allow for accessibility, particularly for smaller firms, that do not generally have access to deep compliance or legal expertise, where the amount of detailed rules can be bewildering
- Finally, a large volume of detailed, prescriptive and highly complex rules can divert attention towards adhering to the letter rather than the purpose of regulatory standards

For these reasons, the FCA believes that further enhancing its risk-based and evidence-based approach to regulation with an increased emphasis on principles and outcomes is the way to progress its regulatory regime.

Treating customers fairly

The FCA’s Treating Customers Fairly (TCF) initiative is intended to reinforce Principle 6 (Customers’ interests). It is a core part of the FCA’s move to a more principles-based approach to regulation. The TCF initiative aims to introduce a step-change in the behaviour of the financial services sector and to deliver six improved outcomes for consumers.

These outcomes are summarised below:

- Outcome 1: Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture
- Outcome 2: Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly
- Outcome 3: Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale
- Outcome 4: Where consumers receive advice, the advice is suitable and takes account of their circumstances

- Outcome 5: Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect
- Outcome 6: Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint

5.3. The FCA risk-based approach to supervision

The FCA takes a risk-based approach to its supervisory role, targeting its resources in such a way as to give most supervisory effort to those activities that pose the greatest risk to the successful fulfillment of its statutory objectives.

Firm Systematic Framework

The name of the supervisory tool used by the FCA is the 'Firm Systematic Framework' (FSF). FSF will use a common framework across all sectors, which is targeted to the type of firm. The common features involve:

- *Governance and culture* - assess the effectiveness of a firm's process for identifying, managing and reducing conduct risks
- *Product design* - determine the processes a firm has in relation to determining whether products meet customer's needs
- *Sales or transaction processes* - assess firm's systems and controls
- *Post-sales/services and transaction handling* - how effective are firm's processes to ensure customers are treated fairly after the point of dale service or transaction, and including complaints handling
- Business Model and Strategy analysis - to give a view on how sustainable the business would be in respect of conduct, and where the future risk might lie (linking with the Business Model Threshold condition check carried out at authorisation)
- Assessment of how the firm embeds fair treatment of customers and ensures market integrity. The assessment has four modules:
- Deciding what actions are required by the firm - addressing issues highlighted by the FCA
- Communication to the firm - setting out the assessment and actions required

Categorisation of Firms by the FCA

The FCA will categorise all firms for the purposes of conduct supervision and will categorise FCA-regulated firms for prudential supervision.

The conduct supervision categories are C1, C2, C3, C4.

C1 and C2 firms are judged to pose the greatest risks to consumers or market integrity, while C3 and C4 firms are considered to have a lower impact on the FCA's objectives. In general, the list of firms in each category are as follows:

- C1 includes banks and insurance groups with a very large number of retail customers and universal or investment banks with very large client assets and trading operations
- C2 includes firms across all sectors with a substantial number of retail customers or significant wholesale firms
- C3 includes firms across all sectors with retail customers or a significant wholesale presence

- C4 includes smaller firms, including almost all intermediaries

5.4. Enforcement and disciplinary powers of the FCA

Introduction

The FCA is obliged to ensure that participants in the marketplace comply with the law and relevant regulations.

Compliance by firms with regulatory requirements is the responsibility of management. The Supervision Sourcebook produced by the FCA highlights the FCA's approach to this responsibility.

Information gathering by the FCA

Direct supervision by the FCA is carried out via supervision visits by FCA enforcement officers.

The FCA normally expects to give reasonable notice of a visit. However, a firm must permit representatives of the FCA to have access **with** or **without notice** during normal business hours.

FSMA 2000 has granted the FCA certain statutory powers to assist it in its ability to investigate and gather information. FCA surveillance officers can:

- Demand the production of documents, tapes, files, computer data or any other information required by the FCA (copies of which may be removed)
- Demand that **any** employees make themselves available for interview

The FCA can demand that meetings take place at the FCA or the firm's premises.

Cooperation by firms and individuals

The FCA expects senior management to take steps to remedy any shortfall by the firm (or individuals working for it) in relation to the regulatory requirements.

Where consumers suffer loss as a result, the FCA seeks to ensure redress is provided.

The FCA has the **legal power** to require an authorised firm, RIE or RCH to produce information and/or documentation. It is also a criminal offence not to cooperate with the FCA during an investigation or to provide false or misleading information.

During the course of an investigation there is no automatic requirement that the firm (or individual) stops trading.

5.5. Disciplinary process and measures

Regulatory Decisions Committee (RDC)

Although the FCA does have executive powers to make decisions regarding the disciplinary process, it will usually refer more significant matters to the Regulatory Decisions Committee (RDC).

The RDC is accountable to the board of the FCA, but is operationally independent of the FCA. RDC members represent the public interest and are drawn from financial services practitioners and non-practitioners. The only FCA employee is the Chair of the RDC.

The RDC will inform the person under investigation of its progress through the issuance of **statutory notices** and other notices. These notices are:

- **Warning notice**: this provides details of the disciplinary actions or formal procedures the regulator proposes to take
- **Decision notice**: this provides details of the disciplinary actions or formal procedures the regulator has decided to take after representations. The action may differ from that set out in the warning notice
- **Further decision notice**: this is an amendment to a decision notice and can only be issued with the recipient's consent
- **Final notice**: this sets out the terms of final action that the regulator has decided to take once formal procedures have been completed. It states the date from which this action takes effect.
- **Supervisory notice**: this is preventative and protective rather than disciplinary. The notice will normally have immediate effect.
- **Notice of discontinuance**: this is issued where the investigation is being discontinued. This can be issued at any stage in the investigation
- **Private warning**: this is issued when, despite having concerns regarding the behaviour of a firm or individual, the FCA may decide that it is not appropriate to bring formal disciplinary action

The disciplinary process

Typical events surrounding a disciplinary process are as follows:

- Investigation and preliminary findings: The enforcement officers investigate a firm or individual through their information gathering powers. They formulate their preliminary findings and send these to the RDC
- RDC primary assessment: Based on these findings the RDC can issue a warning notice, supervisory notice, notice of discontinuance or private warning to the firm or individual.
- Representation to the RDC: The firm has the right to make a representation to the RDC, either orally or in writing. The regulators must give the firm or individual at least 28 days to make this representation.
- RDC secondary assessment: The RDC can issue a decision notice, a supervisory notice or a notice of discontinuance to the firm or individual.
- Formal appeal to the Upper Tribunal: If a firm or individual has been issued a supervisory notice or (further) decision notice, they can appeal against theses to the Upper Tribunal (Tax and Chancery Chamber). The firm or individual must be given at least 28 days to launch this appeal.
- Final decision: Any action to be taken by the regulators against the firm or individual is finalised at this stage. The final notice will be published on the regulator's website, unless publication would be prejudicial to the interests of consumers.

Decision on disciplinary measures

When the FCA identifies a breach by a firm or individual during an investigation, it has the power to take disciplinary action. Under Section 66 of FSMA 2000, the FCA must commence disciplinary action within three years of first being aware of misconduct.

In deciding whether or not to take disciplinary action the FCA will consider the following factors:

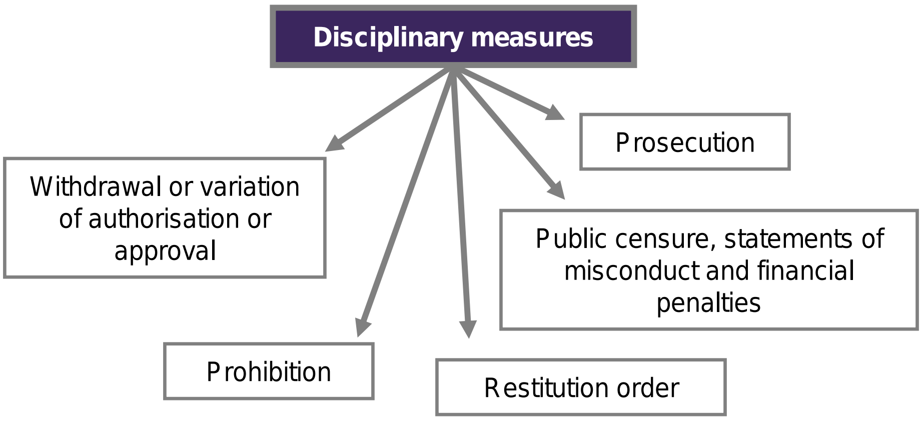
- The nature and seriousness of the breach
- The conduct of the firm or approved person after the breach

- The previous regulatory record of the firm
- The degree of cooperation during the investigation process

Disciplinary measures

The regulator may choose to perform any of the following disciplinary measures:

- Vary or withdraw authorised status
- Withdraw approved person status
- Issue a prohibition order (S56 FSMA 2000)
- Public censure indicating a firm's contravention of FSMA 2000
- Statements of misconducts issued to individuals
- Financial penalties imposed on individuals and firms
- Restitution orders to restore clients to a position they held before any regulatory breach
- Prosecution, if the act is deemed criminal by the regulator, for example insider dealing or money laundering



6. The Regulated Activities Order

6.1. The General Prohibition

Introduction

As previously mentioned, FSMA 2000 provides the statutory framework for regulation of investment and other sorts of financial business in the UK.

Of particular importance is the legal requirement that firms must be properly authorised before being permitted to carry out regulated activities.

This requirement is spelt out in the **general prohibition**, found in S19 FSMA 2000.

The General prohibition (S19 FSMA 2000)

The general prohibition states that "no person may carry on a regulated activity in the UK unless he is an authorised person or an exempt person".

The consequence of the general prohibition is to control entry into the financial services industry with the aim of protecting investors.

Note: in general, it is **firms** (not individuals) that obtain authorisation under FSMA 2000.

Key issues

General prohibition: key issues

- The definition of **regulated activities**: the Act defines these as carrying out **specified activities** in relation to **specified investments**
- The procedures by which a firm becomes **authorised**
- The categories of **exempt** persons

Note that the procedures a firm has to take to become authorised, and the categories of exempt persons, are considered in the next chapter which deals with the regulation of market participants. Here, the focus is on the first key issue: to define what is meant by 'specified investments' and 'specified activities'.

The Regulated Activities Order

Specified activities and specified investments are defined in the Regulated Activities Order 2001.

The Regulated Activities Order is secondary legislation, approved by Parliament, once the primary legislation of FSMA 2000 has been completed.

For example, the requirement to be authorised comes from S19 FSMA 2000 (primary legislation). The detailed definitions of what constitutes a regulated activity is provided by the Regulated Activities Order 2001 (secondary legislation).

The Regulated Activities Order effectively acts as an appendix to the main Act.

6.2. Specified activities

Specified activities are defined in the Regulated Activities Order 2001.

Authorisation (or exemption) under FSMA 2000 is required before firms can carry out these activities.

The **specified activities** are as follows:

- Dealing in investments: buying, selling, subscribing for or underwriting investments, either as agent or principal
- Arranging deals in investments: matching buyers and sellers
- Managing investments: exercising discretion over investment decisions
- Advising on investments: only where the advice relates to securities, contractually based investments and mortgages (i.e. not deposits)
- Operating a Multi-lateral Trading Facility (MTF): a system which brings together multiple buyers and sellers of financial instruments in a way that results in a contract. Formerly known as an Alternative Trading System (ATS)
- Safeguarding and administering investments: safeguarding covers acting as a custodian of investments on behalf of another. Administering relates to services provided to the owner or manager of investments (e.g. settlement)
- Establishing, operating or winding up a collective investment scheme or stakeholder pension scheme: includes acting as a trustee of an authorised unit trust (AUT) and acting as a depositary of an investment company with variable capital (ICVC)
- Sending dematerialised instructions: electronic transfers of title to securities (e.g. CREST)
- Effecting or carrying out contracts of insurance (general and life) as principal and assisting in the administration and performance of a contract of insurance
- Lloyd's activities: certain activities in relation to Lloyd's are regulated, such as managing the underwriting capacity of a Lloyd's syndicate
- Providing funeral plan contracts
- Entering into and administering a regulated mortgage contract: this includes mortgage advice, administration and mortgage lending
- Home finance activities
- Accepting deposits
- Issuing electronic money (e-money) which can be used to pay for goods and services instead of cash, e.g. Paypal
- Agreeing to carry out most regulated activities
- Bidding in emissions auctions
- Operating or managing a dormant account fund

6.3. Excluded activities

The following activities are **not** regulated and do not require authorisation under FSMA 2000:

- Investment advice in newspapers: advice that takes the form of regularly updated news or information provided that the provision of investment advice is not the primary purpose of the newspaper or publication. Note that **tip sheets** (issued by financial institutions) are not excluded

- Television broadcasts and similar activities

- Providing information: organisations such as Reuters and Bloomberg do not need to be authorised

- Trustees, nominees and personal representatives: the trustee or representative **must not receive remuneration**

It therefore follows that a trustee of an authorised unit trust would need to be authorised as they are paid for their services.

- Operating an employee share scheme

- Providing insurance as principal is covered but **not** the activities of loss adjusters

- Trading on one's own account: transactions are not regulated if the principal investor is also the end user and no service is offered to others, i.e. a person buying shares for himself/herself does not need to be authorised provided that he/she is not holding himself/herself out to be a dealer in the investments

- Dealing in contracts for foreign exchange

- Overseas person: defined as firms which do not carry out regulated activities from a permanent place of business within the UK. This exception covers two categories. The activity will be excluded provided that the overseas firm conducts its activities in the UK through an authorised or exempt firm or where the activity is the result of an unsolicited approach by a UK individual; for example, if a UK individual asks a US broker to buy US shares, the firm does not need to be authorised under FSMA 2000.

6.4. Specified investments

Specified investments are defined by the Regulated Activities Order as being regulated under FSMA 2000. They are:

- Shares in companies: any corporate or unincorporated body constituted under UK or overseas law

- Certificates representing securities, e.g. depositary receipts

- Warrants: the right to buy a new share in a company

- Debt instruments: both public and private issues

- Units in collective investment schemes: both units in unit trusts and shares in investment companies with variable capital (ICVCs). Note that ICVCs are sometimes referred to as open-ended investment companies (OEICs)

- Options to buy or sell:

  - Other investments

  - Currencies

  - Precious metals - gold, silver, platinum and palladium
  - Options on these options
- Futures contracts for **investment** (or **speculative**) purposes

The definition does **not** apply where contracts are used for **risk management** (i.e. commercial or hedging) purposes.

Note that contracts traded on Recognised Investment Exchanges are presumed to be for investment purposes. Unless the examiner tells you otherwise you should assume that futures are for investment purposes and therefore are specified investments.

- Contracts for differences (e.g. the FTSE 100 future, interest rate swaps (IRSs), forward rate agreements (FRAs) for interest rates, spread bets and rolling spot forex contracts)
- Lloyd's syndicates: individuals and companies whose combined financial backing provides the underwriting capacity for insurance and re-insurance markets
- Rights under contracts of insurance: both general (e.g. home and motor insurance) and life policies are covered. Note that car breakdown insurance is specifically excluded
- Rights in a stakeholder pension: private pensions for employees who are not part of a company pension or for the self-employed
- Rights under a funeral plan: savings schemes to provide funds for a funeral on death
- Rights under a regulated mortgage contract. In a regulated mortgage, the loan is secured by a first legal mortgage or it is on a property which is located in the UK, which will be occupied (at least 40% of the time) by the borrower or their family
- Home finance - this takes two forms: home reversion plans and home purchase plans
  - Home reversion plans are where a homeowner sells all or part of their home to a plan provider in return for a lump sum or a series of cash flows. However, the homeowner retains the right to live in the property until death or some other event causes them to vacate the property
  - Home purchase plans are an alternative way to purchase a house without taking out an interest bearing mortgage. These are designed to fit in with Islamic Law
- Deposits: certain banking activities are within the scope of FSMA
- Rights or interests in investments, e.g. repos in relation to specified investments

6.5. Excluded investments

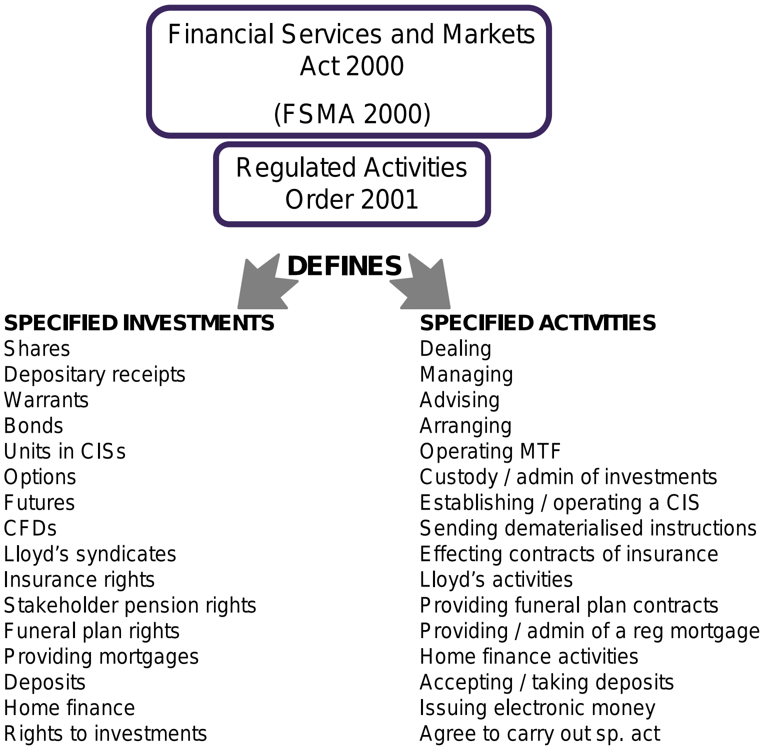
Excluded investments are those items that are **not** defined as specified investments by the Regulated Activities Order 2001. Consequently, firms whose only activity is in relation to these 'investments' do **not** require authorisation under FSMA 2000.

The following are excluded investments:

- Physical property (e.g. land, antiques and commodities)
- Currencies and transactions in currencies (e.g. spot and forward contracts for foreign exchange)
- Premium bonds

- National Savings Certificates (in fact, **all** National Savings Bank products)

6.6. Specified investments and specified activities



6.7. Contravention of the general prohibition

Criminal offences and penalties

S23 FSMA 2000 makes it a criminal offence to carry on a regulated activity without authorisation or exemption.

The FCA has the power to **prosecute** these offences and to institute civil enforcement proceedings. The maximum criminal penalty for breaking the general prohibition is two years in jail and an unlimited fine.

Civil remedies

The FCA may also seek civil intervention and can ask a court for:

- Injunctions against likely or continuing breaches, orders to remedy such breaches and freezing orders against likely disposals of assets
- Restitution orders for profits obtained, or losses suffered by others
- Compulsory administration, bankruptcy or winding-up orders for inability to pay debts or, in the last case, because it would be just and equitable

Voidable contracts

Contracts entered into where there has been a breach of the general prohibition are **voidable** at the option of the investor.

The investor has the following choices:

- Enforce the contract: rely on the agreement and sue for damages if any loss is suffered
- Avoid the contract: the investor has the right to his/her money back

7. Summary

7.1. Key concepts

Introduction to financial markets

- LO 1.1.1 - The features of the financial markets
- LO 1.1.2 - The role and impact of financial institutions
- LO 1.1.3 - The role of the government in the financial markets

European Union (EU)

- LO 3.1.1 - The legal status of EU directives and regulations within the UK
- LO 3.1.2 - The role and powers of the European Securities and Markets Authority
- LO 3.1.4 - The purpose and scope of the Undertakings for Collective Investment in Transferable Securities (UCITS) Directives
- LO 3.1.5 - The purpose and scope of the European Market Infrastructure Directive

Regulatory environment

- LO 3.2.1 - The roles of the Financial Conduct Authority (FCA), Prudential Regulation Authority (PRA), Bank of England, Financial Policy Committee (FPC) and HM Treasury
- LO 3.2.6 - The function of the Information Commissioner's Office (NOTE: the rest of this objective is covered in Chapter 6: Other Regulatory Requirements)
- LO 3.2.2 - The different roles of the FCA and the PRA for dual-regulated firms

The Financial Conduct Authority

- LO 3.3.1 - The role and statutory objectives of the FCA
- LO 3.3.2 - The blocks of the FCA Handbook
- LO 3.5.18 - The FCA's approach to temporary product intervention
- LO 3.6.1 - The risk-based approach to supervision and the enforcement and disciplinary powers of the FCA

The general prohibition

- LO 3.2.3 - The scope of the Financial Services and Markets Act 2000 (as amended by the Financial Services Act 2012)
- LO 3.2.4 - The scope of the Regulated Activities Order 2001 (as amended) in terms of specified activities and specified investments

Now you have finished this chapter you should attempt the chapter questions.

Authorised and approved persons

1. Introduction

1.1. Chapter overview

In the previous chapter, you read about the general prohibition of FSMA 2000. This chapter explains what is meant by **authorised** persons and defines the categories of **exempt** persons. As a general rule, an authorised person refers to a firm rather than an individual.

On the other hand, individuals working for an authorised firm and performing a **controlled function** would have to become **approved**. It may seem a small point but it is important that you appreciate the correct terminology. From now on, references to '**authorised persons**' will mean firms, while references to '**approved persons**' will mean individuals. You will learn of the two main ways in which a firm may obtain authorised status.

You will also be introduced to various codes of ethics, on which you could be asked to comment in the exam. These are the **principles for business** for authorised firms and the **statements of principle** for approved persons. In addition to the FCA's codes there are also CFA codes and principles that need to be understood and adhered to.

1.2. Learning outcomes

On completion of this module you will:

Authorised persons

- LO 3.3.5 - Explain, in outline, the procedures for authorisation of firms, including knowledge of the threshold conditions and liaison with the PRA where relevant

Markets in Financial Instruments Directive (MiFID)

- LO 3.1.3 - Explain the purpose and scope of the Markets in Financial Instruments Directive (MiFID) with respect to: passporting, roles of the home state and host state, core and non-core investment services, financial instruments covered by the legislation

Exempt persons

- LO 3.2.3 - Explain the scope of the Financial Services and Markets Act (FSMA) 2000 (as amended by the Financial Services Act 2012) (Exempt persons)

- LO 3.4.2 - Explain the need for, and relevance of, investment exchanges needing to be recognised by the FCA

- LO 3.4.3 - Explain how the Bank of England regulates clearing houses

- LO 3.4.4 - Identify the recognised investment exchanges and clearing houses in the UK

Principles for Businesses

- LO 3.3.3 – Identify the FCA's Principles for Businesses and explain their application and purpose

- LO 3.3.4 – Explain the consequences of breaching the FCA's Principles of Businesses

- LO 3.2.5 – Explain the purpose and scope of the FCA's rules regarding Senior Management Arrangements, Systems and Controls (SYSC)

Controlled functions and approved persons

- LO 3.3.10 - Define a controlled function and identify the types of controlled functions defined within the FCA
- LO 3.3.8 - Explain the application procedure for an Approved Person (SUP 10) and how the PRA may also be involved
- LO 3.3.7 - Identify the main assessment criteria in the FCA's Fit and Proper Test for Approved Persons (FIT)
- LO 3.3.9 - Explain the procedure for an Approved Person moving within a group and how the PRA may also be involved (SUP 10)

Statements of Principle

- LO 3.3.6 - Define an Approved Person and explain the application and purpose of the Statements of Principle and Code of Practice for Approved Persons (APER)

Training and competence and the retail distribution review

- LO 3.3.11 - Explain the requirements relating to training and competence (TC 1-3)
- LO 3.3.12 - Explain the professionalism requirements that have to met by retail investment advisers and investment managers (TC 1-3)
- LO 3.5.17 - Explain the rules on adviser charging and remuneration (COBS 6.3 & 6.4)
- LO 3.5.24 - Distinguish between independent advice and restricted advice (COBS 6.2A)

Code of ethics and professional standards

- LO 2.2.1 - Identify the elements of the CFA Code of Ethics and Standards of Professional Conduct
- LO 2.2.2 - Explain the professional principles and values on which the CFA Code of Ethics and Standards of Professional Conduct is based
- LO 2.2.3 - Apply the CFA Code of Ethics and Standards of Professional Conduct to a range of ethical dilemmas
- LO 2.1.1 - Describe the need for ethics in the investment industry
- LO 2.1.2 - Identify the ethical obligations to clients, prospective clients, employers and co-workers
- LO 2.1.3 - Identify positive and negative behavioural indicators
- LO 2.1.4 - Critically evaluate the outcomes which may result from behaving ethically - for the industry, individual advisers, and consumers. **(This will be tested in the question bank)**
- LO 2.1.5 - Critically evaluate the outcomes which may result from limiting behaviour to compliance within the rules - for the industry, individual advisers, and consumers. **(This will be tested in the question bank)**

2. Authorised persons

2.1. Basic requirement

FSMA 2000 requires any person undertaking regulated activities in the UK to be **one** of the following:

- An authorised person
- An exempt person

As a general rule, firms rather than individuals apply to become authorised under FSMA 2000. To this effect, an authorised (or exempt) person refers to a firm.

Individuals, on the other hand, apply to become 'approved'. This procedure is discussed later in this chapter.

It is both a criminal and civil offence to conduct unauthorised investment activity as it is a breach of the general prohibition (S19 FSMA 2000) - see Chapter 1 for details.

2.2. Authorisation

As discussed below, there are two principal types of authorisation: Part 4A permission and passporting.

Part 4A permission

Applications to the FCA under Part 4A of FSMA 2000 may be made by:

- An individual (sole trader)
- A body corporate (including a branch of a body corporate) - i.e. a company
- A partnership
- An unincorporated association (which is not an authorised person and which wishes to apply to carry on regulated activities in the UK)

The regulator (FCA or PRA) has to satisfy itself that the applicant has sufficient financial resources and management skills to undertake the relevant functions (i.e. is 'fit and proper'). Although it is firms that apply for authorisation, the regulator will also consider the fitness and properness of all individuals in a position of responsibility as well as the firm itself.

Applicants must apply in respect of each business activity they wish to pursue. Authorisation is specific, not general.

If the application is accepted, the firm will receive written notification of the decision and the regulator's register of authorised persons is updated.

Alternatively, the regulators grant authorisation subject to limitations or for a narrower scope of business than was originally requested, or may simply reject the application outright.

Threshold conditions

In order for an applicant to obtain permission, the regulator must be satisfied that it is fit and proper. In accordance with S41 FSMA, a firm must meet and continue to satisfy the following 'threshold conditions' for the activity concerned. The regulator provides guidance to the threshold conditions in the 'COND'

Sourcebook, contained within the High Level Standards block of the Handbook. Note that the threshold conditions are also restated in the Supervision Sourcebook (abbreviated to 'SUP') in the Regulatory Processes block of the Handbook.

In brackets, we have stated which regulator is responsible for assessing this threshold condition.

Legal status (PRA only)

Sets out the legal status that the applicant must have if it wishes to carry on certain regulated activities.

Location of offices (FCA for single-regulated and PRA for dual-regulated)

Provides that a company must have its head office and registered office in the UK.

Effective supervision (FCA for single-regulated and both for dual-regulated)

Relates to the effect of group companies and controlling shareholders on supervisability. The regulator must be satisfied that a controlling shareholder will not prevent the regulator from effective regulation. For these purposes, a close link is defined as a company or individual owning 20% or more of the voting capital of the applicant.

Appropriate resources (FCA for single-regulated only)

Relates to the appropriateness of an applicant's financial resources and non-financial resources such as human capital.

Appropriate non-financial resources (FCA for dual-regulated only)

Relates to the appropriateness of an applicant's non-financial resources such as human capital.

Business to be conducted in a prudent manner (PRA only)

Relates to the appropriateness of an applicant's financial resources and non-financial resources.

Fitness and propriety (suitability) of the applicant (FCA for single regulated and both for dual-regulated)

Relates to the ethical suitability of the applicant, i.e. the firm must be considered to be 'fit and proper' - in particular the management and staff of the firm must be competent.

Business model (FCA for single regulated and both for dual-regulated)

This is a new threshold condition (from 1 April 2013) requiring a firm’s business strategy to be suitable for the type of firm carrying on comparable regulated activities. Matters relevant to determining the suitability of business strategies will include business model compatibility with affairs being conducted in a sound and prudent manner. The Firm will further need to conduct its activities in the interests of consumers and with the integrity of the UK financial system in mind.

Apportionment of a claims representatitive (PRA only)

This is relevant to insurance companies only.

Dual-regulated firms

Note that a dual-regulated firm must apply to the PRA to vary or cancel its Part 4A permission. The PRA may determine an application to vary permission only with the consent of the FCA. An FCA-only regulated firm will have to apply to the FCA to vary or cancel its Part 4A permission except where it seeks to vary its permission to include a PRA-regulated activity, in which case it must apply to the PRA.

Passporting

Another way to obtain authorisation to conduct regulated activity in the UK is to be 'passported' into the UK via a European Directive.

There are various directives allowing a firm already authorised in one EEA state to carry on investment business in the UK. These include:

- MiFID
- The UCITS Directive (Undertakings for Collective Investments in Transferable Securities)

The UCITS Directive allows collective investment schemes (CIS) to be passported.

MiFID allows investment services **firms** to be passported into the UK, without the need for Part 4A permission, and is discussed in detail below.

3. Markets in Financial Instruments Directive (MiFID)

3.1. Introduction

As discussed in Chapter 1 the UK regulatory framework is influenced by both UK and European law.

European law seeks to promote a single European marketplace. It achieves this via directives, which are agreed amongst member states and incorporated into the local statutory frameworks.

The main objectives of MiFID are to:

- Increase post-trade transparency across the EEA
- Ensure best execution of trades across the EEA
- Ensure cost effective execution venues are available across the EEA

MiFID allows investment services firms to be passported into the UK and throughout the EEA.

3.2. The EEA

Under the scope of MiFID, investment businesses can set up branches in other countries in the EEA without having to seek local authorisation. The arrangement is often known as 'passporting'.

The EEA comprises:

- European Union (EU) countries
- Norway
- Iceland
- Liechtenstein

For example, a German stockbroker would be able to set up a UK branch by asking its local regulator, who would in turn contact the FCA, i.e. the firm requires permission from both its home state and the FCA.

You will **not** be examined on which countries are members of the EEA.

3.3. MiFID: scope

Investment services and activities

MiFID applies to any firm whose head office and registered office are situated in the same EEA state and which conducts investment services and activities, as defined by MiFID.

These activities are often referred to as 'core' activities and include:

- Reception and transmission of orders in relation to one or more financial instruments
- Execution of orders on behalf of clients
- Dealing on own account
- Portfolio management

- Investment advice
- Underwriting and placing of financial instruments
- Operation of multi-lateral trading facilities (MTFs)

However, in order to acquire a passport to provide these services throughout the EEA, the activities must be conducted with regard to MiFID instruments (investments).

Instruments covered by MiFID

MiFID instruments include:

- Transferable securities, e.g. shares, bonds and CFDs
- Money market instruments
- Units in collective investment schemes
- Derivatives relating to securities, currencies, interest rates or yields
- Commodity derivatives
- Credit derivatives
- Financial contracts for differences
- Other derivatives (relating, e.g. to climate variables or other statistics)

Summary of scope

In summary, a firm conducting any activities in investments within the scope of MiFID is considered to be doing MiFID business.

For example, a UK firm offering dealing services in bonds would need Part 4A permission from the FCA, and would then be allowed to passport its services throughout the EEA as the firm is conducting MiFID business.

However, a UK firm offering advice on pensions would also need Part 4A permission from the FCA, but would **not** be able to passport its services throughout the EEA.

From this example, you can see that MiFID business does not cover the full range of business listed under the Regulated Activities Order (RAO). The most notable omissions are that retail products: mortgage business, insurance business and pension business are not considered MiFID business.

Nevertheless, MiFID business can be seen as a subsection of the business covered in the RAO.

On a final note, a firm that conducts MiFID business will be referred to as a MiFID firm. The title 'MiFID firm' is determined by the business that the firm conducts and **not** by whether or not the firm has chosen to passport that business.

Ancillary services (non-core)

Under MiFID, a firm which carries out ancillary services only will not be a MiFID firm and will, therefore, not be able to benefit from passporting its services into other member states.

However, if a firm carries on both core activities and ancillary services, it will be subject to MiFID and will be able to provide these services in other member states. Ancillary services can, therefore, be deemed ‘passportable’ on the condition that they are accompanied by at least one core activity.

Ancillary services include:

- Safekeeping and administration of financial instruments, including custody and related services
- Granting loans to an investor (to carry out a transaction in which the firm is involved)
- Advice to undertakings on capital structure and on mergers and acquisitions
- Foreign exchange services
- Investment research and financial analysis
- Services related to underwriting

3.4. MiFID: responsibilities of the respective regulators

Once a firm has passported its business, inevitably that firm will have responsibilities to regulators in both its **home** state and **host** state.

Home state

The home state is the state in which the firm has their registered office.

The home state regulator will take responsibility for:

- Authorisation
- Prudential supervision, such as the capital adequacy rules
- Conduct of business rules, when conducting business in the home states
- Conduct of business rules, when conducting business in the host state from an office outside that host state. This is often referred to as cross-border selling
- Client asset rules, such as the custody rules and client money rules

Host state

The host state is the state into which the firm has passported their business.

The host state regulator will take responsibility for:

- Conduct of business rules, when conducting business in the host state from a branch office in the host state
- Other rules, such as the approval of controlled functions

Note: under the FCA conduct of business rules, EEA firms permitted to operate in the UK (incoming firms) must notify retail clients in writing regarding which rules are governed by the home state.

4. Exempt persons

4.1. Introduction

Certain categories of persons carrying on regulated activities do not require any authorisation under FSMA 2000.

Such a person is called an **exempt person**, as defined by the Exemption Order.

The most important exempt persons are:

- Appointed representatives
- Recognised investment exchanges and clearing houses
- Lloyd's syndicate members
- Members of designated professional bodies
- Other exempted persons

Each category of exempt person is described below.

4.2. Appointed representatives

Large firms selling directly to the public often engage the services of self-employed representatives. These individuals are known as appointed representatives (or **tied agents**) and do not need individual authorisation from the FCA. Firms, as well as individuals, may also act as appointed representatives of a product provider, such as a life assurance company.

An appointed representative will only provide advice on the products and services of a single product provider. This contrasts with an independent financial advisor (IFA) who is permitted to advise on the marketplace as a whole. Consequently, IFAs must obtain authorisation.

The employing firm is responsible for ensuring that appointed representatives meet the 'fit and proper' criteria, and must take **complete responsibility** for their actions and omissions.

4.3. Recognised Investment Exchanges (RIEs)

Certain investment exchanges need to be **recognised** by the FCA in order to provide services to their customers. The regulators will insist on the exchange meeting ‘recognition requirements’ set out in FSMA 2000. These requirements include:

- High standards of integrity, sufficient financial resources and co-operation with regulators
- Business on the exchange is conducted in an orderly manner and dealings are limited to investments in which there is a proper market
- Effective monitoring and recording of transactions
- Rules setting out procedures in the event of a default by a member of the exchange
- Arrangements for investigating complaints

As recognised investment exchanges have been subject to rigorous conditions, they are exempt from the requirements of the authorisation process.

This is the current list of RIEs:

- BATS Trading
- CME Europe
- Euronext UK Markets
- London Stock Exchange (LSE)
- Liffe Administration and Management (NYSE.Liffe)
- London Metal Exchange (LME)
- ICE futures
- ICAP Securities and Derivatives Exchange (ISDX)

You will only be tested explicitly on LSE and NYSE.Liffe.

Recognised Overseas Investment Exchanges (ROIEs)

Certain overseas exchanges which can be accessed electronically from the UK are known as **recognised overseas investment exchanges (ROIEs)**.

Examples of ROIEs include:

- Nasdaq
- Chicago Mercantile Exchange (CME Group)
- Swiss Stock Exchange
- EUREX
- Australian Securities Exchange

Recognition is given by the FCA.

You will not be tested explicitly on any of these exchanges.

Designated Investment Exchanges (DIEs)

The FCA **designates** other overseas exchanges, which would have met the recognition criteria if they had been situated in the UK but are, in fact, based overseas. Examples of DIEs include the New York Stock Exchange, the Tokyo Stock Exchange and the Chicago Board Options Exchange (CBOE).

Note that DIEs are **not** exempt persons, as they do not fall under the FCA's jurisdiction in the first place.

You will not be tested explicitly on any of these exchanges.

4.4. Recognised Clearing Houses (RCHs)

Agreements to buy and sell securities take place on exchanges but the delivery of the security in return for cash will happen through a clearing house.

The previous regulator (FSA) had responsibility for recognising and supervising both RIEs and RCHs. The FSA 2012 transferred responsibility for regulating settlement systems and RCHs, collectively known as Financial Market Infrastructures (FMIs), to the Bank of England. Institutions providing both exchange services and central counterparty systems will be regulated jointly by the BoE for its RCH activities and by the FCA for its exchange services.

The Bank of England recognises five clearing houses in the UK:

- Euroclear UK and Ireland who operate the CREST system
- LCH.Clearnet
- ICE Clear Europe Limited
- CME Clearing Europe
- LME Clear

You will only be tested explicitly on Euroclear UK and Ireland and LCH.Cleanet.

4.5. Recognised Overseas Clearing Houses (ROCHs)

The Bank of England has recognised and supervises a number of Recognised Overseas Clearing Houses (ROCHs). These include:

- ICE Clear US Limited
- SIS X-clear AG
- The Chicago Mercantile Exchange [CME] Clearing

You will not be tested explicitly on any of these clearing houses.

4.6. Members of Lloyd's

Whilst the Society of Lloyd's itself requires authorisation under FSMA 2000, a **member** of a Lloyd's syndicate is an exempt person.

Note, however, that advising on syndicate participation, or managing a syndicate, would require authorisation.

4.7. Members of the professions

A person who is a member of a Designated Professional Body (DPB), e.g. an accountant or solicitor, and is carrying on incidental regulated activities, does not require authorisation.

This recognises the fact that certain professions are regulated by their own industry bodies in such a way that their customers can have confidence in their methods of conducting investment business.

Member firms of DPBs are not automatically granted exemption from authorisation, but must apply to their professional body for their licence. Furthermore, two other conditions must be met; these are:

- The firm only provides incidental investment services; and
- It does not receive remuneration in respect of the investment services it provides other than from its clients

Consequently, professional firms receiving commissions from unit trust or pension providers would require authorisation under FSMA 2000.

Authorisation would also need to be obtained where the investment activity is a distinct and separate business from the usual core activities of the firm.

4.8. Other particular exempted persons

Other particular exempt persons defined by secondary legislation include:

- Supranational bodies, e.g. the International Monetary Fund (IMF)
- Local authorities
- Housing associations
- The National Grid
- Trade unions
- The Treasury Taskforce
- The English Tourist Board
- Government organisations (e.g. the Bank of England, other central banks and the UK National Savings Bank)

In addition, charities and the Student Loans Company are exempt in respect of **deposit taking**.

5. Principles for Businesses

5.1. The Effect of the Principles for Businesses

The Principles are a general statement of the fundamental obligations of firms under the regulatory system. They derive their authority from the FCA rule-making powers as set out in the Act and reflect the regulatory objectives.

The Principles apply to every authorised firm.

The principles provide a basis on which the FCA may apply to a court for an injunction or restitution order or require a firm to make restitution. Breach of a principle does not, of itself, give rise to an action, but will be taken into account for purposes of discipline and intervention. The principles do not provide basis for actions by private persons in relation to damages.

5.2. The Principles for Businesses

The 11 Principles for Businesses are as follows (each Principle is set out in **bold letters**):

Integrity

A firm must conduct its business with integrity.

Those working in the financial services industry have responsibilities to clients, and any profit must be made fairly.

Skill care and diligence

A firm must conduct its business with due skill, care and diligence.

Work must be of a high standard.

Management and control

A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

This places emphasis on the way a firm is organised and managed.

Financial prudence

A firm must maintain adequate financial resources.

This builds in flexibility when a firm suffers losses or the economy takes a downturn.

Market conduct

A firm must observe proper standards of market conduct.

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 which is clear, fair and not misleading.

This allows clients to make reasoned decisions concerning their investments.

Conflicts of interest

A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.

One means of avoiding conflict is through the use of barriers to information flow within a firm, called **Chinese Walls**. In this way a sales team could be prevented from knowing any positions taken by a firm in order to avoid a potential conflict of interests.

Note that the use of Chinese Walls is not compulsory, as this would be unrealistic for very small firms with a minimal number of employees. Where Chinese Walls are not implemented, the firm must manage conflicts of interests in other ways, e.g. disclosure or declining to act for certain clients.

Customers: relationships 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 upon its judgement.

Clients' assets

A firm must arrange adequate protection for clients' assets when it is responsible for them.

Relations with regulators

A firm must deal with its regulators in an open and cooperative way and must disclose to the FCA appropriately anything relating to the firm of which the FCA would reasonably expect notice.

This Principle aims to ensure that the FCA and its member firms enjoy a relationship where the FCA can be less obtrusive in its day-to-day monitoring.

5.3. Senior management arrangements, systems and controls (SYSC): Guidance on Principle 3

Purpose

SYSC - Senior Management and Arrangements, Systems and Controls - is a sourcebook found in the High Level Standards block of the FCA Handbook.

The purposes of SYSC are:

- Further guidance as to how senior management can fulfil their responsibilities under Principle for Businesses 3: to take reasonable care to organise and control the firm's affairs
- To encourage directors and senior managers of authorised firms to take appropriate responsibility for the apportionment of responsibilities systems and controls
- To vest responsibility for that control in specific directors and senior managers
- To create a common platform for this element among firms covered by the Capital Requirements Directive and MiFID

SYSC 4: General organisational requirements

- General requirements – A firm should create clear and transparent lines of responsibility

- Persons who directly direct the business – Persons responsible for controlling the firm should be of good repute and sufficiently experienced. Where the firm is an alternative investment fund (AIF) there must be at least two such managers

- Responsibility of senior personnel – A firm must appoint senior personnel in roles responsible for the implementation of regulatory controls

- Apportionment of responsibility – A firm must apportion significant responsibilities to senior managers that are clear and appropriate. A firm must also create functions responsible for apportionment and oversight

SYSC 5: Employees, agents and other relevant persons

Where a firm appoints persons, either on permanent contracts or on a temporary basis, it must do so while ensuring:

- The skills, knowledge and expertise of the persons appointed are suitable for the roles they are performing

- There must be an adequate segregation of duties to prevent conflicts of interest

- Relevant persons are made aware of procedures that must be followed

- The systems and controls must take into consideration the nature, scale and complexity of the business and must be reviewed regularly

SYSC 6: Compliance, internal audit and financial crime

A firm must establish, implement and maintain adequate policies and procedures sufficient to ensure compliance of the firm including its managers, employees and appointed representatives (or where applicable, tied agents) with its obligations under the regulatory system and for countering the risk that the firm might be used to further financial crime.

The compliance function must also be available to advise and assist those responsible for carrying out regulated activities to comply with the firm's obligations under the regulatory system.

SYSC: Other requirements

A firm must also establish and maintain systems and controls for the monitoring and managing of risk control (SYSC 7), outsourcing of roles (SYSC 8), record keeping (SYSC 9) and conflicts of interest (SYSC 10). The risk control is then amplified in SYSC 12, 13, and 14.

SYSC: Whistleblowing

Purpose

The whistleblowing provisions aim to:

- Remind firms of the provisions of the Public Interest Disclosure Act 1998 (PIDA)

- Encourage firms to consider adopting and communicating to workers appropriate internal procedures for handling workers' concerns

Effect of PIDA

Under PIDA, any clause or term between a worker and his employer precluding the worker from making a protected disclosure ('blowing the whistle') is void.

A protected disclosure is a qualifying disclosure (one made in good faith) that tends to show that one or more of the following ('a failure') has been, is being, or is likely to be, committed:

- A criminal offence
- A failure to comply with any legal obligation
- A miscarriage of justice
- The putting of the health and safety of any individual in danger
- Damage to the environment
- Deliberate concealment relating to any of the above

Links to fitness and propriety

The FCA would regard as a serious matter any evidence that a firm had acted to the detriment of a worker because he/she had made a protected disclosure. Such evidence would call into question the fitness and propriety of the firm or relevant members of staff.

6. Controlled functions and approved persons

6.1. Controlled functions

Introduction

In total there are 18 controlled functions listed in Section 10 of the Supervision Sourcebook ('SUP 10'), which is contained within the Regulatory Processes block of the Handbook. (Although CF7 has been deleted, the FCA has not renumbered the remaining functions. So, for example, CF11 prior to the deletion of CF7 is not now CF10.) As previously described, all individuals carrying out a controlled function must be assessed as fit and proper under the approved persons regime.

If a person wishes to change functions, this will usually require a new approval. The firm has a duty to inform the FCA in writing within seven days (Form C) if an approved person ceases to perform a controlled function.

Controlled functions are grouped together under five main headings below.

Note that all functions, except those in the category of customer functions, are classed as **significant influence functions**.

For dual-regulated firms, the FCA and PRA share oversight of controlled functions.

Governing functions

(CF 1)* Director: includes 'shadow directors', e.g. directors of a holding company who may direct the directors of the firm.

(CF 2)* Non-executive director: does not undertake day-to-day executive responsibilities, but takes a broad view of the direction of the business.

(CF 3)* Chief executive: leads other directors and carries ultimate responsibility.

(CF 4)* Partner: excludes limited partners.

(CF 5)* Director of unincorporated association.

(CF 6)* Member of governing body of a small friendly society (a 'small friendly society' is a body that offers investors tax efficient savings).

Required functions

Note that it is **compulsory** for the firm to appoint someone to the following:

(CF 8) Apportionment and oversight: directors and senior managers responsible for apportioning responsibilities among staff and overseeing the establishment and maintenance of internal controls.

(CF 10) Compliance oversight: directors and senior managers responsible for compliance.

(CF10A) CASS oversight operation function.

(CF 11)* Money Laundering Reporting Officer (MLRO): the central contact internally and externally for money laundering issues.

(CF 12)* Appointed actuary: only applicable to PRA-regulated firms.

(CF 12A)* With-profits actuarial function

(CF 12B)* Lloyd's actuarial function

Systems and controls functions

(CF 28)* Systems and controls function: employee responsible for reporting to the governing body about the firm's financial affairs, its risk exposure and its internal systems and controls, procedures and policies.

Significant management functions

(CF 29) Significant management function.

In most firms, the people carrying out governing functions (i.e. the directors) and/or the systems and control functions will also be carrying out the managerial functions.

The requirement to identify individuals carrying out a significant management function is only in larger firms where there is a level of management able to influence the firm despite being below board level.

FCA guidance suggests that it is unlikely to be necessary for firms with less than 100 approved persons and/or insurance companies with gross premiums below £100m.

Where the requirement does exist, the following activities represent a significant management function:

- Designated investment business: senior managers responsible for investment services activities, e.g. head of equities
- Other business operations: senior managers responsible for non-investment services, e.g. head of retail banking
- Insurance underwriting: senior managers responsible for effecting contracts of insurance
- Financial resources: senior managers responsible for committing the firm's financial resources, e.g. acquisition of assets and overall financial planning
- Settlements: senior managers responsible for back office functions

Customer functions

(CF 30) Customer functions: covers employees who perform the functions of:

- Trainee investment advisor
- Corporate finance advisor
- advisor on syndicate participation at Lloyd's
- Customer trading
- Investment manager

Libor functions

(CF 40) Benchmark submission function

(CF 50) Benchmark administration function

Dual-regulated firms

For dual-regulated firms, the FCA and PRA share oversight of controlled functions. The asterisked functions above fall under the remit of the PRA in dual-regulated firms.

6.2. Approved persons

Approved person status: criteria

If a firm appoints an individual to perform a 'controlled function', it must also apply to the relevant regulator to grant approved person status for that individual.

The approved person regime is limited by FSMA 2000 to those who:

- Exert significant influence over the firm
- Deal with customers
- Deal with the property of customers

Note that 'deal' does not just mean undertake a transaction. Dealing with customers includes employees who have a relationship with customers and talk to them concerning a controlled function.

Firms who use non-approved persons to carry out controlled functions are liable to be sued under S71 FSMA 2000.

Fit and proper test

The FCA will only grant approved person status if the individual is fit and proper to undertake controlled functions.

When considering whether an individual is fit and proper, the FCA will take into account the activities of the firm and the markets in which it operates. For example, a person may be fit and proper to deal with market professionals but not private consumers.

The FCA has the right to discuss any application with the firm submitting the application on behalf of an employee and the right to retain notes on any discussions held.

In assessing fitness and propriety the FCA considers:

Honesty, integrity and reputation

- Criminal convictions, including old (spent) convictions as defined by the Rehabilitation of Offenders Act 1974
- Civil findings relating to financial activities
- Discipline by the FCA or other regulators
- Complaints which have been upheld
- Involvement in a company that has gone into liquidation
- Honesty and openness in dealing with the FCA
- Breaches of industry rules, e.g. FCA rules

The FCA is also entitled to look back into the last five years of a person's employment history in order to evaluate their suitability.

Competence and capability

- Exam success in appropriate qualifications
- Experience and training

Financial soundness

- Breach of a court order requiring the payment of debts
- Bankruptcy

Approval is either granted or withheld. There is no such thing as conditional approval.

After resigning as an approved person, an individual is still liable to disciplinary action from the FCA for a period of **three years**.

Where an approved person ceases to perform a controlled function, the firm must notify the FCA within **seven business days**.

Withdrawal of approval

Where the FCA believes that an individual is no longer fit and proper, it may withdraw its approval.

If the FCA decides to withdraw approval it will inform the individual by issuing a warning notice followed by a decision notice.

7. Training and Competence (TC) and the Retail Distribution Review (RDR)

7.1. Training and Competence (TC)

Introduction

The purpose of the Training and Competence (TC) Sourcebook is to define the standards that firms should achieve. The FCA then expects firms to make their own arrangements to meet these standards.

It is important to recognise the links with other parts of the FCA Handbook such as SYSC and APER, which also cover the responsibilities of approved persons in relation to systems and controls and ensuring competent staff.

S59 FSMA requires firms to take reasonable care that no person performs a controlled function without approval from the relevant regulator. Before the regulator can grant an application for such approval, it must be satisfied that the person is fit and proper. Under S61 of FSMA the fit and proper test for those requiring approval includes assessing qualifications, training and competence.

Competence means having the skills, knowledge and expertise needed to discharge the responsibility of an employee's role. This includes achieving a good standard of ethical behaviour.

Assessing and maintaining competence

Assessment of competence and supervision

A firm must not allow an employee to carry on a prescribed activity without appropriate supervision.

Where an employee is giving advice in packaged products to retail clients and has not been assessed as competent to do so, the firm must ensure that the individual supervising and assessing that employee has passed an appropriate exam.

Examination requirements before starting activities

A firm must ensure that an employee does not carry on a prescribed activity (other than an overseeing activity) for which there is an examination requirement without first passing the relevant regulatory module of an appropriate examination.

A firm must ensure that an employee does not carry on any of the following activities without first passing each module of an appropriate examination:

- 'Advising and dealing' activities (as prescribed)
- The activity of a broker fund advisor
- Advising on syndicate participation at Lloyd's
- The activity of a pension transfer specialist

A firm should select an appropriate examination from the list maintained by the FCA.

Exemptions from the requirements

There are certain circumstances where a firm would not need to follow the examination requirements set out above. These conditions are that a firm should be satisfied that an employee:

- Has at least three years' relevant experience overseas
- Has not needed to pass the examinations previously
- Has passed the relevant regulatory module of an appropriate exam

The latter two conditions do not apply to someone benefiting from the 30-day rule. This is where an employee performs a function whilst based overseas and spends no more than 30 days in the UK during any 12 months. Nevertheless, this person will need to be supervised by an appropriately approved person.

Record keeping

A firm must make appropriate records to demonstrate compliance with the rules on TC and keep them for the following periods after an employee stops carrying on the activity:

- Five years - MiFID business
- Three years - non-MiFID business
- Indefinitely - pension transfer specialist

7.2. The Retail Distribution Review (RDR)

Professionalism standards for investment advisors

The Retail Distribution Review was a review of retail advice in the UK. The result of the review led to retail investment advisors needing to increase their level of professionalism and knowledge, with the aim of improving trust in the retail investment sector. It focused on four main improvements and took effect on 1st January 2013.

Ethical standards

Ethical standards are essential in the financial services, where a large number of the population invest their hard-earned savings in an industry they do not fully understand, and possibly do not trust. Maintaining a high level of ethics in financial advice is seen as a way to enhance the perception of professionalism.

A higher level of qualification

In order to emphasise the level of professionalism in the retail advice sector, advisors are required to hold a relevant qualification of at least Level 4, as stated by Ofqual. Professional bodies, including CFA Society of the UK, created qualifications to meet this requirement. The qualification taken and passed by the advisor not only needed to meet the level of difficulty required, but also the specific focus, including ethical standards. For those that held a sufficient level of qualification, but one that did not cover all the areas necessary, there was the ability to fill the gaps with gap-fill study. The full list of qualifications and gap-fill requirements is managed by the FCA and is available in their handbook.

Continuous professional development (CPD)

Once an advisor has attained a level of knowledge, they need to actively maintain that level of knowledge through CPD. Advisors need to complete a minimum of 35 hours of CPD each year. 21 of these hours should be structured learning including courses, seminars and appropriate e-learning.

Statement of Professional Standing (SPS)

Statements of Professional Standing (SPS) are a requirement for all retail advisors and are awarded by accredited bodies.

Before awarding the SPS, accredited bodies will ensure advisors follow an appropriate code of ethics, and check that they hold an appropriate qualification. They will ensure advisors meet CPD requirements, through sample checks (at least 10%). Most accredited bodies also offer services to help record CPD, although there is no requirement for the advisors to use these.

Firms employing retail advisors are required to submit data to the FCA every 12 months about each advisor. This data will include details on the advisor's honesty, integrity and professionalism, including any complains or problems with the advisor. Accredited bodies also feed back to the FCA of advisors who no longer meet the standards required to obtain the SPS – failure to attain the appropriate CPD for example.

Failure to meet or continue to meet these standards will result in the FCA preventing the advisor from making personal recommendations to retail customers.

Advisor charging

Introduction

Since the end of 2012, new rules have governed those firms making personal recommendations to retail clients. The rules cover both independent and restricted advisors (but not basic advice) in the UK who offer advice in a retail investment product.

Elimination of commission-based advice

A key element of these rules is a prohibition of advisors receiving product provider commission. This was deemed to distract the advisor firm from its duty to the client and focus instead on the commission available.

Under the RDR regime, an advisor firm must not solicit or receive any commission from the provider of a retail investment product being recommended by the advisor. The prohibition also extends to other services linked with the advice, such as arranging or administering the transaction. Reciprocal to this is a ban on the product providers offering or paying commissions to advisors.

Instead of commissions, the advisor firm will be paid an advisor charge, which has been agreed in advance by the client.

Advisor charges

The RDR rules require firms to work out an appropriate structure for charges when calculating the advisor charge. It is acceptable for this to be in a standard format like a 'price list' and not specifically tailored for each client.

This charging structure must be disclosed to the client in writing ‘in good time’ before any advice or related services are given. In conjunction with the client's best interest rule, this information should be made in ‘clear and plain language’.

The total advisor charge payable must be disclosed and agreed with the client ‘as early as practicable’ in a durable medium or via a website. Clients can then choose to pay the advisor charge upfront or have it deducted from their investment. If the client chooses to have it deducted from their investment, they must be informed of how much will be invested and what impact the deduction will have on any cancellation procedures.

Records

Firms are required to retain records of their charging structure and the total advisor charge payable by each client. If the charge greatly differs from the charging structure, the reasons for the discrepancy should be adequately recorded.

Application

The RDR rules will apply equally to:

- Independent advice – IFAs. These independent advisors will have to have knowledge of all retail investment products and not just packaged products
- Restricted advice – These are not independent and could be tied to one product provider or /multi-tied

The new rules do not apply to:

- Basic advice (advice on stakeholder products using pre-scripted questions) where advisors will still have the ability to earn commission on sales
- Non-advised services
- Execution-only sales
- Advice on stocks and shares or structured deposits

8. Statements of Principle

The FCA has also set out **seven** Statements of Principle with which approved persons (individuals) must comply:

Table 1. Statements of Principle

Statement of Principle	Possible breaches
1. Act with integrity in carrying out controlled function	Deliberately misleading by act or omission
	Deliberately recommending an unsuitable investment
	Deliberately failing to disclose a conflict of interest
2. Act with due skill, care and diligence in carrying out controlled function	Failing to inform clients or the firm of material information
	Undertaking transactions without understanding the risks
	Continuing to perform a controlled function having failed to meet the appropriate standards
3. Observe proper standards of market conduct in carrying out controlled function	Failure to comply with the Code of Market Conduct
4. Deal with the FCA and with other regulators in an open and cooperative way and disclose appropriately any information of which the FCA would reasonably expect notice	Failure to report promptly
	Failure to inform or assist the regulator when necessary
Statements of Principle 5-7 apply to significant influence function only	
5. When performing a significant influence function, take reasonable steps to ensure that the business of the firm is organised so that it can be controlled effectively	Failure to clearly set out and communicate the organisation of the business and the responsibilities of staff
	Failure to carefully review the role of staff who perform unsatisfactorily
6. When performing a significant influence function, exercise due skill, care and diligence in managing the business of the firm	Failure to keep up-to-date with events affecting their area of responsibility
	Delegating authority without checking the competence of the delegate
	Failure to supervise and monitor a person who has been delegated responsibility
7. When performing a significant influence function, take reasonable steps to ensure that the business of the firm complies with the relevant requirements and standards of the regulatory system	Failure to ensure that the business has operating procedures and systems which comply with the regulatory environment
	Failure to take timely and appropriate steps to deal with actual or suspected problems

Customer functions have to comply with the Statements of Principle 1 to 4 only. Significant influence functions have to comply with **all seven** of the Statements of Principle.

Note than an individual who breaches one or more of the Statements of Principle can be disciplined **without** the firm as a whole being disciplined. For example, an individual may mislead a client about the likely performance of an investment by providing inappropriate projections of future investment returns, despite appropriate procedures put in place by the firm. This would breach Principle 1: Integrity.

The FCA has issued a Code of Practice for Approved Persons (the Code). This sets out examples of behaviour which do not comply with the Code. The examples are not exhaustive and the descriptions only have the status of evidential provisions.

9. Code of Ethics and Professional Standards

9.1. Introduction

The CFA Institute Code of Ethics and Standards of Professional Conduct (Code and Standards) are fundamental to the values of the CFA Institute and essential to achieving its mission to lead the investment profession globally by setting high standards of education, integrity, and professional excellence. High ethical standards are critical to maintaining the public's trust in financial markets and in the investment profession.

Since their creation in the 1960s, the Code and Standards have promoted the integrity of CFA Institute members and served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations.

All CFA Institute members (including holders of the Chartered Financial Analyst® (CFA®) designation) and CFA candidates must abide by the Code and Standards and are encouraged to notify their employer of this responsibility. Violations may result in disciplinary sanctions by the CFA Institute. Sanctions can include revocation of membership, candidacy in the CFA Program, and the right to use the CFA designation.

9.2. The Code of Ethics

Members of CFA Institute (including Chartered Financial Analyst® (CFA®) charterholders) and candidates for the CFA designation ('Members and Candidates') must:

- Act with integrity, competence, diligence, respect, and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets
- Place the integrity of the investment profession and the interests of clients above their own personal interests
- Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities
- Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession
- Promote the integrity of, and uphold the rules governing, capital markets
- Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals

9.3. Standards of Professional Conduct

I. Professionalism

A. Knowledge of the Law

Members and Candidates must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organisation, licensing agency, or professional association governing their professional activities. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.

B. Independence and Objectivity

Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another's independence and objectivity.

C. Misrepresentation

Members and Candidates must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities.

D. Misconduct

Members and Candidates must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.

II. Integrity of capital markets

A. Material Non-public Information

Members and Candidates who possess material non-public information that could affect the value of an investment must not act or cause others to act on the information.

B. Market Manipulation

Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.

III. Duties to clients

A. Loyalty, Prudence, and Care

Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests. In relationships with clients, Members and Candidates must determine applicable fiduciary duty and must comply with such duty to persons and interests to whom it is owed.

B. Fair Dealing

Members and Candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.

C. Suitability

1. When Members and Candidates are in an advisory relationship with a client, they must:

   - Make a reasonable inquiry into a client's or prospective clients' investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly

   - Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action

- Judge the suitability of investments in the context of the client's total portfolio

2. When Members and Candidates are responsible for managing a portfolio to a specific mandate, strategy, or style, they must only make investment recommendations or take investment actions that are consistent with the stated objectives and constraints of the portfolio

D. Performance Presentation

When communicating investment performance information, Members or Candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.

E. Preservation of Confidentiality

Members and Candidates must keep information about current, former, and prospective clients confidential unless:

1. The information concerns illegal activities on the part of the client or prospective client.

2. Disclosure is required by law.

3. The client or prospective client permits disclosure of the information.

IV. Duties to employers

A. Loyalty

In matters related to their employment, Members and Candidates must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm to their employer.

B. Additional Compensation Arrangements

Members and Candidates must not accept gifts, benefits, compensation, or consideration that competes with, or might reasonably be expected to create a conflict of interest with, their employer's interest unless they obtain written consent from all parties involved.

C. Responsibilities of Supervisors

Members and Candidates must make reasonable efforts to detect and prevent violations of applicable laws, rules, regulations, and the Code and Standards by anyone subject to their supervision or authority.

V. Investment analysis, recommendations, and action

A. Diligence and Reasonable Basis

Members and Candidates must:

1. Exercise diligence, independence, and thoroughness in analysing investments, making investment recommendations, and taking investment actions.

2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

B. Communication with Clients and Prospective Clients

Members and Candidates must:

1. Disclose to clients and prospective clients the basic format and general principles of the investment processes used to analyse investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.
2. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.
3. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

C. Record Retention

Members and Candidates must develop and maintain appropriate records to support their investment analysis, recommendations, actions, and other investment related communications with clients and prospective clients.

VI. Conflicts of interest

A. Disclosure of Conflicts

Members and Candidates must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

B. Priority of Transactions

Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.

C. Referral Fees

Members and Candidates must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from, or paid to, others for the recommendation of products or services.

VII. Responsibilities as a CFA Institute Member or CFA Candidate

A. Conduct as Members and Candidates in the CFA Program

Members and Candidates must not engage in any conduct that compromises the reputation or integrity of the CFA Institute or the CFA designation or the integrity, validity, or security of the CFA examinations.

B. Reference to CFA Institute, the CFA designation, and the CFA Program

When referring to the CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program, Members and Candidates must not misrepresent or exaggerate the meaning or implications of membership in the CFA Institute, holding the CFA designation, or candidacy in the CFA Program.

9.4. Ethics in the investment industry

Professionalism goes beyond compliance

Of course it is very important that all participants in the financial services follow regulatory and legal stipulations in their relationships with clients and counterparties. However, it is also very important that participants understand the requirement to act with the highest levels of professional standards. This includes following professional codes of conduct, such as that of the CFA detailed the previous section of this manual.

One of the most famous avowals of the application of ethical standards at both an individual and corporate level was the Latin motto of the old London Stock Exchange, Dictum meum pactum (My word is my bond). What these short words intend to say is: you can trust me/us. There is no qualification, there is no small print, and there is no attempt to provide wriggle-room.

Another way of putting this sentiment is to memorise the following rule-of-thumb:

- Client first
- Firm second
- Self third

At the individual level, sections III and VI of the CFA Standards of Professional Conduct remind us of our ethical responsibilities towards our clients, over and above complying with the regulatory framework and our legal responsibilities. In addition, if you are guided by ethical principles, compliance with regulation is much easier!

Ethics vs. Compliance

Most of the financial services industry is heavily regulated in order to ensure clients are protected from mistreatment by more experienced practitioners. However, past experience in regulation suggests that prescriptive standards have been unable to prevent misconduct. The ever-expanding rule books, designed to prevent misdemeanour, have not stopped further mis-selling, market misconduct or any other detrimental activity.

Is unethical behaviour a product of the individual or the environment in which they operate?

There are strong arguments in favour of the latter, which is why corporate responsibility and ethical behaviour are strongly linked. This syllabus focuses in detail on the regulatory and legislative side of the financial services. However, it also covers areas of corporate responsibility, such as the Model Code, the Combined Code for Corporate Governance and the Stewardship Code. These codes actively encourage all stakeholders in business to ‘do the right thing’, and all agree that it must become part of the corporate culture from the top down, for independent directors and internal policies, in order to work. This should not, however, take away from the personal responsibility of the individual.

The key difference between ethics and compliance is summarised below:

Table 2.

Ethics	Compliance
Prevention	Detection
Principles-based	Laws/rules-based
Values-driven	Fear-driven
Implicit	Explicit
Spirit of the law	Letter of the law
Discretionary	Mandatory

Why do people behave unethically?

Firms should look at their corporate culture to identify whether the internal structures could lead to unethical behaviour. For example:

- A culture of paying 'lip-service' to non-regulatory issues
- Failure to segregate responsibilities leading to conflicts of interest
- Bonuses structured purely on amount sold, rather than the suitability of what was sold
- Lack of personal accountability
- Lack of monitoring of adherence to policies

Problems of unethical behaviour

Failure to meet client needs through unethical behaviour can impact on the financial services industry in general – for example, lack of confidence from the investors – and more specifically on individual firms – for example, damage to reputation.

The more general impact on the industry can lead to a stagnation in the economy and reactions in the government's fiscal stance on spending and taxation that could cause the economy to suffer more.

The damage to the reputation of individual firms will clearly impact on client retention, but also staff retention – most individuals are averse to being associated with unethical behaviour. It could also, in extreme cases lead to loss of regulated status.

Good ethical practice

Firm's that display a good ethical culture will push this from the top. This can be done through:

- The board's commitment to ethical practices in their business model
- Appointing a senior manager to oversee ethical behaviour
- Implementing, publicising and enforcing ethical policies
- Identifying and rewarding ethical good practice

10. Summary

10.1. Key concepts

Authorised persons

- LO 3.3.5 – The procedures for authorisation of firms, including knowledge of the threshold conditions and liaison with the PRA where relevant

Markets in Financial Instruments Directive (MiFID)

- LO 3.1.3 – The purpose and scope of the Markets in Fiancial Instruments Directive (MiFID) with respect to: passporting, roles of the home state and host state, core and non-core investment services, financial instruments covered by the legislation

Exempt persons

- LO 3.2.3 - The scope of the Financial Services and Markets Act (FSMA) 2000 (as amended by the Financial Services Act 2012) (Exempt persons)
- LO 3.4.2 – The need for, and relevance of, investment exchanges needing to be recognised by the FCA
- LO 3.4.3 – How the Bank of England regulates clearing houses
- LO 3.4.4 – The recognised investment exchanges and clearing houses in the UK

Principles for Businesses

- LO 3.3.3 – The FCA's Principles for Businesses and explain their application and purpose
- LO 3.3.4 – The consequences of breaching the FCA's Principles of Businesses
- LO 3.2.5 – The purpose and scope of the FCA's rules regarding Senior Management Arrangements, Systems and Controls (SYSC)

Controlled functions and approved persons

- LO 3.3.10 - A controlled function and identify the types of controlled functions defined within the FCA
- LO 3.3.8 - The application procedure for an Approved Person (SUP 10) and how the PRA may also be involved
- LO 3.3.7 - The main assessment criteria in the FCA's Fit and Proper Test for Approved Persons (FIT)
- LO 3.3.9 - The procedure for an Approved Person moving within a group and how the PRA may also be involved (SUP 10)

Statements of Principle

- LO 3.3.6 - An Approved Person and the application and purpose of the Statements of Principle and Code of Practice for Approved Persons (APER)

Training and competence and the retail distribution review

- LO 3.3.11 - The requirements relating to training and competence (TC 1-3)

- LO 3.3.12 - The professionalism requirements that have to met by retail investment advisers and investment managers (TC 1-3)
- LO 3.5.17 - The rules on adviser charging and remuneration (COBS 6.3 & 6.4)
- LO 3.5.24 - Independent advice and restricted advice (COBS 6.2A)

Code of ethics and professional standards

- LO 2.2.1 - The elements of the CFA Code of Ethics and Standards of Professional Conduct
- LO 2.2.2 - The professional principles and values on which the CFA Code of Ethics and Standards of Professional Conduct is based
- LO 2.2.3 - The CFA Code of Ethics and Standards of Professional Conduct to a range of ethical dilemmas
- LO 2.1.1 - The need for ethics in the investment industry
- LO 2.1.2 - The ethical obligations to clients, prospective clients, employers and co-workers
- LO 2.1.3 - Positive and negative behavioural indicators

Now you have finished this chapter you should attempt the chapter questions.

The conduct of business and client assets rules

1. Introduction

1.1. Chapter overview

In this chapter we look at the conduct of business rules (COBS). These rules cover the need to categorise the client a firm is working with, communications with clients, the advisory and execution services of a firm and the protection of clients' assets.

This is a long and detailed chapter and it may be worth breaking up your study of this chapter in to manageable sections.

1.2. Learning outcomes

On completion of this module you will:

Client categorisation

- LO 3.5.1 - Explain the purpose of client categorisation
- LO 3.5.2 - Distinguish between a retail client, a professional client and an eligible counterparty (COBS 3.4, 3.5 & 3.6)
- LO 3.5.3 - Apply the rules relating to treating a client as an elective professional client (COBS 3.5.3)
- LO 3.5.4 - Apply the rules relating to treating a client as an elective eligible counterparty (COBS 3.6.4)
- LO 3.5.5 - Apply the rules relating to providing clients with a higher level of protection (COBS 3.7)

Communicating with clients

- LO 3.5.7 - Explain the purpose and scope of the financial promotions rules and the exemptions from them (COBS 4.1)
- LO 3.5.13 - Explain the rules relating to systems and controls in relation to approving and communicating financial promotions (COBS 4.10)
- LO 3.5.8 - Explain the fair, clear and not misleading rule (COBS 4.2)
- LO 3.5.9 - Explain the rules relating to communications with retail clients (COBS 4.5)
- LO 3.5.10 - Explain the rules relating to past, simulated past and future performance (COBS 4.6)
- LO 3.5.11 - Explain the rules relating to direct offer promotions (COBS 4.7)
- LO 3.5.12 - Explain the rules relating to cold calls and other promotions that are not in writing (COBS 4.8)
- LO 3.5.15 - Explain the rules relating to distance marketing communications (COBS 5.1)
- LO 3.5.14 - Explain the record keeping requirements relating to financial promotions (COBS 4.11)

Packaged Product Disclosures

- LO 3.5.33 - Explain the obligations relating to preparing product information (COBS 13.1 & COLL 4.7)
- LO 3.5.34 - Explain the rules relating to the form and content of a key features document and a key investor information document (COBS 13.2, 13.3, 14.2 & COLL 4.7)
- LO 3.5.35 - Explain the rules relating to cancellation rights (COBS 15)
- LO 3.5.36 - Distinguish between packaged products and retail investment products

Information about the firm

- LO 3.5.16 - Explain the rules relating to providing information about the firm and compensation information (COBS 6.1)

Client agreements

- LO 3.5.6 - Apply the rules relating to client agreements (COBS 8.1)

Suitability

- LO 3.5.19 - Explain the rules relating to assessing suitability (COBS 9.2)

Appropriateness

- LO 3.5.20 - Explain the rules relating to assessing appropriateness (COBS 10.2)
- LO 3.5.21 - Explain the rules relating to warning a client about the appropriateness of their instructions (COBS 10.3)
- LO 3.5.22 - Identify circumstances when assessing appropriateness is not required (COBS 10.4, 10.5 & 10.6)

Dealing and managing

- 3.5.29 - Explain the purpose of the principles and rules on Conflicts of Interest, including: identify, recording and disclosing conflicts of interest and managing them to ensure the fair treatment of clients (PRIN 2.1.1, Principle 8, SYSC 10.1.1 - 7 + 10.1.8 / 9 + 10.2)
- 3.5.30 - Explain the rules relating to investment research produced by a firm and disseminated to clients (COBS 12.2)
- 3.5.31 - Explain the rules relating to the publication and dissemination of non-independent research (COBS 12.3)
- 3.5.32 - Explain the disclosure requirements relating to the production and dissemination of research recommendations (COBS 12.4)
- 3.5.25 - Explain the rules relating to best execution (COBS 11.2)
- 3.5.26 - Explain the rules relating to client order handling (COBS 11.3)
- 3.5.27 - Explain the rules relating to the use of dealing commission (COBS 11.6)
- 3.5.28 - Explain the rules on personal account dealing (COBS 11.7)

Reporting information to clients

- 3.5.38 - Apply the rules relating to occasional reporting to clients (COBS 16.2)
- 3.5.39 - Apply the rules relating to periodic reporting to clients (COBS 16.3)
- 3.5.40 - Explain the rules relating to reporting on the progress of an authorised fund to unit holders (COLL 4.5)
- 3.5.37 - Apply the rules relating to record keeping for client orders and transactions (COBS 11.5)

Client assets

- 3.5.41 - Explain the concept of fiduciary duty
- 3.5.42 - Explain the application and purpose of the rules relating to custody of client assets held in connection with MiFID business (CASS 6.1)
- 3.5.43 - Explain the rules relating to the protection of clients' assets and having adequate organisational arrangements (CASS 6.2)
- 3.5.44 - Explain the rules relating to depositing assets with third parties (CASS 6.3)
- 3.5.45 - Explain the purpose of the rules relating to the use of clients' assets (CASS 6.4)
- 3.5.46 - Explain the rules relating to records, accounts and reconciliations of clients' assets (CASS 6.5)
- 3.5.47 - Explain the application and general purpose of the client money rules (CASS 7.2)
- 3.5.48 - Explain the rules relating to the segregation of client money (CASS 7.4)
- 3.5.49 - Explain the rules relating to records, accounts and reconciliations of clients' assets (CASS 7.6)
- 3.5.50 - Explain the rules relating to mandate accounts (CASS 8)

2. Contextual Points

2.1. The general application rule

The COBS rules apply to all authorised firms which carry on the following activities:

- Accepting deposits i.e. commercial banking
- Long-term insurance business in relation to life policies
- Designated investment business

The term 'designated investment business' covers fewer activities than the full range of 'regulated activities' (as defined in FSMA 2000 and discussed in Chapter 1). It does not include mortgages and home finance, general insurance (i.e. car and house insurance), or pure protection products (e.g. a life policy with a life of less than ten years and no surrender value).

You are not expected to know what activities are and are not designated investment business.

2.2. Appointed representatives

The COBS rules apply directly to a firm. They apply indirectly to the appointed representative of a firm.

An appointed representative is:

- A party to a contract with an authorised person (his/her principal) which permits or requires him to carry on business
- Someone for whose activities the authorised person has accepted responsibility in writing

An example of an appointed representative is a self-employed advisor who sells the firm's products.

Although the COBS do not apply directly to a firm's appointed representatives, a firm will always be **directly** responsible for the acts and omissions of its appointed representatives in carrying on business for which the firm has accepted responsibility.

2.3. MiFID business

Many of the rules distinguish between designated investment business and MiFID business.

MiFID business is discussed in Chapter 2 in detail. It is a much narrower range of activities than designated investment business. It can, however, be seen as a subsection of designated investment business.

In the context of the COBS rules it will be sufficient for you to know if the rule applies for all designated investment business or MiFID business.

2.4. Durable medium

The FCA often states that a firm must provide information in a durable form. It has a distinct definition of a durable form or medium.

A durable medium is any of the following:

- Paper

- Any instrument which enables the recipient to store information in an accessible way for future reference which allows the unchanged reproduction of information stored. Examples of this are:
  - Floppy disks
  - CD-ROMs
  - DVDs
  - The hard drive of the recipient's computer
- But **not** internet websites unless they fulfil the criteria in this definition

The firm should use an appropriate durable medium for the business carried out.

The durable medium should also be chosen by the recipient.

3. Client Categorisation

3.1. The purpose of client categorisation

Client categorisation is a vital process for the firm to perform, as only by categorising a client can a firm know which rules to apply.

There are three categories of client:

- Retail clients
- Professional clients
- Eligible counterparties

The formal definition of a client includes more than just existing customers of a firm. You may come across the following expressions:

- 'Consumer' – this refers to a natural person who is a retail client
- 'Customer' – this refers to retail clients and professional clients, but not eligible counterparties
- 'Client' – this refers to any or all of retail clients, professional clients, and eligible counterparties

Therefore, we can say that clients are customers (professional clients and retail clients) and eligible counterparties.

The following persons are defined as a client of a firm:

- A person to whom the firm provides a service or an ancillary service (in the case of MiFID business)
- A potential client
- In relation to the financial promotion rules, a person to whom a financial promotion is communicated by or on behalf of the firm
- A client of an appointed representative of the firm

3.2. General notifications to clients

A firm must notify a client of its categorisation (as a retail client, professional client or eligible counterparty) and, before providing any services, inform the client in a durable medium about any right the client has to request a different categorisation and about any limitations to the level of client protection.

Of the three categories, an eligible counterparty is not technically a client. You will see later in this section that eligible counterparties are the most knowledgeable and experienced parties in the markets, and when these parties conduct certain business with each other it becomes difficult to identify who is the firm and who is the client.

For this reason, the FCA creates the eligible counterparty category to show that we are not looking at a firm doing business for a client, but equals doing business with each other.

3.3. Retail clients

A retail client is a client who is not a professional client or an eligible counterparty. This will normally be individuals and small businesses.

3.4. Professional clients

A professional client is either a **per se** professional client or an **elective** professional client.

A per se professional client is automatically a professional client.

An elective professional client **chooses** to be a professional client.

Per se professional clients

This is the full list of per se professional clients.

1. Firstly, it is organisations required to be authorised or regulated to operate in the financial markets, including:
   - A credit institution
   - An investment firm
   - Any other authorised or regulated financial institution
   - An insurance company
   - An authorised CIS (or its management company)
   - A pension fund (or its management company)
   - A commodity or commodity derivatives dealer
   - A local (i.e. a self-employed trader on an open-outcry exchange)
   - Any other institutional investor
2. Next, in relation to MiFID business, an undertaking can be a 'per se' professional client if it meets **two** out of the **three** tests below:
   - Balance sheet total of €20m
   - Net turnover of €40m
   - Own funds of €2m
3. In relation to non-MiFID business the tests are different:
   - A company or limited liability partnership (LLP) with called up share capital of at least £5m; or
   - A company meeting **two** of the following **three** size requirements:
     - Balance sheet total of €12.5m
     - Net turnover of €25m
     - Average number of employees: 250
4. A national or regional government (such as a local authority), a public body that manages public debt, a central bank, an international or supranational institution (such as the World Bank or the IMF) or another similar international organisation

5. An institutional investor whose main activity is to invest in financial instruments (MiFID business) or designated investments (non-MiFID business)

Elective professional clients

Elective professional clients are those that are not automatically professional clients. These clients can choose to be treated as such. Normally a client would choose to do this because they would be charged lower fees by the firm.

A firm may treat a client as an elective professional client if it complies with:

- The 'qualitative test'; and
- The procedures; and
- The 'quantitative test'

Qualitative test

The firm must check that the client is able to be a professional client.

In particular the 'qualitative test' requires the firm to undertake an adequate assessment of the expertise, experience and knowledge of the client. This must give reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making its own investment decisions and understands the risks involved.

The procedures

The procedures require that:

- The client must state in writing that it wishes to be treated as a professional client (either generally or in respect of a particular service or transaction or type of transaction or product)
- The firm must give the client a clear written warning of the protections and investor compensation rights the client may lose
- The client must state in writing, in a separate document from the contract, that it is aware of the consequences of losing such protections

In summary, this is a **three-way** process. The client states it wants this treatment, the firm provides details of the consequences and the client confirms it understands this.

Quantitative test

The 'quantitative test' only applies to MiFID business.

This requires that at least **two** of the following criteria are satisfied:

- The client has carried out transactions, of significant size, on the relevant market at an average frequency of ten per quarter over the previous four quarters
- The size of the client's financial instrument portfolio (defined as including cash deposits and financial instruments) exceeds €500,000
- The client has relevant work experience. In particular, the client works, or has worked, in the financial sector for at least one year in a professional position. This position must require knowledge of the transactions or services to be undertaken

Other points to note about electing up

The following further points about elective professional clients should be noted:

- If the client is an entity, the qualitative test should be performed in relation to the person authorised to carry out transactions on its behalf
- An elective professional client should not be pressured to possess market knowledge and experience comparable to a per se professional client

What if a client no longer meets the test?

There should be systematic reviews of professional clients to ensure that they still meet the requirements. If the firm becomes aware that an elective professional client no longer fulfils the relevant initial conditions for elective status, the firm may need to recategorise the client as a retail client. If the client is recategorised, it must be notified of this.

3.5. Eligible counterparties

An eligible counterparty is either a per se eligible counterparty or an elective eligible counterparty.

In relation to MiFID business, a client can only be an eligible counterparty in relation to eligible counterparty business.

Eligible counterparty business

Eligible counterparty business comprises services and activities carried on with or for an eligible counterparty in the areas of dealing on the accounts, execution of orders on behalf of clients or reception and transmission of orders (or any ancillary services directly related to these).

Essentially eligible counterparty business can be summarised as acting as principal broker or transmitting to a third party with an eligible counterparty.

Per se eligible counterparties

The following are per se eligible counterparties (this includes entities from inside and outside the EEA):

- An investment firm
- A credit institution
- An insurance company
- A UCITS scheme (or its management company)
- A pension fund (or its management company)
- Another authorised or regulated EEA financial institution
- Certain own account dealers in commodities or commodity derivatives
- A national government (including a body dealing with public debt)
- A central bank
- A supranational organisation, such as the IMF or World Bank

Elective eligible counterparties

The status of being an elective eligible counterparty is only available to an undertaking (not to an individual).

An elective eligible counterparty may be:

- Any per se professional client (except an institutional investor)
- Any elective professional client who asks for this status (but only in respect of services or transactions for which it could be treated as a professional client)

In relation to MiFID business, the firm must obtain express confirmation from the client that it agrees to be treated as an eligible counterparty (this confirmation may be either in the form of a general agreement or in respect of each individual transaction). So a client can choose to be a professional client for one type of business and choose to be an eligible counterparty for another business type.

Who cannot be an elective eligible counterparty?

As an eligible counterparty is provided with less protection, two types of client cannot be eligible counterparties. These are:

- Individuals
- Other institutional investors (e.g. SPVs)

3.6. Providing clients with a higher level of protection

A per se eligible counterparty may be treated as a professional client or a retail client; and a per se professional client may be treated as a retail client. This may be done either on the firm's own initiative or at the request of the client.

Where a per se eligible counterparty asks to be subject to conduct of business protections, the firm must treat that client as a professional client (unless the client expressly requests treatment as a retail client).

In relation to the MiFID business, if a per se eligible counterparty or a per se professional client requests treatment as a retail client, it must enter into a written agreement with the firm specifying the scope of the recategorisation (i.e. what services or transactions it applies to).

Recategorising a client as a retail client under these provisions does not necessarily mean that it will become an eligible complainant or can use the Financial Ombudsman Service (FOS).

3.7. Policies and procedures

Policies and procedures

A firm must have in place appropriate written internal policies and procedures to categorise its clients.

4. Communicating with clients, including financial promotions

4.1. Financial promotions: sources of regulation

The financial promotion rules are complicated and involve two separate, but linked, sources of regulation.

These are:

- S21 FSMA 2000
- Conduct of business rules

Each of these is explained in more detail below.

4.2. S21 FSMA 2000

A financial promotion is an invitation or inducement to engage in investment.

S21 FSMA 2000 imposes a restriction on the communication of financial promotions by unauthorised persons. A person **must not** communicate a financial promotion unless:

- An authorised person; or
- The content of the financial promotion is approved by an authorised person

This rule amplifies:

- Principle 6 (customers' interests) which requires a firm to pay due regard to the interests of its customers and treat them fairly; and
- Principle 7 (communications with clients) which requires a firm to pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading

Breach of S21 carries a penalty of two years in jail and an unlimited fine.

4.3. Approving financial promotions

Before a firm approves a financial promotion for communication by an unauthorised person, it must confirm that the financial promotion complies with the financial promotion rules and it must withdraw its approval if at any time it becomes aware that this is no longer the case, and notify any person known to be relying on its approval.

A firm must not approve a financial promotion to be made in the course of a personal visit, telephone conversation or any other interactive dialogue.

Relying on another firm's confirmation of compliance

A firm may communicate a financial promotion which has been:

- Produced by another person

- Approved (as regards confirmation of compliance with the financial promotion rules) by another firm

So long as it takes reasonable care to establish that the confirmation of compliance was validly given and has not been withdrawn.

4.4. Types of communication

Communication media

There are no restrictions on the types of media that can be used for financial promotions. Examples of means of communication include:

- Printed advertising
- Radio and television broadcasts
- Personal visit
- Telephone call
- Email
- Internet
- Electronic media such as digital and interactive television

Financial promotions: examples

Financial promotions can therefore take the following forms:

- Product brochures
- General advertising in magazines, newspapers, radio and television programmes and websites
- Mailshots: post, fax, email and other media
- Telemarketing activities such as telephone calls from call centres
- Presentations to groups of individuals
- Tip sheets

Non-written communications

A **non-written** financial promotion is a financial promotion made during the course of:

- A personal visit
- A telephone conversation
- Other interactive dialogue

Contact can be initiated by the client, in which case it is described as '**solicited**'; or by the firm, in which case it is '**unsolicited**' (an unsolicited real-time communication is, of course, simply an elaborate regulatory description of a cold call).

Written promotions

Promotions other than non-written are termed as written. These are traditional advertisements such as letters, emails, websites and newspapers.

With **written** promotions there is no personal interaction between the firm and the client.

The meaning of 'made', 'directed at' and 'recipient'

A communication being **made** to another person is a reference to a communication being addressed, whether verbally or in writing, to a **particular** person or persons (e.g. where it is contained in a telephone call or letter).

A communication being **directed** at persons is a reference to a communication being addressed to persons **generally** (e.g. where it is contained in a television broadcast or website).

A **recipient** of a communication is the person to whom the communication is made or (in the case of a non-real-time financial promotion which is directed at persons generally) any person who reads or hears the communication.

4.5. Financial promotion conduct of business rules

In general, the conduct of business rules apply when a firm:

- Communicates with a client in the UK
- Communicates a financial promotion (or approves one for communication) to a person in the UK

The conduct of business rules also apply to the communication of a cold call to a person outside the UK (unless the cold call is made from a place outside the UK for the purposes of non-UK business).

4.6. Fair, clear and not misleading communications

The fair, clear and not misleading rule

A firm must ensure that a communication by the firm or a business or a financial promotion communicated or approved by the firm is fair, clear and not misleading.

The rule applies to a firm that communicates to a client in relation to designated investment business.

This rule does **not** apply to financial promotions communicated by the firm that:

- Are excluded communications
- Are non-retail communications

An example of an excluded communication is a one-off financial promotion that is not a cold call (i.e. a promotion communicated only to one recipient, or only to one group of recipients, in relation to a product or service that has been tailored to the particular circumstances).

A non-retail communication is one made only to eligible counterparties or professional clients.

4.7. Other general rules

A financial promotion addressed to a client must be clearly identifiable as a financial promotion. This does not apply in the case of 'image advertising', which is a communication consisting only of the name and logo of the firm, a contact point and the types of regulated activities (and associated fees or commissions) provided by the firm.

Any reference in advertising to an investor compensation scheme must be limited to a factual reference to the scheme.

4.8. Communication with retail clients

Information contained in a communication or financial promotion that is addressed to, or likely to be received by, a retail client must:

- Include the name of the firm
- Be accurate and give fair balance between relevant investment benefits
- Be sufficient for, and comprehensible by, the average likely recipient
- Avoid disguising, diminishing or obscuring important items, statements or warnings

The FCA makes particular reference to identifying capital at risk products.

Where comparative information is provided, the comparison must be meaningful and presented in a fair and balanced way.

Any reference to a particular tax treatment must prominently state that this depends on individual circumstances and may be subject to change in the future.

4.9. Past, simulated past and future performance

Past performance

Where information communicated by a firm contains an indication of past performance (e.g. of an investment or a financial index), the following rules apply:

- That indication must not be the most prominent feature of the communication
- Performance information must cover at least the last five years (or the whole available period, if less), and must be based on complete 12-month periods
- The reference period and source information must be stated
- There must be a prominent warning that the figures refer to the past and that past performance is not a reliable indicator of future results
- The currency must be clearly stated (if different from that of the EEA state where the retail client is resident), together with a warning about the effect of currency fluctuations
- If the indication is based on gross performance, the effect of commissions, fees or charges must be disclosed

Simulated past performance

When information contains an indication of simulated past performance, this must:

- Relate to an investment or a financial index and be based on the actual past performance of an investment or financial index which is the same as, or underlies, the investment concerned
- Comply with the same rules as apply to indication of past performance (above)

Future performance

Where information contains an indication of future performance, this must:

- Not be based on, or refer to, simulated past performance
- Be based on reasonable assumptions supported by objective data
- Disclose the effect of commissions, fees or charges (if based on gross performance)
- Contain a prominent warning that such forecasts are not a reliable indicator of future performance

4.10. Direct offer financial promotions

Direct offer financial promotions are financial promotions that enable a person to enter into an agreement with a firm by responding in a specified manner (such as completing a tear-off or coupon in a newspaper or magazine).

If it is likely to be received by a retail client, a direct offer financial promotion must contain:

- Such as the information set out in the disclosure of information rules (in COBS 6) as is relevant to the product or service being promoted (this covers information about the firm, its services, the safeguarding of investments, cost and charges)
- If it does not relate to MiFID business, additional appropriate information enabling the client to understand the nature and risks of the investment and to take investment decisions on an informed basis

Exemptions

- For MiFID business:
  - Image advertising
- For non-MiFID business:
  - Excluded communications under the FPO
  - Deposits (**not** ISA or CTF deposits)
  - Pure protections contracts

4.11. Promotions that are not in writing

When a firm initiates a non-written financial promotion communicated to a particular person outside the firm's premises, the person communicating must:

- Only do so at an appropriate time of day
- Identify him/herself and the firm he/she represents at the outset and make clear the purpose of the communication
- Clarify that the client can continue with or terminate the communication at any time
- Give a contact point to any client with whom he/she arranges an appointment

4.12. Cold calls and other promotions that are not in writing

Restriction on cold calling

A firm may only make a cold call in one of the following three circumstances:

- The recipient of the cold call has an established existing client relationship with the firm and envisages receiving cold calls
- The cold call relates to a generally marketable product (which is not a higher volatility fund)
- The cold call relates to activities where the only investments involved are readily realisable securities (other than warrants) and generally marketplace non-geared packaged products

'Packaged products' are defined as:

- A life policy
- A unit in a regulated collective investment scheme
- A stakeholder pension scheme
- An interest in an investment trust savings scheme
- A personal pension scheme

'Higher volatility funds' are defined as regulated CIS in which the price of units is likely to fluctuate significantly because of investments by the fund in warrants or derivatives or because of long-term borrowing.

'Readily realisable securities' are defined as:

- A government or public security
- Any other security which is listed and regularly traded on an EEA exchange or regularly traded on RIE

4.13. Distance Marketing Directive (DMD)

The DMD aims to ensure that for consumers (defined below) there is a consistent cross-border approach to providing both information about a product and cancellation rights when business is conducted either in writing, electronically or over the telephone (distance contracts).

This information includes:

- Information about the firm
- Information about the financial service
- Information about the contract
- Information about redress

This information must be provided in a clear and comprehensible manner.

5. Packaged Product Disclosures

5.1. Product disclosure: purpose

Under Principle 7 (communications with clients) firms must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.

A firm must prepare a key features document for each packaged product in good time before that document has to be provided.

Packaged products

Packaged products are any of the following products:

- A life policy
- A unit in a regulated collective investment scheme
- A stakeholder pension scheme
- An interest in an investment trust savings scheme
- A personal pension scheme

Key features disclosures are also required for:

- Cash deposit ISAs
- Cash deposit Child Trust Funds (CTFs)

5.2. Key features document (KFD)

Key features must be provided in a ‘durable medium’ and must also:

- Be produced and presented to at least the same quality and standard as the sales or marketing material used to promote the relevant product
- Display the firm's brand at least as prominently as any other
- Include the 'key facts' logo in a prominent position at the top of the document
- Include the following statement in a prominent position:
  - 'The Financial Conduct Authority is the independent financial services regulator. It requires us, [provider name], to give you this important information to help you to decide whether our [product name] is right for you. You should read this document carefully so that you understand what you are buying, and then keep it safe for future reference.'

Contents of a KFD

A KFD must:

- Include enough information about the nature and complexity of the product
- Explain:
  - The arrangements for handling complaints about the product

- That compensation might be available from the FSCS
- Details covering the right to cancel or withdraw exists
- (For a CTF) that stakeholder CTFs, cash-deposit CTFs and share CTFs are available and which type the firm is offering
- (For a personal pension scheme) clearly and prominently, that stakeholder pension schemes are generally available and might meet the client's needs as well as the scheme on offer

5.3. UCITS IV: CIS Key Investor Information Document (KIID)

One of the key provisions of the new UCITS IV directive is the introduction of Key Investor Information Documents (KIIDs) for UCITS-compliant collective investment schemes. These replaced the simplified prospectus documents of UCITS III, which was felt to have several deficiencies. The KIID is aimed at retail investors, and should be couched in language that retail investors will find simple to understand. The KIID must be clear, fair and not misleading, and should include only information that a retail investor would need to make an informed investment decision. The following items are necessary in the KIID:

- Identification of the scheme
- A short description of the scheme's investment objectives and investment policy
- Past performance information, or if relevant, performance scenarios
- Costs and associated charges
- The risk/reward profile of the scheme, including risk warnings where appropriate

5.4. The client's right to cancel

Application

This rule applies to:

- Most providers of retail financial products that are based on deposits or designated investments
- Firms that enter into distance contracts with consumers that relate to accepting deposits or designated investment business

A consumer has a right to cancel any of the following contracts with a firm:

- Life policies and pension schemes within 30 calendar days
- Any other packaged product within 14 calendar days

Start of cancellation period

The cancellation period begins on the latter of:

- The day of the conclusion of the contract, except in respect of contracts relating to life policies where the time limit will begin from the time when the consumer is informed that the contract has been concluded
- From the day on which the consumer receives the contractual terms and conditions and any other pre-contractual information

Disclosing a right to cancel or withdraw

The firm must disclose in a durable medium to the consumer in good time before or, if that is not possible, immediately after the consumer is bound by a contract that attracts a right to cancel or withdraw.

5.5. Retail investment products

The description 'retail investment products' is a new classification that has been introduced by the FCA and purposely broadens the definition for the old packaged products. A summary of the differences is below:

Table 3. Retail investment products

Packaged product	Retail investment product
A life policy	Life policies (including investment bonds)
A unit in regulated collective investment schemes	Units in regulated and unregulated collective investment schemes
An interest in an investment trust savings scheme	An interest in an investment trust savings scheme
A stakeholder pension	A stakeholder pension/group stakeholder pension
A personal pension	A personal pension scheme (including self-invested personal pensions)/group personal pension scheme
	Share in an investment trust
	Structured capital at risk products
	Any other product that has been packaged in order to change the features of the product

5.6. Inducements

Rule on inducements

In relation to designated investment business or, in the case of MiFID business, another ancillary service, a firm must not pay to, or accept from, a person other than the client (or someone acting on the client's behalf) any fee or commission (or provide or receive any non-monetary benefit) unless the following conditions are satisfied:

- The fee, commission or benefit does not impair compliance with the firm's duty to act in the best interests of the client
- The firm clearly discloses to the client the existence, nature and amount of the fee, commission or benefit before providing the service, but this disclosure requirement is subject to the following qualifications:
  - In the case of business other than MiFID business, disclosure is only required if the business includes giving a personal recommendation in relation to a packaged product
  - In the case of business other than MiFID business, disclosure is not required if the benefit falls within the table of reasonable non-monetary benefits (see below)
  - Disclosure is not required where a firm is giving basic advice on a stakeholder product
- In the case of MiFID business, the fee, commission or benefit is designed to enhance the quality of the service to the client

Proper fees which are necessary for the provision of the business or ancillary services (such as custody costs, settlement and exchange fees, legal fees, etc.) are permissible since, by their nature, they cannot give rise to conflicts with the firm's duties to act honestly, fairly and professionally in accordance with the best interest of its clients.

Reasonable non-monetary benefits

In relation to the sale of packaged products, the FCA has drawn up a table of reasonable non-monetary benefits (referred to above) which may usually be given by a product provider (such as a life assurance company or a unit trust operator) to a firm (such as an IFA). The table includes the following items:

- Gifts, hospitality and promotional prizes of a reasonable value
- Assistance in promoting packaged products
- Generic product literature (i.e. letterheads, leaflets, forms and envelopes)

Record keeping: inducements

Where a firm gives a fee, commission or benefit to another firm it must make a record and keep it for at least five years from the date on which the fee etc. was given.

6. Information about the firm, its services and remuneration

6.1. Information disclosure before providing services

General requirements

A firm must provide appropriate information in a comprehensive form to a client about:

- The firm and its services
- Designated investments and proposed investment strategies (including appropriate guidance and warnings about the risks associated with these investments and strategies)
- Execution venues
- Costs and associated charges

The client must be able to understand the nature and risks of the service and of the specific type of investment being offered.

The information may be provided in a standardised format.

This rule applies in relation to MiFID business.

Where the rule applies it relates to a derivative, a warrant or stock lending activity for a retail client. The requirement to provide information about designated investments and proposed investment strategies also applies to business other than MiFID business.

6.2. Further information to be provided

A firm must provide a retail client and (in the case of MiFID business) any client with prescribed information. This includes:

- Information about the firm and its services:
  - Name and address of the firm and appropriate contact details
  - Method and language of communication
  - Statement that the firm is authorised (and the name of its competent authority i.e. regulator)
  - Whether the firm is acting through an appointed representative (or a tied agent)
  - Details of occasional and periodical reporting
  - Conflicts of interest policy
- Information about safeguarding of designated investments and client money
- Information about costs and associated charges

This information must be provided in a durable medium, whether before any service is provided or (if this is impossible, as where an agreement is concluded by distance communication) immediately after starting to provide the service.

A firm carrying on MiFID business must also make available information to enable a client to identify any relevant investor compensation scheme.

Most of the information about the firm, its services, the investments, fees and charges will be provided in an initial disclosure document (IDD) to retail clients before engaging in business.

6.3. Information by a firm that manages investments

If a firm proposes to manage investments for a retail client, the following information must be provided so as to enable the client to assess the firm's performance:

- The method and frequency of valuation of the client portfolio
- Details of any third party who may provide the discretionary management
- Information of any benchmark against which the performance of the client portfolio will be compared
- The types of designated investments that may be included in the client portfolio and the types of transactions that may be carried out in those designated investments
- The management objectives, the level of risk and any specific constraints on the management of the portfolio

6.4. Safeguarding of client's designated investments and money

A firm that holds designated investments or client money for a retail client must provide that client with the following information:

- If held by a third party
  - The responsibility of the firm for any acts or omissions by the third party
  - The consequences for the client of the insolvency of the third party
- If the designated investments belonging are not segregated from those of the third party or of the firm, notify the retail client and warn of the resulting risks
- If the accounts of the client will be subject to the law of jurisdiction other than that of an EEA state and an indication that the rights of the client may differ accordingly
- If applicable, about the existence and terms of any security interest or lien which the firm has or may have over the client's designated investments or client money
- A summary description of the steps which the firm takes to ensure the protection of the designated investments belonging to the client or client money it holds

Before entering into stock lending of a retail client's assets, a firm has to provide the clients, in a durable medium, which contains clear, full and accurate information on the obligations and responsibilities of the firm with respect to the use of those designated investments.

6.5. Information about the cost and associated charges

A firm must provide a retail client with information on costs and associated charges including, if applicable:

- The total price to be paid by the client in connection with the designated investment or the designated investment business or ancillary service

- If paid in a foreign currency, the applicable currency conversion rates and costs
- Notice of the possibility that other costs, including taxes, may arise for the client
- Arrangements for payment

6.6. Compensation information

A firm carrying on MiFID business must inform their client of any relevant compensation scheme available to the client, for example the Financial Services Compensation Scheme.

This information must include the amount and scope of cover available, and any rules affecting the claims process. These rules may include any formalities or conditions that the client may face. This information must be made available in a durable medium in the official language (or languages) of the EEA state.

6.7. Timing and medium

Timing

The firm must make these disclosures in good time before the provision of services.

The disclosure of information can be made immediately after starting to provide services if by request of the client the agreement was concluded through distance marketing.

Clients must be informed of any material changes by durable medium in good time.

Medium

The information should be provided:

- In a durable medium; or
- On the website, where the website conditions have been fulfilled

7. Client agreements

The conduct of business rules describe a client agreement as a written basic agreement between the firm and the client, which sets out the essential rights and obligations of the firm and the client.

A client agreement is required when a firm carries on designated investment business for retail clients and (in relation to MiFID business) for professional clients. It must be provided in a durable medium.

A client agreement is not required where a firm is effecting contracts of insurance in relation to a life policy issued, or to be issued, by the firm in principal.

The firm must provide the client with the terms of agreement before the earlier of:

- The client agreement becoming binding
- The provision of any services

At the same time, the firm must provide the client with information about itself and its services, as required by COBS 6 (see previous section), including information on communications, conflicts of interest and authorised status.

(This rule on timing is relaxed in the case of an agreement concluded by distance communication).

8. Suitability

8.1. Application

The rules on suitability apply to a firm which makes a personal recommendation in a designated investment or which manages investments.

In the case of non-MiFID business the rules only apply if:

- The client is a retail client
- The firm is managing the assets of an occupational pension scheme, stakeholder pension scheme or personal pension scheme

8.2. Assessing suitability: the obligations

A firm must take reasonable steps to ensure that a personal recommendation, or a decision to trade, is suitable for its client.

In order to assess suitability, the firm must obtain appropriate information about the client's:

- Investment knowledge and experience
- Financial situation
- Investment objectives

The firm must obtain this information from the client, and it must be sufficient to give the firm a reasonable basis for believing that a proposed transaction:

- Meets the client’s investment objectives
- Is such that the client is able financially to bear any related investment risks consistent with the client's investment objectives
- Is such that the client has the necessary experience and knowledge to understand those risks

The firm is entitled to rely on the information provided by the client (unless it is aware that the information is manifestly out of date, inaccurate or incomplete).

Note (importantly) that if the firm does **not** obtain the necessary information to assess the suitability, it must **not** make a personal recommendation to the client or take a decision to trade for the client.

In the case of MiFID business conducted with professional clients, the firm is entitled to assume:

- In the case of all professional clients, that they have the necessary experience and knowledge to understand the risks; and
- In the case of per se professional clients, that they are able financially to bear any related investment risks

Churning (which is overtrading in securities) and switching (which is overtrading in packaged products) were both formerly prohibited under the conduct of business rules. The motivation behind the practice was to generate commission for the firms, rather than act in the best interests of the client. A reference to churning and switching is still retained in the present rules as guidance in identifying practices that would not pass the suitability report.

8.3. Suitability reports

Transactions requiring a suitability report

Some personal recommendations made by a firm to a retail client must be supported by a suitability report. This is where the recommendation relates to:

- Transactions in a regulated CIS, an interest in an investment trust savings scheme or an investment trust where the shares are to be held in a PEP or ISA
- The purchase, sale or surrender of, or conversion or conciliation of rights under or suspension of contributions to, a personal pension scheme or a stakeholders' pension scheme
- An election to make income withdrawals or to purchase a short-term annuity
- Entering into a pension transfer or pension opt-out

A suitability report is also required to support a personal recommendation made by a firm to any client in relation to a life policy.

There are some circumstances where the obligation to provide a suitability report does not apply. These include:

- A recommendation about a regulated CIS where the firm is acting as investment manager for a retail client
- The client is habitually resident outside the EEA and is not in the UK at that time

Context of suitability report

The suitability report must, at least:

- Specify the client's demands and needs
- Explain why the firm believes that the recommended transaction is suitable for the client
- Explain any possible disadvantages of the transaction for the client

Timing of suitability report

The firm must provide the suitability report to the client:

- In the case of a life policy – before the contract is concluded (unless immediate cover is necessary)
- In the case of a personal pension scheme or stakeholder pension scheme – no later than 14 days after the contract is concluded (this is tied in with the timing of cancellation rights, which are not included in your syllabus)
- In any other case – at, or as soon as possible after, the effecting of the transaction

9. Appropriateness (for non-advised services)

9.1. Application

The rules on appropriateness apply to a firm which provides investment services in the course of MiFID business other than making a personal recommendation and managing investments. This will typically be non-advised services.

9.2. Assessing appropriateness: the obligations

When providing a firm must ask the client to provide information about his/her relevant knowledge and experience to enable the firm to assess whether the service or product envisaged is appropriate for the client.

The firm must determine whether the client has the necessary experience and knowledge to understand the risks involved in relation to the product or service (in this context, the firm may assume that a professional client has the necessary experience and knowledge to understand the risks involved in relation to the products or services for which he/she is classified as a professional client).

As with the rule on suitability, the firm is entitled to rely on the information provided by the client (unless it is aware that the information is manifestly out of date, inaccurate or incomplete).

9.3. Warning the client

A firm is required to give a warning to the client in two circumstances (these warnings may be provided in a standardised format):

- Where the firm considers, on the basis of the information received, that the product or service is **not** appropriate for the client, it must warn the client of that
- Where the client does not provide information to enable the firm to assess appropriateness (or where the client provides insufficient information regarding his/her knowledge and experience), the firm must warn the client that it is **unable to determine** whether the product or service is appropriate for him/her

If a client asks the firm to go ahead with a transaction despite the warning given by the firm, it is up to the firm to decide it is in the interest of the client to do so in the circumstances.

9.4. Assessing appropriateness: when it need not be done

A firm is not required to ask its client to provide information or to assess appropriateness if the service only consists of execution and/or reception and transmission of orders and it relates to a non-complex financial instrument.

Non-complex financial instruments are:

- Shares traded on a regulated (or equivalent) market
- Money market instruments, binds or other forms of securitised debt (excluding those embedding a derivative)
- Units in a UCITS scheme
- Other non-complex financial instruments

Non-complex financial instruments must satisfy the following criteria:

- They are not derivatives (or similar products)
- There are frequent opportunities to trade them at independently determined, publicly available prices
- They do not involve a potential liability that exceeds their cost
- There is publicly available information on their characteristics that is likely to be readily understood by the average retail client for the purpose of making an investment decision

10. Dealing and managing

10.1. Application

The rules in this section on dealing and managing apply to all firms except:

- The rules on personal account dealing apply to any designated investment business activities carried on from an establishment in the UK

- The rules on the use of dealing commission apply only to a firm that acts as an investment manager

10.2. Conflicts of interest

Application

The rules on conflicts of interest apply where a common platform firm is carrying on regulated (or ancillary) activities or providing ancillary services (when these constitute MiFID business) for a client. The status of the client (retail client, professional client or eligible counterparty) is irrelevant for this purpose.

A firm must take all reasonable steps to identify conflicts of interest between:

- Itself (including its managers, employees and appointed representatives) and a client of a firm

- One client of the firm and another client

- Different departments within the same firm

Management or disclosure of conflicts of interest

Principle for Business 8 states a firm must have effective arrangements to manage conflicts of interest so as to prevent them giving rise to a material risk of damage to a client's interests. Under SYSC10, this includes having a written policy.

Where these arrangements might not be sufficient to prevent the risk of damage to a particular client's interests, the firm, before undertaking business for that client, must disclose relevant details of the conflict of interest in a durable medium (i.e. in writing, email, or equivalent form).

10.3. Investment research

Investment research produced by a firm to be disseminated to clients

When a firm produces investment research for dissemination to its clients or to the public, the financial analysts involved in the production of investment research (and other relevant persons) may have interests which conflict with the interests of the persons to whom the investment research is disseminated.

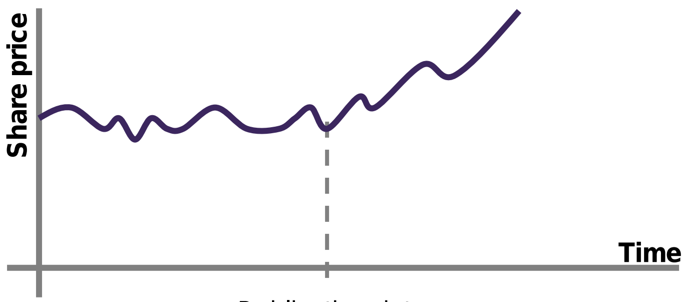
Accordingly, the firm must ensure the implementation of all the measures for managing conflicts of interest in SYSC 10 (conflicts of interest).

In particular, a firm must ensure that:

- If a financial analyst or other relevant person has advance knowledge of investment research which is not yet available to the firm's clients or the public, he/she must not undertake personal transactions or trade on behalf of another person (including the firm) until the recipients of the investment research have had a reasonable opportunity to act on it (there are exceptions for dealing as a market maker in good faith and in the ordinary course of business and for dealing to execute an unsolicited client order).

- A financial analyst or other relevant person must not undertake personal transactions in financial instruments to which the investment research relates contrary to current recommendations (except in exceptional circumstances and with prior approval from the firm's legal or compliance function)
- The firm, a financial analyst or other relevant person must not accept inducements from those with a material interest in the subject matter
- The firm, a financial analyst or other relevant person must not promise issuers favourable research coverage
- Issuers, relevant persons (other than financial analysts) and any other persons must not, before the dissemination of the investor research, be permitted to review a draft of it for the purpose of verifying the accuracy of factual statements made in it, or for any other purpose other than verifying compliance with the firm's legal obligations, if the draft includes a recommendation such as a target price

A firm is not obliged to comply with all these requirements where it is simply disseminating investment research produced by another person, where the producer is itself subject to these requirements and is independent of the firm.



An FSA firm must not knowingly deal for its own account until the clients for whom the publication was intended have had a reasonable time to react to it unless:

- The firm is a market maker dealing in the normal course of business
- Unsolicited customer orders

Publication and dissemination of non-independent research

Investment research is research which is presented as being objective and independent. Non-independent research is a research recommendation which does not constitute investment research (and which cannot, therefore, be presented as being objective and independent).

Non-independent research must:

- Be clearly identified as a marketing communication
- Contain a clear and prominent statement that:
  - It has not been prepared in accordance with rules designed to promote the independence of investment research
  - It is not subject to any prohibition on dealing ahead of the dissemination of investment research

The financial promotion rules apply to non-independent research as though it were a marketing communication.

Research recommendation: required disclosure

The Market Abuse Directive, which was implemented in the UK in July 2005, introduced new requirements relating to the disclosures that must be made when a firm prepares or disseminates research recommendations. These rules apply to all firms that prepare or disseminate research recommendations.

These disclosure obligations do not require a firm to breach effective Chinese Wall arrangements that are already in place.

A firm must take reasonable care:

- To ensure that any research recommendation it publishes is fairly presented
- To disclose any interests or conflicts of interest it may have in any investments covered by the research

The research document must disclose clearly and prominently the identity of the person responsible for its production and, in particular:

- The name and job title of the individual who prepared the research recommendation
- The name of the firm (and the fact it is authorised or regulated by the FCA)

10.4. Best execution

Best execution obligation and execution factors

When executing an order for a client, a firm must take all reasonable steps to obtain the best possible result for its client, taking into account the execution factors.

The execution factors are defined as the 'price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of an order'.

Best execution criteria

A firm must take into account the following criteria for determining the relative importance of the execution factors:

- The characteristics of the client, including the categorisation of the client as retail or professional
- The characteristics of the client order
- The characteristics of financial instruments that are the subject of that order

- The characteristics of the execution venues to which the order can be dissected

For the purposes of this rule, execution venue means a regulated market, a multilateral trading facility (MTF), or a market maker or other liquidity provider.

Role of price

In the case of a retail client, the best possible result must be determined in terms of the total consideration, representing the price of the financial instrument and the costs related to execution.

The costs related to execution must include all expenses incurred by the client which are directly related to the execution of the order, including execution venue fees, clearing and settlement fees and any other fees paid to third parties involved in the execution of the order.

Competing execution venues

In the case of a retail client, where there are two or more competing execution venues, the firm, in assessing and comparing the results that could be achieved for the client on each execution venue, must take its own commissions and costs for executing the order into account.

The firm must not structure or charge its commissions in such a way as to discriminate unfairly between execution venues.

The competing execution venues that will be assessed by the firm are the ones that are listed in the firm's order execution policy (see below).

10.5. Order execution policy

In order to satisfy its obligation to obtain the best possible result for its clients, a firm is required to establish and operate an order execution policy. This policy must include, for each class of financial instrument, information about the different execution venues that the firm will use to execute client orders and the factors affecting the choice of execution venue.

Information about the order execution policy

A firm must provide appropriate information to its clients about its order execution policy. In the case of a retail client, the firm must provide the following details about its execution policy before executing any transaction:

- An account of the relative importance the firm assigns to the execution factors
- A list of the main execution venues used by the firm
- A clear and prominent warning that any specific instructions from the client may prevent the firm from taking the steps that it would otherwise have taken under its order execution policy to obtain the best possible result for the client

(This warning is needed because, whenever a client gives a specific instruction about an order, the firm is required to execute the order in accordance with that specific instruction; and this overrides any requirement the firm might otherwise have, e.g. to compare between execution venues, and satisfies the firm's obligations under the best execution rule).

Where the order execution policy provides for the possibility that client orders may be executed outside a regulated market or an MTF, the firm must receive consent from its clients about this possibility. This could be general consent or with regard to individual transactions.

Order execution policy: other requirements

- A firm must obtain the prior consent of its clients to its order execution policy
- A firm must obtain the prior express consent of its clients before executing their orders outside a regulated market or an MTF. This may be by means of a general agreement or transaction-by-transaction
- A firm must regularly monitor the effectiveness of its order execution arrangements and execution policy, and it must review them annually
- A firm must be able to demonstrate to its clients, at their request, that it has executed their orders in accordance with its order execution policy

Duty of portfolio managers to act in clients' best interests

The obligation to act in the best interest of its clients is extended to a portfolio manager when it places an order with another entity for execution on behalf of its client.

A portfolio manager is defined as a firm which manages portfolios in accordance with mandates given by clients on a discretionary client-by-client basis (i.e. a discretionary investment manager providing a personalised service).

The same obligation applies to any firm which receives and transmits orders to another entity for execution on behalf of a client.

10.6. Client order handling

General principles

A firm must implement procedures which provide for the prompt, fair and expeditious execution of client orders. In general, otherwise comparable orders should be executed in chronological order of receipt by the firm.

Orders executed on behalf of clients must:

- Be promptly recorded and allocated
- Otherwise comparable orders must be carried out sequentially and promptly

If the characteristics of the order or prevailing market conditions make this impracticable, or:

- The interest of the client requires otherwise
- If there is any material difficulty in properly carrying out an order promptly

A retail client must be immediately notified of the case.

Aggregation and allocation of orders

A firm is not permitted to aggregate a client order with an own account transaction or another client order unless the following conditions are met:

- It must be unlikely that the aggregation will work overall to the disadvantage of any client whose order is to be aggregated
- It must disclose to each client that the effect of aggregation may work to their disadvantage in a particular order

- The firm must have in place an order allocation policy, providing in precise terms for the allocation of aggregated orders

If a firm aggregates a client order with an own account transaction and the aggregated order is partially executed, it must allocate the related trades to the client in priority to the firm. However, if the firm is able to demonstrate reasonable grounds that, without the combination, it would not have been able to carry out the order on such advantageous terms, or at all, it may allocate the own account transaction proportionally, on accordance with its order allocation.

Client limit orders

Where a client places a limit order in respect of shares traded in a regulated market and the order is not immediately executed under prevailing market conditions, then, unless the client expressly instructs otherwise, the firm must make the order public with a view to having it executed as soon as possible. The firm can do this by transmitting the order to a regulated market or MTF that operates an order book trading system. This is part of the pre-trade transparency rules.

This obligation to make public a limit order will not apply to a limit order that is large in scale compared with normal market size (large in scale for this purpose is a size greater than approximately 10% of the share's average daily trading volume).

10.7. Use of dealing commission

Background

For many years fund management firms and broking firms were permitted to do business with one another on the basis of 'soft commission' (or 'softing') agreements.

These allowed the fund manager to pass on to its own underlying customers the commission or other charges it incurred for outing transactions through the broking firm, and in return for these charges the fund manager received from the broker valuable goods or services in addition to the execution of its customers' orders.

In other words, it could be argued that the underlying customers were paying not only for the execution of the transactions done on their behalf, but also for certain additional benefits received by the fund manager.

Soft commission business was always regarded as controversial, and the rules that permitted it were eventually removed from the regulator's Handbook in 2006.

Use of dealing commission to purchase goods or services

There are controls on an investment manager which:

- Executes its customer orders through a broker
- Passes on the broker's charges (whether commission or otherwise) to its customers
- In return for these charges, receives goods or services in addition to the execution of its customer orders

These controls require the investment manager who does business in this way to be reasonably satisfied that the goods or services it receives from the broker:

- Are related to the execution of trades on behalf of its underlying customers **or** comprise the provision of research

- Will reasonably assist that investment manager in the provision of its services to its customers and are not likely to impair compliance with its duty to act in the best interest of its customers

(In this context, a 'customer' is a client of the firm who is not an eligible counterparty).

The most common service provided by brokers that would comply with this rule is investment research.

Non-permitted goods and services

Examples of goods and services that the FCA does **not** regard as meeting the relevant requirements include:

- Portfolio valuation or performance measurement
- Computer hardware
- Dedicated telephone lines
- Seminar fees
- Subscriptions for publications
- Travel, accommodation and entertainment costs
- Office administrative computer hardware
- Membership fees to professional associations
- Purchase or rental of office equipment
- Employees' salaries
- Direct money payments
- Publicly available information
- Custody services
- Post-trade analytics (relating to trade execution condition only)
- Price feeds or unanalysed historic price data relating to provision of research condition only

Prior and periodic disclosure

An investment manager who uses dealing commission to purchase goods or services in accordance with these rules must make prior and periodic disclosure to its customers. This disclosure must include details of the goods or services that relate to trade execution and, wherever appropriate, separately identify the details of the goods or services that relate to the provision of research.

Prior disclosure should be made to a customer before conducting business. Periodic disclosure to the firm’s customers should be made at least annually. A record of each periodic disclosure must be made and retained by the firm for at least five years.

10.8. Personal account dealing

A firm must have in place arrangements to prevent inappropriate dealing by any relevant person (this includes directors, partners, managers, employees and appointed representatives). Personal account dealing rules follow the home state regulations for firms, i.e. it is not dependent on where the client is based.

This covers personal account transactions which:

- Are prohibited under the Market Abuse Directive
- Involve the misuse or improper disclosure of confidential information relating to clients or their transactions
- Conflict or are likely to conflict with the firm's obligations to a customer under the regulatory system

This prohibition extends also to a relevant person:

- Advising or procuring another person to enter into such a transaction
- Disclosing it in such a way that it could be used to the same effect

This rule also covers:

- Financial analysts who have advance knowledge of the content of investment research
- Relevant persons who misuse information relating to pending client orders of which they have advance knowledge

The firm's arrangements on personal account dealing must ensure that:

- Each relevant person is aware of the restrictions on personal transactions (and of the firm's arrangements in this area)
- The firm is informed promptly of all personal transactions
- A record is kept of all personal transactions notified to the firm (including any authorisation or prohibition in connection with such a transaction)

The rule on personal account dealing does not apply to personal transactions in:

- A discretionary account managed independently of the relevant person
- Rights or shares in a UCITS scheme
- Life policies

11. Reporting information to clients

11.1. General client reporting requirement

In relation to MiFID business a firm must ensure that a client receives adequate reports in the services provided to it by the firm (including, where applicable, the costs associated with the transactions and services).

11.2. Occasional reporting (confirmations)

Timing of dispatch

When a firm has carried out an order on behalf of a client, it must promptly provide the client, in a durable medium, with the essential information concerning the execution of the order.

In the case of a retail client, the firm's notice must include the relevant trade confirmation information (see below). This must be sent as soon as possible and no later than the next business day after execution (or, where the confirmation is received by the firm from a third party, no later than the next business day after receipt).

Trade confirmation information

Essential information includes, for example:

- Maturity, delivery or expiry date of derivatives
- For options, the last exercise date, expiry style and strike price
- When closing out an option, essential details of the open contract closed out, and of the profit or loss arising for the client as a result of closing the contract out
- Date of exercising an option, and whether exercise creates a purchase or sale for the client
- The strike price of the option, and the total consideration due to or from the client (where applicable)

11.3. Periodic reporting

Provision of periodic statement

If a firm is managing investments on behalf of a client, it must provide the client with a periodic statement in a durable medium (unless such a statement is provided by another person).

In the case of a retail client, the periodic statement must include the relevant periodic information (see below).

Timing of periodic statement

In the case of a retail client, the periodic statement must be provided once every six months (or, if the retail client so requests, every three months).

If the retail client elects to receive information about executed transactions on a transaction-by-transaction basis (and there are no transactions in derivatives during the period):

- The periodic statement must be provided once every 12 months

- The firm must comply with the occasional reporting rules (confirmations) for each transaction executed

If a firm manages investments for retail clients or the portfolio includes contingent liability investments/leveraged portfolio, the firm must report within one business day any losses beyond a pre-determined limit.

11.4. Reporting information about authorised funds to unitholders

Introduction

Although not part of the FCA's conduct of business rules (COBS), it is worth highlighting the requirements for an authorised collective investment scheme to report to unitholders on a regular basis. These rules are contained in the collective investment schemes sourcebook (COLL).

Overview

The authorised fund manager must provide the unitholders with regular and relevant information about the progress of the authorised fund by:

- Preparing and sending a short report to all unitholders half-yearly; and
- Preparing, annually, and making a long report available to unitholders on request.

The short report

The short report must contain:

- The name of the scheme or sub-fund;
- Its stated investment objectives and the strategy used to achieve this;
- A brief assessment of the risk profile;
- For a UCITS scheme, the most up-to-date synthetic risk and reward indicator and any changes to that figure during the period;
- The name and address of the authorised fund manager;
- A review of the investment activities and investment performance during the period;
- A performance record to contextualise the results of the investment activities;
- Sufficient information on where the portfolio is invested and how this has changed over the period;
- Any other significant information on the activities of the scheme and the results of those activities; and
- A statement that the latest long report is available on request.

The long report

The long report contains the full accounts and reports prepared by the fund manager, the depository and the auditor.

12. Client Assets

12.1. Fiduciary duty

The main objective of the rules relating to client assets (including client money) is designed to ensure that client assets are protected either in the case of an authorised firm becoming insolvent or from the misuse of client assets by a firm or its employees.

Remember that under the EEA passporting regime a passported firm applies its **home** state's rules on client assets. Therefore, a UK firm passported to Germany would still be required to follow the FCA rules on client assets.

12.2. Holding of clients' assets

Purpose

- To restrict co-mingling of clients' and firms' assets
- To minimise the risk of client assets being used without the consent or against the wishes of the clients

Application

The custody rules apply to a firm when it is safeguarding and administering investments.

The regulated activity of safeguarding and administering investments covers:

- Safeguarding and administration of assets by the firm
- Arranging the safeguarding and administration of assets by a third party

The definition of safe custody investments includes:

- Safe custody investments - designated investments that a firm receives or holds
- Custody assets - any other assets the firm holds in the same portfolio as a designated investment on behalf of the client

Exemptions

The custody rules **do not** apply to:

- Deposits made with a Banking Consolidation Directive (BCD) credit institution
- Coins held by the firm for the value of their metal
- Investment business passported into the UK
- Designated investments held on behalf of an affiliated company (**unless** they are held for a client, or the affiliated business is an arm's length client)
- A firm acting as the operator of an alternative investment fund (AIF) or UCITS scheme

Delivery vs. payment (DvP) transactions

The firm will sometimes have possession of client investments ***temporarily***, e.g. if investments are being bought from or sold to a client.

The custody rules **do not** apply to DvP transactions, provided:

- Delivery of the investment is due within **one business day** of payment
- Delivery or payment by the firm will occur within **three business days** of the client making delivery or payment

Registration of investments held

A firm must effect appropriate registration or recording of legal title to a financial instrument in the name of:

- The client (or the trustee firm). Unless the client is an authorised person acting on behalf of its client, in which case it may be registered in the name of the client of that authorised person.
- A nominee company which is controlled by:
  - The firm
  - An affiliated company
  - A recognised investment exchange or a designated investment exchange
  - A third party with whom financial instruments are deposited
- Any other third party if:
  - Law outside the UK requires it and the firm has taken reasonable steps to determine that it is in the client's best interests
  - The firm has notified the client in writing
- The firm if:
  - Law outside the UK requires it and the firm has taken reasonable steps to determine that it is in the client's best interest
  - The firm has notified the client if a professional client, or obtained prior written consent if a retail client

12.3. Depositing assets and arranging for assets to be deposited with third parties

Third parties can be used to hold assets belonging to the firm or a client of the firm. The firm must:

- Exercise all due skill, care and diligence in the selection of the third party
- Ensure the assets belonging to the firm are separately recorded from those held by the third party
- Conduct period reviews of the third party considering:
  - The expertise and market reputation of the third party; and

  - Any legal requirements or market practices that could adversely affect the clients’ rights

- Make and keep up to date records of the grounds on which the third party was selected and/or retained

Clearly the third party should operate in a country that is subject to regulation that is significantly similar to the UK client asset rules. However, this may not be the case if:

- The assets are of a nature that require them to be deposited in such a country; or

- A professional client has requested in writing that they are helped in that country.

Use of clients’ assets

A firm must not enter into arrangements for securities-financing transactions (such as stock lending or repurchase agreements), unless:

- The client has given express prior consent to the use of the financial instruments on specified terms; and

- The use of that client's financial instruments is restricted to the specified terms to which the client consents.

12.4. Reconciliations

Introduction

The firm will have three different sets of records relating to the safe custody business it provides:

- A record of the safe custody investments that it is accountable for, but does **not** hold in its possession

- A record of safe custody investments that it **does** physically hold itself

- A record of **all** the safe custody investments held on a client-by-client basis

These must each be reconciled according to different time frames and methods as set out below.

If a firm has not or cannot comply with these requirements it must notify the FCA in writing without delay.

Record of investments not held by the firm

A firm must, as often as is necessary, perform a reconciliation of its record of safe custody investments for which it is accountable but which it does not physically hold, with statements obtained from custodians.

Record of investments held by the firm

These must be reconciled as often as is necessary against a **count** of the safe custody investments in its possession.

The counting of the investments held may be by either one of two methods:

- By way of a **total count**, which means that the investments are counted and reconciled as at the **same date**

- By way of the **rolling stock** method. This entails counting the investments over a period of time. This may only be used subject to the FCA's approval

A firm that uses an alternative reconciliation method must first send a written confirmation to the FCA from the firm's auditor that the firm has in place systems and controls which are adequate to enable it to use the method effectively.

Record of all investments held

This must be reconciled against the location of each investment. Here the firm must reconcile **what** investments they are holding for the client with **where** they are held.

Shortfalls

Any discrepancies thrown up by the reconciliation process must be corrected promptly and any shortfalls made up for.

12.5. Client money rules

Application

When a firm holds money which belongs to someone else then it is client money.

The rules apply where the firm is holding client money in relation to **designated investment business**.

Not client money: due and payable to the firm

Money is not client money when it becomes properly due and payable to the firm for its own account.

For fees and commissions payable by customers, 'due and payable' means:

- They have been accurately calculated on a basis previously disclosed to the client by the firm
- Five business days have elapsed since a statement showing fees and commissions has been despatched to the client, and the firm has taken reasonable steps to ensure that the client does not question them
- The precise amount of the fees or commissions has been agreed by the client, or has been determined by a court, arbitrator or arbiter

Other circumstances where the money becomes due and payable are when the firm sells securities as principal to the client or buys them as agent on behalf of the client. When the firm subsequently receives the money it is entitled to keep it for its own account.

When a firm has entered into an arrangement under which commission is rebated to a client, those rebates should be treated as client money as soon as the firm has completed its obligations.

Finally, where a firm sells assets held as security against client obligations, the amount of the liability belongs to the firm but any **excess** must be either returned to the client or held as client money.

Not client money: discharge of fiduciary duty

Money is not client money when the firm has discharged its responsibilities to segregate client money and holds it separately. Examples include when money is paid to:

- The client or their representative
- A third party on behalf of the client (e.g. payment to a clearing house to cover a margin call)
- A bank account of the client

- The firm where it is an excess in the client bank account (e.g. records show there is more in the account than is attributable to the client)

When a firm draws a cheque or other payable order to discharge its fiduciary duty, it must continue to treat the sum concerned as client money until the cheque or order is presented and paid by the bank.

Interest

A firm must pay retail clients all interest earned on client money, **unless** it notifies them in writing of:

- Whether or not interest is to be paid on client money
- If so, on what terms and at what frequency

Any interest due to a client must be treated as client money.

Segregation of client money

Client funds should be **segregated** from those of the firm by the use of client money bank accounts.

The FCA generally requires a firm to place client money in a client bank account with an 'approved bank'. An approved bank can be a central bank, a BCD credit institution, a bank authorised in its respective country or a qualifying money market fund.

A BCD credit institution is one that complies with the Banking Consolidation Directive.

A qualifying money market fund is a CIS authorised under UCITS or their local competent authority.

Firms must create trusts over client money bank accounts by an exchange of trust letters with the bank(s) holding client money. This prevents liquidators setting off client assets against the debts of the firm in an insolvency situation.

If a firm leaves some of its own money in a client money account, this will be referred to as a 'pollution of trust'. A liquidator will be able to seize **all** the money held in the client account for the general creditors of a bank.

Client money requirement

Every business day, firms are required to ensure that they have enough funds in client accounts to cover the client money requirement, i.e. physical cash held must equal the total of balances on client money accounts.

Reconciliations

A firm must reconcile its records of client balances to bank statements from approved banks as often as is necessary. The firm must complete the reconciliation of client money within 10 business days of the date to which the reconciliation relates.

This is done by comparing the balance on each client bank account against the statement or confirmation issued by the bank holding the accounts. The firm must also compare the balance (currency by currency) on each client transaction account against the statement or confirmation. This reconciliation applies to all approved collateral held by the firm.

If a discrepancy exists, firms must identify the reason and correct the discrepancy **as soon as possible**. Unresolved shortfalls in client funds need to be met out of the firm's resources until the discrepancy is resolved.

If a firm cannot comply with the reconciliation rules it must notify the FCA as soon as possible.

13. Record keeping requirement

13.1. Conduct of Business Sourcebook

In the Conduct of Business Sourcebook (COBS) the record keeping requirement is summarised below:

Table 4. Record keeping requirement

Type of business	Record keeping requirement
Pension transfers, opt outs or FSVC	Indefinitely
Life policy or pension scheme	5 years
MiFID or equivalent third country business	5 years
Any other case (e.g. other non-MiFID business)	3 years

The exception to this is where a financial promotion relates to pensions or life policies. For this document records must be kept for six years.

13.2. Client Assets Sourcebook

In the Client Assets Sourcebook (CASS) all record for CASS 6 and CASS 7 are kept for five years.

14. The Conduct of Business and Client Assets rules: summary

14.1. Key concepts

Contextual points

- These are not syllabus driven, but are useful to introduce some concept from the chapter

Client categorisation

- LO 3.5.1 - The purpose of client categorisation
- LO 3.5.2 - A retail client, a professional client and an eligible counterparty (COBS 3.4, 3.5 & 3.6)
- LO 3.5.3 - The rules relating to treating a client as an elective professional client (COBS 3.5.3)
- LO 3.5.4 - The rules relating to treating a client as an elective eligible counterparty (COBS 3.6.4)
- LO 3.5.5 - The rules relating to providing clients with a higher level of protection (COBS 3.7)

Communicating with clients

- LO 3.5.7 - The purpose and scope of the financial promotions rules and the exemptions from them (COBS 4.1)
- LO 3.5.13 - The rules relating to systems and controls in relation to approving and communicating financial promotions (COBS 4.10)
- LO 3.5.8 - The fair, clear and not misleading rule (COBS 4.2)
- LO 3.5.9 - The rules relating to communications with retail clients (COBS 4.5)
- LO 3.5.10 - The rules relating to past, simulated past and future performance (COBS 4.6)
- LO 3.5.11 - The rules relating to direct offer promotions (COBS 4.7)
- LO 3.5.12 - The rules relating to cold calls and other promotions that are not in writing (COBS 4.8)
- LO 3.5.15 - The rules relating to distance marketing communications (COBS 5.1)
- LO 3.5.14 - The record keeping requirements relating to financial promotions (COBS 4.11)

Packaged Product Disclosures

- LO 3.5.33 - The obligations relating to preparing product information (COBS 13.1 & COLL 4.7)
- LO 3.5.34 - The rules relating to the form and content of a key features document and a key investor information document (COBS 13.2, 13.3, 14.2 & COLL 4.7)
- LO 3.5.35 - The rules relating to cancellation rights (COBS 15)
- LO 3.5.36 - Packaged products and retail investment products

Information about the firm

- LO 3.5.16 - The rules relating to providing information about the firm and compensation information (COBS 6.1)

Client agreements

- LO 3.5.6 - The rules relating to client agreements (COBS 8.1)

Suitability

- LO 3.5.19 - The rules relating to assessing suitability (COBS 9.2)

Appropriateness

- LO 3.5.20 - The rules relating to assessing appropriateness (COBS 10.2)
- LO 3.5.21 - The rules relating to warning a client about the appropriateness of their instructions (COBS 10.3)
- LO 3.5.22 - Circumstances when assessing appropriateness is not required (COBS 10.4, 10.5 & 10.6)

Dealing and managing

- LO 3.5.29 - The purpose of the principles and rules on Conflicts of Interest, including: identify, recording and disclosing conflicts of interest and managing them to ensure the fair treatment of clients (PRIN 2.1.1, Principle 8, SYSC 10.1.1 - 7 + 10.1.8 / 9 + 10.2)
- LO 3.5.30 - Explain the rules relating to investment research produced by a firm and disseminated to clients (COBS 12.2)
- LO 3.5.31 - The rules relating to the publication and dissemination of non-independent research (COBS 12.3)
- LO 3.5.32 - The disclosure requirements relating to the production and dissemination of research recommendations (COBS 12.4)
- LO 3.5.25 - The rules relating to best execution (COBS 11.2)
- LO 3.5.26 - The rules relating to client order handling (COBS 11.3)
- LO 3.5.27 - The rules relating to the use of dealing commission (COBS 11.6)
- LO 3.5.28 - The rules on personal account dealing (COBS 11.7)

Reporting information to clients

- LO 3.5.38 - The rules relating to occasional reporting to clients (COBS 16.2)
- LO 3.5.39 - The rules relating to periodic reporting to clients (COBS 16.3)
- LO 3.5.40 - Explain the rules relating to reporting on the progress of an authorised fund to unitholders (COLL 4.5)
- LO 3.5.37 - The rules relating to record keeping for client orders and transactions (COBS 11.5)

Client assets

- LO 3.5.41 - The concept of fiduciary duty

- LO 3.5.42 - The application and purpose of the rules relating to custody of client assets held in connection with MiFID business (CASS 6.1)
- LO 3.5.43 - The rules relating to the protection of clients' assets and having adequate organisational arrangements (CASS 6.2)
- LO 3.5.44 - The rules relating to depositing assets with third parties (CASS 6.3)
- LO 3.5.45 - The purpose of the rules relating to the use of clients' assets (CASS 6.4)
- LO 3.5.46 - The rules relating to records, accounts and reconciliations of clients' assets (CASS 6.5)
- LO 3.5.47 - The application and general purpose of the client money rules (CASS 7.2)
- LO 3.5.48 - The rules relating to the segregation of client money (CASS 7.4)
- LO 3.5.49 - The rules relating to records, accounts and reconciliations of clients' assets (CASS 7.6)
- LO 3.5.50 - The rules relating to mandate accounts (CASS 8)

Now you have finished this chapter you should attempt the chapter questions.

Complaints and redress

1. Introduction

1.1. Chapter overview

This chapter covers the main issues in the Redress block of the FCA Handbook. Specifically, it deals with the handling of investor complaints and the actions a firm must take to ensure they are quickly resolved. It also covers the role of the Financial Ombudsman Service (FOS). The FOS can award compensation if it feels an investor has been wronged. Finally, you will learn of the Financial Services Compensation Scheme (FSCS). This scheme was set up to provide compensation to investors in the event of an authorised firm becoming insolvent (and therefore unable to meet any claims against it).

1.2. Learning outcomes

On completion of this module you will:

Complaints and redress

- 3.6.2 - Explain the FCA rules relating to handling of complaints (DISP 1.3)
- 3.6.6 - Explain the procedure and time limits for the resolution of complaints (DISP 1.4, 1.5 & 1.6)
- 3.6.7 - Apply the rules relating to record keeping and reporting concerning complaints (DISP 1.9 & 1.10)

Financial Ombudsman Service (FOS)

- 3.6.3 - Explain the role of the Financial Ombudsman Service (DISP Introduction and DISP 2)
- 3.6.4 - Apply the rules relating to determination by the Financial Ombudsman Service (DISP 3)
- 3.6.5 - Distinguish between compulsory and voluntary jurisdiction (DISP Introduction)

Financial Services Compensation Scheme (FSCS)

- 3.6.8 - Explain the purpose of the Financial Services Compensation Scheme (FSCS) (COMP 1.1.7)
- 3.6.9 - Identify the circumstances under which the FSCS will pay compensation (COMP 1.3.3, 3.2.1, 4.2.1 & 4.2.2)
- 3.6.10 - Identify the limits on the compensation payable by the FSCS (COMP 10.2.1, 10.2.2 & 10.2.3)

2. Complaints and redress

2.1. Introduction

Investors who suffer losses as a result of another person's inappropriate actions are always entitled to seek redress through the courts.

However, many investors (particularly small investors) may not be in a position to instigate court action. As a result, the Act requires the FCA to ensure that complaints are handled appropriately and that an independent body exists to consider claims.

Note that 'financial loss' can include consequential or prospective loss, in addition to actual loss. For example, financial loss which has not yet crystallised because of the type of product involved (e.g. pensions, endowments, etc.).

2.2. Definition of a complaint

A complaint is any expression of dissatisfaction, oral or written, about financial services activities.

If the complaint is based on the firm's non-compliance with rules, this is referred to as a breach. The rules could be FCA rules, the firm's own rules or any other rules from other organisations, such as HMRC. All breaches must be recorded by the firm.

FCA regulated firms must also establish procedures for handling complaints.

2.3. Complaints procedures

Procedures of the firm

Coverage

All firms are required to operate an **appropriate** and **effective** complaints procedure. Internal complaints procedures must be in writing and cover:

- Receiving complaints
- Responding to complaints
- Referring complaints to other firms
- The appropriate investigation of complaints
- Notifying complainants of their right to go to the Financial Ombudsman Service (FOS) where relevant

The management of the firm has a responsibility to ensure **appropriate controls** are in place to ensure that the rules in relation to complaints are complied with and it is possible to identify recurring and systemic problems.

Publicity

The procedures must be publicised as follows:

- Drawn to the attention of customers (together with the clients' rights of access to the FOS) at the first point of contact or when documentation is first provided

- Sent to customers on request and to complainants automatically when a complaint is received (unless the complaint is resolved in **one day**). The procedures given to customers must contain the specific name of the person dealing with the complaints

Implementation

All employees (and appointed representatives) that deal with clients should be made aware of the complaints procedures.

Complaint procedures must make provision for:

- Complaints to be investigated **promptly and fully** by an employee of sufficient competence who was not involved in the matter which is the subject of the complaint
- The person charged with responding to complaints to have the authority to settle complaints, or to have access to someone who has the necessary authority
- Responses to complaints to address the subject matter of the complaint and, where appropriate, offer appropriate redress

Where redress is appropriate, a firm must provide compensation for any acts or omissions for which it was responsible, and comply with any offer of redress which the complainant accepts.

Timing

A firm must send a written acknowledgement and a copy of the complaints procedure **promptly** from receipt of the complaint, providing the name or job title of the individual handling the complaint for the firm.

A firm has a maximum of **eight weeks** from receipt of a complaint to try to resolve it. By the end of eight weeks, the firm must either send a final response, **or** a response which:

- Explains that the firm is not in a position to make a final response, gives reasons for the further delay and indicates when it expects to be able to provide a final response
- Informs the complainant that he/she may refer the complaint to the FOS if dissatisfied with the delay, and encloses a copy of the Financial Ombudsman Service's explanatory leaflet

When a firm sends a complainant its final response, it must:

- Inform the complainant that he/she may refer the complaint to the FOS if dissatisfied with the final response, and that he/she must do so within six months
- Enclose a copy of the Financial Ombudsman Service's explanatory leaflet

Records

A firm must retain records of complaints for at least **three years** from the date of receipt of the complaint, unless it is a MiFID business, where records must be kept for five years.

These records should include:

- The name of the complainant
- The substance of the complaint
- Any correspondence between the firm and the complainant

- Detail of any redress offered

Reporting complaints to the FCA

The firm must also provide the FCA with twice yearly reports on:

- The total number of complaints
- Complaints closed within four weeks of receipt
- Complaints closed within eight weeks of receipt
- Complaints closed more than eight weeks after receipt
- Complaints outstanding at the end of the reporting period

The reports must be sent even if no complaints were received (i.e. a **nil return**).

A complaint is 'closed' where:

- The firm has sent a final response
- The complainant has accepted in writing the firm's earlier response
- The complainant has not responded to the firm within eight weeks of the firm's written final response

2.4. The Financial Ombudsman Service (FOS)

Introduction

The FCA has established a system for the consideration of complaints against firms by clients who feel aggrieved and entitled to seek redress.

The system involves consideration of the complaint by the firm itself and, if the client is not satisfied, independent investigation of the complaint.

Investigation involves both a mediation stage and a possible subsequent determination stage by the FOS.

The FOS can make awards for a range of reasons including financial loss, pain and suffering, damage to reputation and distress or inconvenience.

Complaints against authorised firms relating to regulated activities fall under the 'Compulsory Jurisdiction' of the FOS.

Unauthorised firms can also submit to the 'Voluntary Jurisdiction' of the FOS by entering into a contract with the FOS as a voluntary participant. This might cover activities outside the definition of designated investment business, such as general insurance, deposit taking and credit/debit card transactions.

Timing

If a complaint has not been settled to the satisfaction of the customer within **eight weeks** of receipt by the firm, the complainant must be informed that he/she has the right to complain to the FOS.

The firm must also provide the complainant with an explanatory leaflet about the FOS and advise him/her that any referral should take place within **six months**.

Dismissal of complaints

A complaint can be dismissed by the FOS if it considers that:

- The complainant has not suffered financial loss, material inconvenience or material distress
- The complaint is frivolous or vexatious
- The firm has already offered reasonable compensation

Investigation

When the FOS investigates a complaint the firm must cooperate with the FOS.

When there is a reasonable possibility of resolution by mediation, the FOS will endeavour to achieve settlement by this route. If mediation is not an option, the FOS will investigate the complaint.

During an investigation, both parties can make representations.

After a provisional assessment is made, if one of the parties objects to the provisional assessment, the FOS will present a written statement of determination.

Only if the complainant accepts the determination is it binding on the firm.

If the complainant rejects the FOS's decision, they can pursue the matter further through the courts.

Compensation

The FOS can make financial awards to complainants. The **maximum award** is £150,000 and reasonable costs (although awards of costs are not common).

If the FOS feels that an amount in excess of the maximum is appropriate it can invite the firm to pay the balance.

2.5. The Financial Services Compensation Scheme (FSCS)

Introduction

The Financial Services Compensation Scheme (FSCS) was established to provide compensation where authorised persons and appointed representatives are unable to satisfy claims against them.

Key elements of a claim

To succeed, a **claimant** must have a **protected claim** against a **relevant person**, and make that claim within the **relevant time limits**.

Note that a claim can only be made once a firm is in liquidation. If the firm still exists the customer must explore all other avenues of redress.

Eligible claimants

The following are eligible claimants:

- Private individuals (including experts) - can claim in respect of all losses. Note this does not cover customers connected to the firm (e.g. directors).

- A body corporate, unincorporated association or mutual association with an annual turnover of less than £1m.
- A partnership with a turnover of less than £1.4m.
- Clients that do not fall under these categories may claim in respect of long-term insurance (e.g. life) and compulsory insurance (e.g. employers' liability).

Authorised firms can never be eligible claimants unless they are a small business (e.g. sole trader) and the claim arises out of regulated activity that they do not have experience of.

Protected claims

Protected claims are claims made in respect of:

- Designated investment business
- Deposits
- Insurance

The activity subject to a claim must be carried out in the UK or in an EEA state by a firm passporting its services there.

Relevant persons

The following are relevant persons:

- An authorised firm
- An appointed representative of the above

(An EEA firm passported into the UK is **not** a relevant person. Customers losing money from the activities of such a firm would have to seek compensation through the firm's home state regulator).

Relevant time limits

Six years from when the claim arose.

Scheme limits

- Deposits - a maximum of £85,000
- Investments - a maximum of £50,000
- Compulsory insurance - 100% of valid claims and unexpired premiums
- All other insurance - at least 90% of the value attributable to the policy

Funding

The FSCS is funded by **authorised firms**.

For the scheme as a whole, the **total payout** for compensation in any one year is **unlimited**.

3. Complaints and redress: summary

3.1. Key concepts

Complaints and redress

- 3.6.2 - The FCA rules relating to handling of complaints (DISP 1.3)
- 3.6.6 - The procedure and time limits for the resolution of complaints (DISP 1.4, 1.5 & 1.6)
- 3.6.7 - The rules relating to record keeping and reporting concerning complaints (DISP 1.9 & 1.10)

Financial Ombudsman Service (FOS)

- 3.6.3 - The role of the Financial Ombudsman Service (DISP Introduction and DISP 2)
- 3.6.4 - The rules relating to determination by the Financial Ombudsman Service (DISP 3)
- 3.6.5 - Compulsory and voluntary jurisdiction (DISP Introduction)

Financial Services Compensation Scheme (FSCS)

- 3.6.8 - The purpose of the Financial Services Compensation Scheme (FSCS) (COMP 1.1.7)
- 3.6.9 - The circumstances under which the FSCS will pay compensation (COMP 1.3.3, 3.2.1, 4.2.1 & 4.2.2)
- 3.6.10 - The limits on the compensation payable by the FSCS (COMP 10.2.1, 10.2.2 & 10.2.3)

Now you have finished this chapter you should attempt the chapter questions.

Financial Crime

1. Introduction

1.1. Chapter overview

You will recall that one of the four statutory objectives of the FCA is to reduce financial crime.

This chapter explains the different types of financial wrongdoing and the penalties incurred if someone is found to have breached the relevant law.

You will begin by looking at insider dealing (a criminal offence defined by the Criminal Justice Act 1993) - a serious offence but notoriously difficult to prosecute.

You will then read about two offences defined by FSMA 2000: misleading statements and practices (S397), and market abuse (S118) and the penalties incurred for non-compliance.

The chapter then moves on to discuss the Proceeds of Crime Act 2002 and the criminal offence of money laundering and the financing of terrorism.

1.2. Learning outcomes

On completion of this module you will:

Insider dealing

- 3.7.7 - Explain the offence of insider dealing covered by the CJA 1993
- 3.7.6 - Explain the meaning of 'inside information' covered by the Criminal Justice Act (CJA) 1993
- 3.7.8 - Identify the penalties for being found guilty of insider dealing
- 3.7.9 - Explain the FCA's powers to prosecute insider dealing

Market abuse (S118 FSMA 2000)

- 3.7.10 - Describe the behaviours defined as market abuse (MAR 1.3, 1.4, 1.5, 1.6, 1.7, 1.8 & 1.9)
- 3.7.11 - Explain the enforcement powers of the FCA relating to market abuse (MAR 1.1.4, 1.1.5 & 1.1.6)

Money laundering

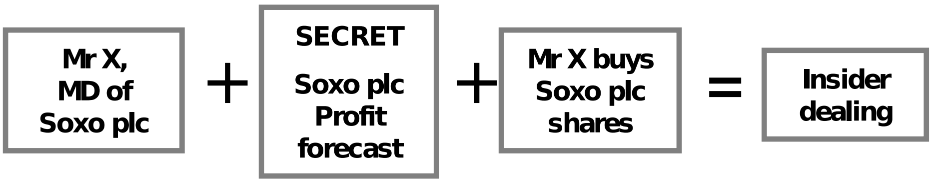
- 3.7.4 - Explain the three stages involved in the money laundering process
- 3.7.1 - Explain the various sources of money laundering and counter terrorism regulation and legislation (FCA rules, Money Laundering Regulations, Proceeds of Crime Act 2002)
- 3.7.2 - Explain the role of the Joint Money Laundering Steering Group (JMLSG)
- 3.7.3 - Explain the main features of the guidance provided by the JMLSG
- 3.7.5 - Explain the four offence categories under UK money laundering legislation

Bribery

- 3.7.12 - Explain the main features of the Bribery Act 2010

2. Insider dealing (Part V Criminal Justice Act 1993)

2.1. Introduction



Company directors and their professional advisors often have access to price-sensitive information about a company's results or prospects. It is a **criminal** offence for anyone to benefit from such information prior to its release to the market as a whole.

The Treasury oversees the insider dealing legislation contained within the Criminal Justice Act 1993.

2.2. Offences

The Criminal Justice Act defines three types of offence as 'insider dealing'. These are:

- **Dealing** on the strength of inside information either on a regulated market or through a professional intermediary

- **Encouraging** another person to deal on the strength of inside information with a reasonable belief that dealing would take place on a regulated market or through a professional intermediary

- **Disclosing** inside information to another person other than in the proper performance of one's duties

Note that disclosing information is only an offence when the person disclosing the information believes that the recipient is **likely** to deal on the strength of that information.

An offence is committed when one of the actions described above is taken and the person has information as an insider. This means that the person **knows** that it is inside information and **knows** that the information is from an inside source.

2.3. Inside information

Many types of information are covered, including financial results, takeover plans and news of the departure of key employees. Under the legislation, the information must have **all** of the following characteristics:

- It relates to a particular issuer (or issuers) of securities, or to a particular issue of securities

- It is specific or precise

- It has not been made public

- It must be likely to have a significant effect on the price once made public

Information that satisfies this definition is called **unpublished, price-sensitive information**.

Dealing on....

Encouraging others to deal on....

Disclosure of....

Inside information

- Specific, or precise
- From an inside source
- Price sensitive

The following categories of information are deemed to be **published** information:

- Published information, for example:
  - Information from a regulatory information service or financial press
  - Information from public records
  - Information published overseas
  - Information selectively published
- Information that can only be acquired by expertise or by payment of a fee
- Information that can be acquired by observation e.g. news broadcasts

2.4. Primary and secondary insiders

A person is defined as an insider if he/she has information that he/she **knows** is inside information and he/she **knows** that it is from an inside source.

Insiders could include directors, employees, shareholders, and anyone obtaining information because of their employment or profession. Such insiders are known as **primary** insiders as they have acquired their information due to their connection with the company. A **secondary** insider (sometimes known as a 'tippee') is anyone who came across inside information, directly or indirectly, from a primary insider. Both types of insider can be guilty of insider dealing.

2.5. Securities affected

Insider dealing legislation relates specifically to abuses of information in respect of financial securities. It therefore includes instruments based on securities, such as stock index futures, share warrants, depositary receipts and equity options. The main **exclusions** are:

- Assets with no secondary market, such as units in **unit trusts** and shares in investment companies with variable capital (ICVCs)
- Commodities and commodity derivatives, e.g. copper options
- Over-the-counter (OTC) markets, such as foreign exchange forward contracts
- Insurance products

2.6. Transactions affected

Only transactions on an exchange or via a professional intermediary (such as a stockbroker) are covered. Thus, a private sale from one investor directly to another is not subject to the legislation.

2.7. Defences

General defences

The following constitute a valid defence to the charge of insider dealing:

- Information was being passed on in the proper course of employment
- The person who passed on the information did not expect the recipient to deal
- The information was already publicly available: this is a very wide-ranging defence since, under the legislation, information disclosed to a 'section' of the public is deemed to be publicly available
- The person would have behaved in the same way even if he/she was not in possession of the inside information

Special defences

There are three further defences relevant to market professionals:

1. **Stabilisation** - a procedure used to maintain the price of new issues, carried out under strict rules.
2. Recipients of **market information** - this is designed to protect market participants where they have knowledge of transactions that have taken place, or are to take place, or that a transaction will not take place.
    - Market information refers to information that market professionals may hear about and it would be unreasonable to prevent them from using. The criteria the court will apply is that 'it was reasonable for an individual in their position to have acted as they did despite having that information as an insider'
    - For example where a market professional knows of the client's intention to enter into a large transaction, then the firm can continue to act on behalf of other clients or deal with them provided that it is reasonable to do so
    - This defence allows a company planning a takeover of another to buy shares in the target company before announcing its full intentions. Although it has price-sensitive information of its own intentions at the time, it will not be found guilty of insider dealing. This defence is called 'bid facilitation'
3. **Market makers** acting in the ordinary course of business - they are duty bound to buy and sell securities.

2.8. Enforcement

The market operations division of the London Stock Exchange (LSE) monitors transactions on the LSE in order to identify possible abuses. Suspicions are passed on to the FCA for investigation and prosecution. The FCA has operating arrangements in place with the Recognised Investment Exchanges (RIEs) which set out the responsibilities of the FCA and the market operators for monitoring, investigation and prosecution.

The FCA also has responsibility for prosecutions.

2.9. Penalties

In a Magistrate's Court the maximum penalty is a fine of £5,000 and six months in jail.

In a Crown Court the maximum penalty is an unlimited fine and seven years in jail.

3. Market abuse (S118 FSMA 2000)

3.1. The offence

Basic offence

Market abuse is a **civil offence** under S118 FSMA 2000.

The rules were amended in 2005 on adoption of the EU Market Abuse Directive (MAD).

The offence applies in addition to the criminal offences of insider dealing and misleading statements and practices and is easier to prove as the burden of proof in civil law is based on the balance of probabilities.

The FCA issues a 'Code of Market Conduct' which forms part of the FCA Handbook. The Code provides guidance on what does and does not constitute market abuse.

Market abuse offences

There are seven types of behaviour in relation to qualifying investments trading or to be traded on a prescribed market which are deemed to be market abuse.

1. Insider dealing

2. Improper disclosure

3. Misuse of information

4. Manipulating transactions

5. Manipulating devices

6. Dissemination

7. Misleading behaviour and distortion

Qualifying investments and prescribed markets

Behaviour will be deemed to constitute market abuse if it occurs in the UK or in relation to qualifying investments traded on a prescribed market.

The Code refers to behaviour as this includes action and inaction.

A prescribed market is:

- Any UK market regulated by an RIE (including AIM) and any regulated market as defined in the Markets in Financial Investments Directive (MiFID)

A qualifying investment is:

- Any investment handled on a UK RIE

For the offences of 'misuse of information' and 'misleading behaviour and distortion', the definition of prescribed markets excludes non-UK regulated markets. This means that these offences are only relevant for UK markets (they are not covered by MAD, but they existed in the UK before MAD and they have been carried forward).

The behaviour must be in relation to qualifying investments. However, 'in relation to' means that the offence can apply to off-exchange dealings too.

Intention

The statutory definition of market abuse does not require the person engaging in the behaviour to have intended to abuse the market. It is the **effect**, rather than the intention of the person, that is important in determining whether market abuse has occurred or not.

3.2. Code of Market Conduct

Background

FSMA defines only the outer limits of what can constitute market abuse. Under S119 FSMA 2000, the FCA has a duty to compile the Code of Market Conduct to 'give appropriate guidance to those determining whether or not behaviour amounts to market abuse'. This Code allows the FCA flexibility to adapt and amend its rules in the face of rapidly changing market practices.

The Code of Market Conduct is contained within the Business Standards block of the FCA Handbook.

Guidance contained within the Code has the authority of an evidential provision. Breach of the Code therefore does not automatically constitute market abuse, but it can be used as evidence towards demonstrating that market abuse has taken place.

Market abuse behaviours

Market abuse is behaviour by one person alone or two or more people jointly or in concert which occurs in relation to:

- Qualifying investments traded on a prescribed market
- Qualifying investments in respect of which a request for trading on a prescribed market has been made
- Related investments of a qualifying investment

The behaviour must be included in one of the seven types of behaviour described below:

1. Insider dealing

This is where an insider deals, or attempts to deal, in a qualifying investment or related investment on the basis of inside information.

An insider is someone who has inside information as a result of:

- Membership of administration, management or supervisory body of an issuer
- Holding capital in an issuer
- Their employment, profession or duties
- Criminal activities
- Obtaining information by other means which he/she knows, or could reasonably be expect to know, is inside information

2. Improper disclosure

This is where an insider discloses inside information to another person other than in the proper course of the exercise of his/her employment, profession or duties.

3. Misuse of information

The behaviour does not fall into Type 1 or 2, but it is based on information which is not generally available to those using the market and which a regular user would regard as relevant, and the behaviour would be regarded as a failure to observe the standards of behaviour reasonably expected.

A regular user is:

- A hypothetical, reasonable person
- Someone who regularly deals on the market and in the investments of the kind in question

4. Manipulating transactions

This is behaviour which consists of effecting transactions or orders to trade that are not for legitimate reasons or in conformity with accepted market practices and which:

- Give, or are likely to give, a false or misleading impression as to the supply of, or demand for, or as to the price of, the qualifying investment
- Secure the price of such investments at an abnormal or artificial level

5. Manipulating devices

Behaviour that consists of effecting transactions or orders to trade which employ fictitious devices or any other form of deception or contrivance.

6. Dissemination

This behaviour consists of the dissemination of information by any means which gives, or is likely to give, a false or misleading impression as to a qualifying investment by a person who knew, or could reasonably be expected to have known, that the information was false or misleading.

7. Misleading behaviour and distortion

The behaviour does not fall into Types 4, 5 or 6 but:

- It is likely to give a regular user of the market a false or misleading impression as to the supply of, demand for, or price or value of qualifying investments
- It would be regarded by a regular user of the market as behaviour that would distort the market in such an investment, and is likely to be regarded by a regular user of the market as a failure on the part of the person concerned to observe the standard of behaviour reasonably expected of a person in his/her position

Statutory exceptions (safe harbours)

The Code also identifies various **statutory exceptions** of behaviour. If a person behaves within one of the statutory exceptions then they are not committing market abuse.

The following are statutory exceptions:

- Conforming with the EU's Buy-back and Stabilisation Regulation

- Conforming with the Conduct of Business Rules
- Disclosures in accordance with the Disclosure Rules
- Conforming with specified rules in the Takeover Code

FSMA 2000 also provides the following additional defences:

- Believing on reasonable grounds that your behaviour does not constitute an offence
- Taking all reasonable precautions and exercising all due diligence to avoid behaving in a way that constitutes an offence (due diligence defence)

3.3. Penalties

Penalties for market abuse are outlined in Part VIII of the Act, with wrongdoers being subject to an unlimited fine.

Other penalties open to the FCA include seeking a restitution order, obtaining an injunction and issuing public statements of misconduct.

4. Money laundering (Proceeds of Crime Act 2002)

4.1. The Proceeds of Crime Act

The three stages

Money laundering is a very serious crime. It is the process by which criminals disguise the source of their criminal proceeds. The legislation on money laundering is the Proceeds of Crime Act (POCA) 2002, as amended by the Serious Organised Crime and Police Act (SOCPA) 2005. It relates to cash generated from any illegal activity – be it drugs, fraud, forgery or tax evasion.

The legislation refers to 'criminal property', which is property that has arisen from 'criminal activity'. Criminal activity is any conduct which:

- Is an offence in the UK
- Would constitute an offence if it had taken place in the UK. However, there is now a defence introduced by SOCPA where the relevant criminal conduct occurred outside the UK in a country where it was not at the time unlawful

The scope of 'relevant criminal conduct' in relation to money laundering is ultimately determined by the Secretary of State.

Money laundering is usually described in three stages: placement, layering and integration. Each stage is explained below:

Stage one: placement

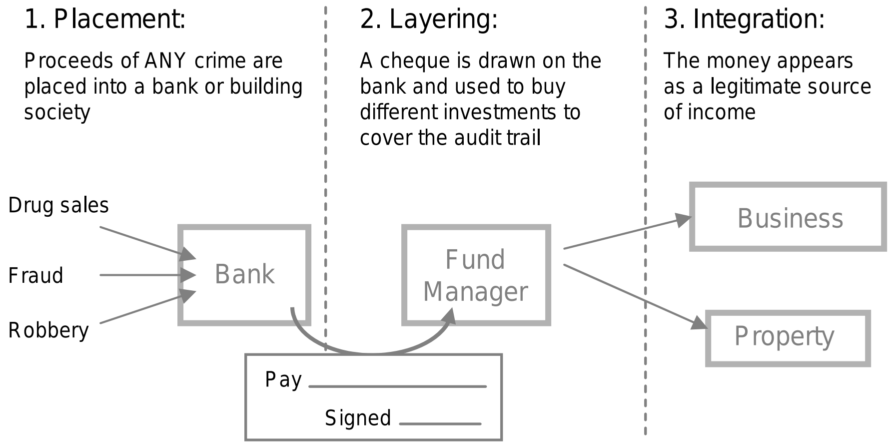
Placement involves the physical disposal of the illegal cash proceeds as a result of a criminal activity. For instance, an investor with illicit proceeds deposits £100,000 into a bank account.

Stage two: layering

Layering is the activity that separates the cash proceeds from their illegal source. For example, the criminal now draws a cheque to buy a range of investments (possibly through an authorised firm).

Stage three: integration

The third and final stage is integration. This stage is an attempt to lose the audit trail even further by re-investing cash proceeds from a seemingly legitimate source back into the financial system. For example, the investments purchased in the layering stage are now sold and the proceeds are reinvested into a business and/or property and real estate.



Relevance to the industry

Firms must maintain a sufficient audit trail of records and documents so that it can be used by the authorities should a suspicious chain of events come to light.

Each firm, no matter how small, must appoint a Money Laundering Reporting Officer (MLRO) to whom suspicions should be reported. The MLRO will then, if appropriate, speak to the relevant authority, which is the National Crime Agency (NCA), formerly known as SOCA.

The MLRO is a required controlled function and therefore must be a senior member of the firm with approved person status. Other conditions for an MLRO are:

- Expected to be based in the UK
- Be sufficiently independent
- Have sufficient resources at his/her disposal

4.2. The Money Laundering Regulations 2007

Application

The Money Laundering Regulations, issued by the Treasury and approved by Parliament, set down detailed procedures on what a firm should do to protect itself against money laundering. They are based on and implement the Money Laundering Directive.

A breach of the Regulations can be committed **whether or not** any money laundering actually takes place. The maximum penalty is a two-year jail sentence and an unlimited fine.

The Regulations apply to:

- Banks, building societies and other credit institutions
- Individuals and firms engaging in investment business within the meaning of the FSMA 2000
- Insurance companies covered by the EU Life Directives, including the life business of Lloyd's of London
- Bureau de change, cheque encashment centres and money transmission services
- Other relevant businesses including lawyers, casinos, estate agents and dealers in high value goods

A risk-based approach to identification

The approach to identifying clients and performing customer due diligence is risk-based. Where there is greater risk of money laundering, there needs to be enhanced due diligence. Where there is less risk of money laundering, simplified due diligence can be used.

Increased emphasis on due diligence

The third and most recent version of the Money Laundering Regulations (2007) has increased the emphasis on obligations regarding due diligence; for example:

- Explicit requirements for firms to undertake ongoing monitoring of business relationships
- Firms being required to identify not just the client, but the beneficial owner underlying the client

It requires firms to take enhanced customer due diligence measures in higher risk situations, while allowing firms to take reduced identification measures for specific situations with a lower risk of money laundering.

It also allows firms to rely on certain other firms for undertaking customer identification.

Simplified due diligence

Identification procedures are not required in the following circumstances:

- Credit or financial institutions subject to the Third Money Laundering Directive
- Supervised credit or financial institutions in states with comparable controls
- Listed companies on regulated markets with specified disclosure obligations
- The beneficiaries of solicitor's accounts
- Certain defined public authorities
- Certain insurance products and pension schemes
- Certain other types of defined products, such as child trust funds

Enhanced due diligence

Note that a firm should carry out identification checks, even on those persons where it is not usually required to do so, if:

- Business is conducted on a non-face to face basis
- A situation presents a higher risk of money laundering or terrorist financing
- The customer is a politically exposed person (PEP)

PEPs are clients who hold or have held public office or have gained a high political profile which could make them vulnerable to corruption. The enhanced due diligence applies to PEPs, their families and associates.

A firm is obliged to have in place procedures to ascertain whether an individual is a PEP. The 2007 regulations provide that a firm has to have in place:

- A requirement that all PEP relationships must be approved by senior management
- Adequate measures to establish source of funds and source of wealth

- Enhanced ongoing monitoring procedures

The FCA rules

FSMA 2000 sets the FCA the objective of reducing financial crime, of which money laundering is a part.

With a view to simplifying the structure and content of the Handbook, the FCA decided to delete the Money Laundering Sourcebook in its entirety and replace it with simpler and more general provisions in Senior Management Arrangements, Systems and Controls (SYSC).

To supplement this, the FCA have also produced a regulatory guide called “Financial Crime: a guide to firms” and also emphasises the guidance available from the Joint Money Laundering Steering Group. These guidance notes are considered when the FCA is assessing whether a firm has met the appropriate requirements in the systems and controls of the firm for mitigating money laundering and the terrorist financing risk.

4.3. The Joint Money Laundering Steering Group (JMLSG)

Introduction

The JMLSG produces Guidance Notes for financial institutions on fulfilling their duties in relation to money laundering and money laundering for terrorist activities. The JMLSG is made up of the leading trade associations in the financial services sector (such as the British Bankers' Association).

In particular, the JMLSG set out the standards expected in relation to senior management's responsibility to control risks that could lead to the firm furthering financial crime. To do this the firm should adopt a risk-based approach.

Risk-based approach

- Senior management roles should include an MLRO and a senior manager responsible for the direction and oversight of anti-money laundering and combating the financing of terrorism (AML/CFT).

- Adequate documentation should be produced, including the policy and procedures of the firm to implement AML/CFT. This documentation must include a named employee responsible for its implementation and an assessment of the firm's risks. These documents must be specific to the firm's business and customer risks - a generic document is not adequate.

- As part of the risk-based approach, the JMLSG also identifies low risk clients. These are clients with a regular income, clients who have had a long-term active relationship with the firm and clients who have court approval; for example, the executors of a will.

Application of the Guidance Notes is not mandatory, and failing to comply with them does not mean that a breach of the Regulations or the FCA rules has occurred. However, they do provide a good indication of the behaviour expected of financial sector firms and are a safe harbour in respect of the Regulations.

POCA 2002 and the Terrorism Act 2000 also require the courts to take account of Guidance that has been approved by HM Treasury when considering whether a person within the financial sector has committed an offence of not reporting. The JMLSG Guidance Notes have received Treasury approval.

Requirements

Internal controls

Under the Regulations, firms must ensure that they set up **appropriate** internal controls and institute a programme of staff training.

A Money Laundering Reporting Officer (MLRO) **must be appointed** to act as an internal and external point of contact for matters arising in relation to money laundering.

An MLRO is also required under the FCA's rules and, as a 'required controlled function', needs FCA approval.

Once a member of staff has reported his/her suspicions to the firm's MLRO he/she has discharged his/her statutory duty and cannot face any criminal liability in respect of the reported transaction.

Education and training

Staff must be **trained to recognise** suspicious transactions. Suspicious transactions would include those which are unusual in size or in timing for the investor, the security or the market.

To facilitate this, firms should set out detailed training schedules on anti-money laundering (AML) awareness for employees.

Identification procedures

The basic requirement

Firms are obliged to verify the identity of new clients as part of customer due diligence (CDD). Unless satisfactory evidence of identity is obtained **in a timely manner**, the business must not proceed (unless a report has been made to NCA).

Firms are **required** to carry out identification procedures on new customers in the following circumstances:

- Where a new business relationship is to be established
- Where the value of the transaction exceeds €15,000
- Where there are suspicions

Firms must:

- Identify the customer and verify the customer's identity on the basis of documents, data or information obtained from a reliable and independent source
- Identify the beneficial owner and take adequate measures on a risk-sensitive basis to verify their identity, so that the firm is satisfied that it knows who the beneficial owner is
- Obtain information on the purpose and intended nature of the business relationship
- Keep the documents, etc, obtained for the purpose of applying CDD up to date
- Conduct ongoing monitoring of the business relationship

Reporting suspicions

Under the Regulations, employees are required to report suspicious transactions **as soon as possible** to the MLRO, who will in turn refer the matter to the NCA. Once an employee has reported his/her suspicion he/she has no further reporting obligation.

Examples when a firm may be suspicious of the motives of a new/existing client include:

- A reluctance of a new client to provide identification documents
- The unnecessary use of a third party to act as an intermediary

- Continual patterns of unusual trading
- A request for non-market price transactions
- The constant use and transfer of bearer securities
- An introduction from a suspicious party or jurisdiction
- Where the client has no obvious reason to use the firm's services
- Unusual and/or frequent payment to third parties

POCA 2002 also has implications for reporting suspicions (see below).

Record keeping

The following records must be made and maintained:

- Evidence of identity: maintained for five years from the end of the firm's relationship with the client
- Transaction records: maintained for five years from the date when the transaction was completed

Records of the following should also be kept for five years:

- The dates when anti-money laundering training was given, the nature of the training and the names of the staff who received training
- Reports made by the MLRO to NCA, consideration of those reports and any action taken as a consequence

4.4. The penalties under the Proceeds of Crime Act 2002

The Proceeds of Crime Act (POCA) 2002, as amended by the Serious Organised Crime and Police Act (SOCPA) 2005, defines money laundering offences and defences.

Offences

Concealing, acquiring, possessing and assisting

The Act makes it an offence for any person to acquire or possess criminal property, or to assist another person engaging in or benefiting from criminal conduct.

The term 'criminal conduct' includes any conduct (wherever it takes place) that would constitute a criminal offence if committed in the UK. This not only includes serious criminal conduct, e.g. drug trafficking offences, terrorist activity, corruption, tax evasion, burglary and theft, fraud, forgery, counterfeiting, product piracy, illegal deposit taking, blackmail and extortion, but also any other offence regardless of size.

There is a **defence** when knowledge or suspicion of the offence is reported to the National Crime Agency (NCA) before the prohibited act is carried out, or as soon afterwards as reasonably practicable.

Failure to report

It is a criminal offence for any person within the regulated financial sector (i.e. anyone who falls within the scope of the Money Laundering Regulations) not to report his/her knowledge or suspicion that money laundering is taking place.

The Act introduces a new requirement to report **as soon as reasonably practicable** where there are 'reasonable grounds' to know or suspect that money laundering is taking place. This places an objective test of suspicion on the regulated financial sector. If a report of a suspicion is not reported as soon as reasonably practicable, a criminal offence is committed.

An additional offence of **not reporting** has also been introduced for Money Laundering Reporting Officers (MLROs). The offence applies where an MLRO who has received an internal report does not make a report to the National Crime Agency (NCA) as soon as is practicable after the internal report was received.

It is a criminal offence to fail to be suspicious of behaviour that would ordinarily give rise to such suspicion.

Members of staff within the regulated financial sector are provided with a **defence** if their employer has not provided them with the training required under the Regulations to recognise and report suspicions or if they have a reasonable excuse for not reporting their suspicion.

Whether an excuse not to report a suspicion is reasonable will depend on the circumstances of the particular case. However, the burden of proof is that the person must demonstrate that he/she did have a reasonable excuse for not reporting their suspicion.

Note that, if an individual reports his/her suspicions regarding money laundering, he/she will **not** be in breach of any duty of confidentiality owed to a client.

Tipping off

A person commits an offence if he/she makes a disclosure which is likely to prejudice any investigation which might be conducted.

This includes disclosure to any third party no matter how small the crime may be.

It is a **defence** against this charge that a person can prove that they neither knew nor suspected that the disclosure would prejudice an investigation. Note that the burden of proof lies with the individual charged with the offence of tipping-off.

Failure to comply with the Money Laundering Regulations

Failure to comply with the Money Laundering Regulations is a criminal offence punishable by a jail term (see below).

Penalties

POCA 2002 defines the following maximum prison terms, all of which can be accompanied by an unlimited fine:

- Concealing, acquiring, possessing and assisting: 14 years
- Failure to report: five years
- Tipping off: two years
- Failure to comply with the Money Laundering Regulations: two years

FSMA 2000 grants the FCA the power to reprimand, fine and prosecute for money laundering offences under POCA 2002.

4.5. Terrorism (Terrorism Act 2000)

Introduction

In the UK, terrorism is defined by the Terrorism Act 2000 Part 1 and is a **criminal offence**.

The definition covers the use or threat of use of 'action' which is:

- Designed to influence the government (UK or overseas) or to intimidate the public (UK or overseas)
- Made for the purpose of advancing a political, religious or ideological cause

Action is relevant for the offence if it:

- Involves serious violence against a person
- Involves serious damage to property
- Endangers a person's life
- Creates a serious risk to the health or safety of the public
- Is designed to seriously interfere with or disrupt an electronic system

Laundering the proceeds of crime vs. financing terrorist acts

There are **two** major differences between the use of criminal and terrorist funds:

- Terrorists can be funded from **legitimate** funds. It is therefore difficult to identify precisely when the funds become terrorist assets.
- Only a small amount may be required to commit an act of terrorism, thus tracking funds can be difficult

Obligations on regulated firms under the Terrorism Act 2000

The Terrorism Act 2000 and the Anti-Terrorism, Crime and Security Act 2001 set out the statutory duties of regulated firms. Like money laundering, the JMLSG Guidance Notes support these obligations.

There is a statutory obligation to report any suspicion of terrorist financing arising in the regulated financial sector. As a result of this, a firm must disclose to the police and an employee must disclose internally if there is suspicion of an offence in respect of:

- Providing funds for terrorism
- Using and possessing terrorist funds
- Laundering money which is terrorist property

For staff working in an authorised firm, an offence is committed if suspicions are not reported where they had subjective suspicions (i.e. actual suspicions) or objective suspicions (i.e. reasonable grounds for being suspicious).

The penalty for failing to make a report is the same as the penalty for failing to disclose a suspicion of money laundering (i.e. a maximum of a five-year jail sentence and an unlimited fine).

5. UK Bribery Act 2010

The Bribery Act 2010 came into force in July 2011 and replaced the old laws on bribery with a more stringent set of anti-bribery rules.

5.1. Offences

Under the act it is an offence to:

- Pay bribes – it is illegal to give/offer a financial, or other, advantage with the intention of inducing a person to perform ‘a relevant function or activity’ improperly
- Receive bribes – it is illegal to receive a financial, or other, advantage in order to encourage the performance of ‘a relevant function or activity’ improperly
- To bribe foreign officials
- Fail as an organisation to prevent bribery

‘Relevant function or activity’ includes any function of a public nature and any activity connected with a business.

5.2. Impact on companies

Under previous laws it was unlikely for a company to be found guilty of bribery unless collusion of senior management could be proved. Therefore this is a significant change to previous legislation and a company could be found guilty without proven knowledge of the activity, but simply a lack of adequate prevention procedures. The government has published illustrative guidance on what amounts to ‘adequate procedures’.

Penalties

- Individual – maximum jail sentence is ten years (increased from seven under this Act)
- Company – unlimited fine

6. Summary

6.1. Key concepts

Insider dealing

- 3.7.7 - The offence of insider dealing covered by the CJA 1993
- 3.7.6 - The meaning of 'inside information' covered by the Criminal Justice Act (CJA) 1993
- 3.7.8 - The penalties for being found guilty of insider dealing
- 3.7.9 - The FCA's powers to prosecute insider dealing

Market abuse (S118 FSMA 2000)

- 3.7.10 - The behaviours defined as market abuse (MAR 1.3, 1.4, 1.5, 1.6, 1.7, 1.8 & 1.9)
- 3.7.11 - The enforcement powers of the FCA relating to market abuse (MAR 1.1.4, 1.1.5 & 1.1.6)

Money laundering

- 3.7.4 - The three stages involved in the money laundering process
- 3.7.1 - The various sources of money laundering and counter terrorism regulation and legislation (FCA rules, Money Laundering Regulations, Proceeds of Crime Act 2002)
- 3.7.2 - The role of the Joint Money Laundering Steering Group (JMLSG)
- 3.7.3 - The main features of the guidance provided by the JMLSG
- 3.7.6 - The four offence categories under UK money laundering legislation

Bribery

- 3.7.12 - The main features of the Bribery Act 2010

Now you have finished this chapter you should attempt the chapter questions.

Other regulatory requirements

1. Introduction

1.1. Chapter overview

This chapter moves away from the financial institutions and looks more generally at company law and regulations. The chapter begins with the link between the two, and the process of floating on the London Stock Exchange. It also introduces you to the United Kingdom Listing Authority, the regulator for listed companies. The chapter then moves on to company law and the need for shareholders to disclose holdings in a company, before moving into the statutory and regulatory regime of takeovers and mergers.

1.2. Learning outcomes

On completion of this module you will:

Flotation

- 1.5.2 - Identify the listing rules in FSMA 2000, and relevant EU directives

Listing on the LSE and other venues

- 1.5.1 - Explain the role of the FCA as the UK listing authority
- 1.5.4 - Explain the purpose of the requirement for prospectus or listing particulars
- 1.5.5 - Identify the main exemptions from listing particulars
- 1.5.3 - Explain the main conditions for listing on the Official list, AIM and ISDX
- 1.6.4 - Explain the London Stock Exchange (LSE) requirements for listed companies to disclose corporate governance compliance

Continuing obligations for LSE traded companies

- 1.6.5 - Explain the continuing obligations of LSE listed companies regarding information disclosure and dissemination
- 1.6.2 - Explain the purpose of corporate governance regulation and the role of the FRC in promoting good corporate governance
- 1.6.3 - Explain, in outline, the scope and content of corporate governance standards in the UK

Company meetings

- 1.6.6 - Explain, in outline, the UK company law requirements regarding the calling of general meetings
- 1.6.7 - Distinguish between annual general meetings and other types of company meetings
- 1.6.8 - Distinguish between the types of resolution that can be considered at company general meetings
- 1.6.9 - Distinguish between the voting methods used at company meetings
- 1.6.10 - Explain the role and powers of a proxy

Notifiable interests

- 1.6.1 - Explain the disclosures required under the disclosure and transparency rules relating to directors' interests and major shareholdings

Statutory control of takeovers and mergers

- 3.2.6 - Explain the function of the following bodies / persons: the Panel for Takeovers and Mergers, the Department for Business Innovation and Skills, and the Competition and Markets Authority

The Takeover Panel (POTAM)

- 3.2.7 - Explain the make up of the Panel on Takeovers and Mergers (the Takeover Panel) and how it is financed

- 3.2.8 - Explain the regulatory status of the City Code on Takeovers and Mergers

- 3.2.9 - Explain the main provisions of the City Code including the bid timetable

2. Flotation

2.1. Introduction

The London Stock Exchange (LSE) manages a main market called the **Official List** and a second tier market called the **Alternative Investment Market (AIM)**. As an alternative to the two LSE markets there is another exchange called ISDX .

Not all public companies are quoted on a public market. Some companies are set up as public companies even if there is no intention to actively trade their shares.

A flotation can go hand in hand with an issue of new shares, i.e. as part of a marketing operation.

Alternatively, a company can achieve a flotation by way of an **introduction**, where shares already issued but trading privately, are made available for trading on an exchange.

Applications to be admitted to the Official List are not, however, made to the London Stock Exchange. Applications for **admission** are made to the UK Listing Authority (UKLA), which is the FCA, and applicants will need to meet the UKLA’s **Listing Rules**.

The **Prospectus Rules** affect all publicly traded companies whether they trade on the main market or AIM, whereas the Listing Rules do not apply to AIM or other similar securities. Both sets of rules are discussed in detail below.

The **Disclosure and Transparency Rules** apply to shares traded on a regulated market in the UK and help prevent insider dealing and market abuse.

The FCA/UKLA is granted the power to created the rules for listing, prospectuses and disclosure and transparency under the Financial Services and Markets Act 2000 (FSMA2000).

Once a company's shares are on the LSE, the company will find itself bound by many sets of regulation including:

- The Companies Act
- Financial Conduct Authority (FCA) and UKLA rules
- The LSE's own rules for members

Many of the rules governing the public companies whose shares trade on exchange have been amended to implement various European directives.

In addition to this, all firms providing services relating to advice, dealing, arranging deals, etc., in these companies’ shares will need to be authorised to do so under FSMA 2000. Remember, the LSE itself (as a recognised investment exchange) is exempt from authorisation.

Advantages and disadvantages

Advantages of flotation

Acquisitions and mergers

The ability to issue paper securities with a market price as an acquisition currency can increase the potential of corporate growth by way of acquisition.

Public profile and prestige

Exposure on a public market will usually bring about an increase in press coverage, resulting in a heightening of public awareness about the company and its products and services.

Disadvantages of flotation

Regulation and cost

A publicly quoted company is more accountable to regulators. It therefore entails a much higher level of disclosure and reporting than is required by non-quoted companies. This, in turn, will lead to additional costs.

Market conditions

A company's share price is susceptible to volatile market conditions. This may result in a lack of liquidity in the company's shares that is beyond the control of the company's directors.

Investor power

Where shares are held by large institutional investors there is a risk that the founders could lose control of what they perceive to be their business.

Other useful information

Dual listing

A dual-listed company (DLC) is a corporate structure in which two corporations function as a single operating business through a legal equalisation agreement, but retain separate legal identities and stock exchange listings. Virtually all dual-listed companies are cross-border, and have tax advantages for the corporations and their shareholders. The equalisation agreements are legal contracts that specify how ownership of the corporation is shared, and are set up to ensure equal treatment of both companies' shareholders in voting and cash flow rights. The contracts cover issues related to dividends, liquidation and corporate governance. Usually the two companies will share a single board of directors and have an integrated management structure.

Cross listing

Dual-listing is not to be confused with cross-listing. Cross-listing of shares is when a firm lists its shares on one or more foreign stock exchange in addition to its domestic exchange. There are a number of possible explanations for firms seeking to crosslist. These include the traditional that the firm expects to benefit from a lower cost of capital because their shares become more accessible to global investors. Another possible motivation is that cross-listings on deeper and more liquid equity markets could lead to an increase in the liquidity of the stock and a decrease in the cost of capital.

3. Listing on the LSE

3.1. The United Kingdom Listing Authority (UKLA)

The FCA is empowered in its role as listing authority by the Financial Services and Market Act 2000 (FSMA 2000) S72.

In this role the UKLA has the duty to set standards for companies wishing to float on an exchange and continuing obligations for those whose shares are traded as well as those who trade the shares.

Where an application is in relation to a company acquiring listed status, the UKLA has the power to assess whether the appropriate standards have been met and, based on this, accept or refuse the application for listed status. If the application has been accepted and listed status granted, the UKLA has the power to discontinue or suspend this status.

It is worth noting that although applications for companies to be admitted on to the LSE Official List go to the UKLA, applications for firms to **trade** on the LSE are made to the London Stock Exchange.

3.2. The UKLA Prospectus Rules

Introduction

The Listing, Prospectus and Disclosure Rules can be found in the FCA Handbook and comprise of three separate sourcebooks. They set out the rules governing any issuer of securities wishing to list on the LSE official list and anyone trading in these securities. They also apply to the appointment of a firm as a sponsor for these issuers and the behaviours of these firms when performing the role of sponsor.

We will look at the requirement for a prospectus first.

The requirement of a prospectus

In the Listing Rules the UKLA generally requires either a prospectus or listing particulars to be completed by a company seeking a listing. The Prospectus Rules set out the detailed rules about these documents.

A prospectus is a publication containing all the relevant information required for a potential investor to make an informed decision about buying a company's shares. Once it has been completed it must be approved by the UKLA, published and advertised in at least one national newspaper.

These financial promotions relating to the issuance of a company's shares must also follow strict rules. In essence they state that the financial promotion must:

- Be identified as a financial promotion and not the prospectus itself
- State where the prospectus can be obtained
- Be consistent with the details stated in the prospectus

Prospectus directive

The UKLA's Prospectus Rules have been brought into line with the Prospectus Directive. The Prospectus Directive sets out the rules which apply to prospectuses for public offers of securities and admission of securities to trading on a regulated market.

Where prospectuses may not be required

Prospectuses are not required in certain circumstances including the following:

- Where the offer is made to qualified investors. The definition of qualified investor is similar to that of the quantitative test for elective professional clients
- Where the offer is made to fewer than 150 natural or legal persons, other than qualified investors, per EEA state
- Where the offer is made to investors who acquire the securities for a total consideration of at least €100,000 per investor or the denomination per unit is at least €100,000
- Where the total consideration of the offer is less than €5m calculated over a period of 12 months
- Where the shares being admitted to market represent less than 10% of the same class of shares already admitted to the same market (applies to admission for trading not public offers)

Any subsequent resale of securities to which these exemptions apply is however regarded as a separate offer and may require a prospectus unless an exemption applies.

Where a prospectus is not required, an issuer would need to produce listing particulars instead. Listing particulars contain the minimum basic information from the prospectus.

3.3. The official list: conditions for entry

The UKLA Listing Rules

There are two listing categories on the official list:

Premium listing – a company meets listing requirements above those required by EU directives, for example requirements on corporate governance. The ability to exceed EU requirements is referred to as 'super equivalency'. These companies are eligible for inclusion in the FSTE indices – adding significant liquidity to the shares.

Standard listing – a company meets the EU listing requirements.

High growth segment (HGS) – for companies that cannot yet meet the premium status, but intend to. They are typically larger than AIM companies and have separate eligibility criteria.

Conditions for listing

The most important UKLA requirements for a **premium listing** are:

Status

The company must be a public company.

Trading record*

The company must normally have a trading history of three years with financial statements, which have been independently audited and published.

Working capital*

The company must demonstrate that it has sufficient working capital to cover at least the next twelve months of business.

Market value of securities

There is a minimum market value requirement for all securities.

- In the case of bringing **equities** to market, the minimum value is £700,000
- In the case of **debt** securities, the minimum value is £200,000

Therefore, should a company bring both debt and equity to the market, the total value must be at least £900,000.

Management

The directors and senior management must have appropriate expertise and experience. They must also comply with the Model Code for Directors' Dealings.

Sponsor*

The company bringing its shares to market must appoint a sponsor. This is typically an authorised firm expert in administering the listing and/or issuing process.

Share ownership

At least 25% of the shares must be distributed to the public. In this instance, the 'public' refers to any person, individual or institution, who is not a director of the company. This is known as the **free float**. A minimum level of free float is desirable as companies with low free floats tend to experience high share price volatility.

NOTE: those conditions marked with * are not required for a standard listing.

Conditions for high growth segment (HGS)

The eligibility criteria for an HGS company include:

- Incorporation in the EEA
- Commercial company issuing equity only
- Free float of 10%
- Compound average growth rate (CAGR) of 20% over three years

3.4. Alternative Investment Market (AIM): conditions for entry

Introduction

AIM is a separate market to the Official List which was set up by the LSE (in 1995) specifically to provide a market for small, young and growing companies. It is not considered an EU regulated market, but is a multilateral trading facility (MTF).

The criteria for acceptance are less onerous than those for the Official List. A company does **not** apply to the UKLA (the FCA) to join AIM. Instead, it is the LSE itself which has the final say on who joins this junior market.

Companies floated on AIM are known as **quoted** companies.

Key roles

Nominated advisor (NOMAD)

The nominated advisor (or NOMAD) plays a key role in advising the company to comply with AIM rules. Companies seeking a flotation are required to appoint a NOMAD whose job it is to satisfy itself that the company is appropriate for AIM and to confirm this in writing to the Exchange.

Any firm wishing to act as a NOMAD must have been accepted on to the register of nominated advisors held by the Exchange.

Nominated broker

AIM companies must appoint an LSE member firm to act as the company's **broker**. The broker's role is to match buyers with sellers in the company's shares, or to act as market maker when such orders cannot be matched.

The broker is also responsible for providing important information about the company which can be accessed via the SETS system (i.e. the stock exchange electronic trading service).

The NOMAD and broker may in practice be the same firm.

Conditions for entry

Status

The company must be a public limited company.

Admission document

The company must produce an admission document disclosing the information required by the Prospectus Directive. This information includes details on the directors, the activities and the accounts. The NOMAD vets this document.

A quoted applicant is not required to produce an admission document unless required under the Prospectus Rules. If a prospectus is required then this shall serve as the admission document. Once a prospectus has been approved by the FCA it must be submitted to the LSE with the admission application and fee before the expected date of admission to AIM.

Accounts

The company must publish accounts in accordance with international accounting standards.

Transferability

Shares must be freely transferable.

AIM vs. Official List: main differences in entry requirements

Note that for AIM applicants there is **no** requirement for:

- Minimum free float
- Minimum trading record
- Shareholder approval
- Minimum market capitalisation

3.5. ICAP Securities and Derivatives Exchange (ISDX)

Introduction

ISDX markets is not part of the London Stock Exchange (LSE), but is another recognised investment exchange for securities in the UK. As another market on which buyers and sellers can gather to trade securities, and on which companies can seek flotation to raise capital, ISDX is in direct competition with the LSE.

Conditions for entry

ISDX markets is closer in nature to the Alternative Investment Market (AIM) of the LSE than it is to the Official List. The conditions for entry reflect this. The conditions for entry include:

- The appointment and retention of a corporate advisor. This role is the equivalent of the NOMAD on AIM
- Demonstrate appropriate levels of corporate governance, with at least one independent director
- Provide a set of published audited financial reports
- Have adequate working capital
- Have no restriction on the transferability of shares
- Have its shares available for electronic settlement

4. The Continuing Obligations of LSE Companies

4.1. Continuing obligations: overview

Once a listing has been obtained, certain **ongoing** obligations have to be met in order to maintain it.

For example, a company listed on the LSE must also follow the rules set out under the UKLA's Model Code and the UK Code of Corporate Governance.

A listed company also has an obligation to fulfil the UKLA's Disclosure and Transparency Rules regarding:

- Disclosure and control of inside information
- Periodic financial reporting
- Vote holder and issuer notifications
- Access to information
- Corporate governance

4.2. Disclosure and transparency rules (DTR)

Introduction

The disclosure and transparency rules (DTR) cover the requirements for a listed company to keep the market informed of all price sensitive information and to fulfil the requirements under corporate governance. They attempt to limit the incidence of inside information being disseminated unequally or illegally, and in order to comply with the Market Abuse Directive and Transparency Directive.

It highlights:

- What type of information should be disclosed
- How and when the information should be disclosed
- Procedures for delaying disclosure

DTR also emphasises that a firm must have effective arrangements in place to deny access to inside information to any person who should not have access to the information.

Disclosure of information

Regulatory Information Service (RIS)

One of the main principles of the Listing Rules is that unpublished price-sensitive information must be disclosed to the market as a whole without delay. A listed company must notify the market of all relevant information which is not public knowledge concerning:

- A change in the company's financial condition
- The performance of its business
- In its expectations as to its performance

Price-sensitive information may not normally be disclosed to anyone else before it has been notified to an RIS (Regulatory Information Service) or PIPS (Primary Information Provider Service).

A key principle of the Listing Rules is to maintain a balance between ensuring the existence of a level playing field amongst investors on the one hand and ensuring efficient and orderly markets on the other. A number of RISs are currently approved by the FCA, including the Regulatory News Service (RNS) of the London Stock Exchange, Business Wire and PR Newswire Disclose. The longest standing PIP is the LSE's Regulatory News Service (RNS).

Secondary Information Providers (SIPS)

The Primary Information Providers are responsible for distributing listed company announcements to the newswire services or Secondary Information Providers. These include Bloomberg and Thomson Reuters. These SIPS disseminate the information provided by the PIPS to the general public.

Analyst research

The UK Listing Rules and Guidance Manual offer listed companies guidance on the way in which their relationships with analysts should be conducted. Analysts need to be aware of and operate within this framework if the relationship is to work smoothly. Analysts should refrain from putting a company into the position where it is likely to commit a breach of the Listing Rules; in particular, by selectively disseminating unpublished price-sensitive information.

Analysts should be particularly aware that, while they are not subjected to the Listing Rules, eliciting the selective dissemination of price-sensitive information may leave them open to an FCA investigation of their conduct under separate FCA powers; for example, under the Market Abuse Regime.

Equality of treatment

Overall the main thrust of all UKLA rules is that a company must ensure that all holders of the same class of listed share be treated equally and fairly.

Periodic financial reporting

The UKLA imposes requirements for companies on the London Stock Exchange to publish financial reports. The following summarises the requirements:

- Fully audited annual financial reports available at the latest four months after the end of the financial year
- Half-yearly financial reports available at the latest two months after the mid-point of the financial year
- Management reports attached to each

Both sets of financial reports must contain a balance sheet (statement of financial position) and profit and loss account (income statement).

The management report gives an account of major factors that have affected the company over the period covered and the principal risks and uncertainties for the near future.

Access to information

We have already seen that, as a publicly traded company, the issuer must give shareholders access to certain price-sensitive information through a regulatory information service (RIS). In addition to the information above, there is a host of other information that exchanges should give shareholders access to. These include:

- Any amendment to the company's constitution, i.e. changes to the articles or memorandums of association
- Any opportunities for holders of securities to exercise rights, such as vote at meetings, collect dividends, take part in rights issues, etc
- Any information about changes to the rights given to the holders of equity
- Any capital restructuring, such as the repayment of debt or company share buybacks

Corporate governance

A premium listed company must comply with the UK Code of Corporate Governance and show how its corporate governance functions in the published directors' report.

The UK Code of Corporate Governance stresses the importance of companies to apportion responsibilities with the company among the directors and to make sure that these responsibilities are being fulfilled.

The directors' report must cover:

- A description of the issuer's control and risk management systems
- A description of the issuer's administrative, management and supervisory bodies and their committees

In addition to this, persons discharging managerial responsibilities must also be bound by the Model Code, restricting their dealing in own-company shares to avoid suspicions that they are abusing their position and the knowledge that comes with it.

The Code on Corporate Governance is covered in more detail below.

4.3. Corporate governance

The UK Code of Corporate Governance

The current Code on Corporate Governance is incorporated into the Listing Rules and became effective in 2010. It replaces the Combined Code written by the Financial Reporting Council (FRC) in 2003. The FRC updated the Combined Code in 2008/9 following those years' financial turbulence, and published the new Code on Corporate Governance in order to implement further recommendations and guidance by the Smith and Higgs committees. The following are a list of the relevant committees and reports on corporate governance:

- Cadbury Report (1992) – set up by the Financial Reporting Council, the London Stock Exchange and the accountancy profession to address financial aspects of corporate governance
- Greenbury Report (1995) – sets out guidance as to the disclosure of directors' remuneration
- Hampel Report (1998) – the original Combined Code, which incorporated the Cadbury and Greenbury reports
- Turnbull Guidance on Internal Controls (1999) – sets out best practice on internal controls and risk management for listed UK companies
- Higgs Report (2003) – role and effectiveness of non-executive directors
- Smith Report (2003) – guidance for audit committees

The main principles of the UK Code on Corporate Governance

Leadership

- Every company should be headed by an effective board that is collectively responsible for the long-term success of the company.
- There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. No individual should have unfettered powers of decision.
- The chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role.
- As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy.

Effectiveness

- The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively.
- There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.
- All directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively.
- All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.
- The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties.
- The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.
- All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance.

Accountability

- The board should present a balanced and understandable assessment of the company's position and prospects.
- The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.
- The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditor.

Remuneration

- Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.

- There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

Shareholder relations

- There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.

- The board should use the AGM to communicate with investors and to encourage their participation.

The Stewardship Code

In addition to the Code on Corporate Governance, the Financial Reporting Council has also created the Stewardship Code. Released in 2010, this Code is a set of principles aimed at institutional investors holding voting rights in UK companies. The idea is to encourage such institutional shareholders to take an active interest in the corporate governance of the companies into which their clients' money is invested.

The Stewardship Code takes a 'comply or explain' approach, meaning that compliance with the Code is not mandatory, but if the institutional investor chooses not to comply with the Code it must explain why they have not done so on their website. They must also send this information to the FRC, which then links to the information provided to it.

The Stewardship Code has seven principles. Institutional investors should:

1. Publicly disclose their policy on how they will discharge their stewardship responsibilities

2. Have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed

3. Monitor their investee companies

4. Establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value

5. Be willing to act collectively with other investors where appropriate

6. Have a clear policy on voting and disclosure of voting activity

7. Report periodically on their stewardship and voting activities

5. Company meetings

5.1. The requirement for company meetings

General meetings give an opportunity to the shareholders of the company to vote on important matters, thereby exercising their ultimate powers of control over the company.

Companies normally hold an Annual General Meeting (AGM) every year. This must be within six months of the publishing of the company accounts, and the interval between AGMs must not exceed 15 months. Matters discussed will typically include normal recurring business such as directors' and auditor's appointments. Listed companies also have to present a remuneration report explaining the various aspects of directors' remuneration.

A company may also hold other general meetings, at which unusual or particularly pressing events are debated as they arise.

Rights to call meetings

Normally meetings will be called by the board.

However, a general meeting can be requisitioned by shareholders who, between them, own 5% or more of the company's voting shares, assuming 12 months have passed since the last meeting. If the directors fail to call a meeting once it has been requisitioned, the shareholders may hold a meeting at the company's expense.

Notice of meetings

AGMs require 21 calendar days' notice to be given to shareholders.

Other general meetings normally require 14 calendar days' notice.

The notice periods can be shortened in the event of consent of 100% of shareholders in respect of an AGM, and 95% of shareholders in respect of an other general meeting.

Notice is deemed to be served from 48 hours of the correct posting of the notice. In the case of electronic notices, these are deemed to be received 48 hours after sending.

5.2. Resolutions at company meetings

At general meetings decisions are made by the passing of resolutions.

There are two types of resolution: **ordinary** and **special**. The Companies Act prescribes which matters require which type of resolution.

Ordinary resolutions

Ordinary resolutions require a simple majority of the votes to be passed i.e. **more than** 50%.

Examples of issues approved by ordinary resolution include:

- Approval of the annual financial statements
- Appointment and removal of auditors
- Appointment and removal of directors

- Approval of a dividend - where dividends are rejected, the directors will propose an alternative dividend

Most of the business of an AGM is conducted by way of ordinary resolution.

Special resolutions

Special resolutions require a majority of 75% or more of the votes in order to be passed.

Examples of issues approved by special resolution include:

- Changing the company's name
- Waiving pre-emption rights
- Change to the Memorandum or Articles of Association
- Share buy-backs

Notice of resolutions

Individual resolutions also require notice to be given to shareholders.

Ordinary resolutions require 14 calendar days' notice.

Special resolutions require 21 calendar days' notice.

5.3. Voting on resolutions

Voting

The passing of resolutions is often carried out by a **show of hands**. Each shareholder present is usually entitled to one vote each per resolution regardless of the number of shares they hold.

Resolutions may also be voted by way of a full **ballot** (or **poll**). This is a written voting process where each shareholder receives voting rights determined by the number and class of their shares. A poll vote may be demanded by shareholders representing 10% or more of the voting rights in the company.

Proxies

If shareholders are unable to attend a meeting, they may appoint a proxy to attend and vote on their behalf. Proxies have no right to speak at meetings but can vote on issues decided by a written ballot or show of hands.

There are two types of proxy:

- A special (or 'two-way' proxy): a person is appointed and directed to vote for or against a particular resolution
- A general proxy: a person is appointed to vote based on what is said at a meeting

Proxies are appointed using proxy forms. A proxy form that does not indicate how the proxy is to vote is deemed to be a general proxy. The status of proxy will remain valid for the duration of the meeting and any adjournment of that meeting.

6. Notifiable interests

6.1. Background

Every company has a register of shareholders maintained by its company secretary. However, the register contains no information about the beneficiaries of shares held on trust, or about the collective holdings of closely connected persons.

In view of concerns that a group of persons may covertly buy up a substantial proportion of the company's shares, possibly in preparation for a surprise takeover bid, the UK Listing Authority's Listing Rules require prompt disclosure of substantial shareholdings, including beneficial holdings.

6.2. EU Transparency Directive

The aim of this Directive is to enhance transparency on EU capital markets by establishing rules for the disclosure of periodic financial reports and of major shareholdings for companies whose securities are admitted to trading on a regulated market in the EU. It has been implemented in the UK through the Disclosure and Transparency Rules (DTR).

EU disclosure of material interests

The Transparency Directive outlines disclosure thresholds as follows: 5%, 10%, 15%, 20%, 25%, 30% 50% and 75%.

Investors have to inform the issuer within **four business days** when reaching, exceeding or moving below the thresholds and the issuer in turn informs the market.

6.3. UK disclosure and transparency rules (DTR)

Disclosure of directors' interests in shares

Directors and other **persons discharging material responsibilities** (PDMR) must notify a listed company of any aquistion or disposal of an interest in that company.

- Notification within **four business days**
- Notification to the listed company
- Listed company will publish through a regulatory information service as soon as possible
- No later than the end of the next business day
- Applies to PDMRs and any connected party

UK disclosure of material interests

When implementing the Directive, EU member states are free to exceed the disclosure requirements in their regulations if they go beyond the requirements of the directive ('super-equivalence'). The law in the UK (Companies Act 2006), makes these rules the responsibility of the FCA in its guise as the Listing Authority (UKLA) and outlined in their Listing Rules. Disclosure of purchases in a UK issuer must be made to the company **within two business days** if a person's notifiable interest in the company's voting shares:

Reaches 3%

Having reached 3%, changes (up or down) to the **next** whole percentage point or more. For example, an increase from 3.9% to 4.1% is notifiable, whereas an increase from 3.1% to 3.9% is not. Further disclosure is required if the shareholding falls below 3%.

Fund managers of authorised, recognised and UCITS schemes are not exempt but their notifiable threshold is 5% and then 10% instead of 3%.

Market makers have imposed upon them a restriction of no greater than or equal to 10%.

Note: if the issuer of the shares is non-UK, then the FCA disclosure rules do not apply. Instead an investor would use the rules under the Transparency Directive.

Connected parties

To determine whether a notifiable 3% shareholding is held, a person must include shares held by the following parties (referred to as connected parties):

- The person's spouse
- The person's minor children (<18)
- Companies where the person controls more than a third of the votes
- Fellow members of any **concert party**. A concert party will exist where there is an agreement between persons to acquire and act collectively in the use of a plc's shares (e.g. on voting)

If two parties acting in concert, each holding 2%, a joint holding of 4% is required to be reported **by both**.

7. Statutory control of takeovers and mergers

7.1. Meaning of takeover and merger

Shareholders of the company own the company and appoint the Directors to manage it.

Any shareholder who acquires >50% of the shares in a company is deemed the **legal owner**, because they are able to appoint directors to run the company according to their wishes.

A takeover bid occurs whenever anyone attempts to acquire >50% of the shares in a company. The person trying to take over the other company could be an individual or a company. The terms takeover and merger are used interchangeably for the purposes of regulation, although merger is more commonly used if two similarly sized companies are to be joined together.

7.2. The Department for Business, Innovation and Skills (BIS)

The Department for Business, Innovation and Skills (BIS) was created in 2009 as an amalgamation of the Department for Business, Enterprise and Regulatory Reform and the Department for Innovation, Universities and Skills. It is an attempt to bring all of the levers of the economy together in one place. Their policy areas – from skills and higher education to innovation and science to business and trade – are focused on helping to drive growth.

BIS has various objectives, for example:

- Raise the productivity of the UK economy
- Improve the skills of the population, on the way to ensuring a world-class skills base by 2020
- Promote world class science and innovation in the UK
- Deliver the conditions for business success in the UK
- Improve the economic performance of all English regions and reduce the gap in economic growth rates between regions

7.3. Relevant takeover legislation

The Competition Act 1998 and the Enterprise Act 2002 aim to ensure that mergers and acquisitions in the UK do not result in uncompetitive practices or a substantial lessening of competition.

Under the Enterprise and Regulatory Reform Act 2013, the Competition and Markets Authority (CMA) is empowered to look at 'qualifying mergers' and decide whether they are allowed to proceed. In certain sectors, such as utility companies in the UK, referrals may be made to the CMA by relevant government ministers.

Where there are more national issues, for example issues of national security, BIS will intervene and take decisions instead.

Qualifying mergers

For a merger to qualify for further investigation, any of the following tests may be satisfied:

- As a result of the merger, the combined enterprise accounts for at least 25% of the supply or acquisition of particular goods or services, either in the UK as a whole or in a substantial part of it (**Share of Supply Test**)

- The turnover of the entity being acquired exceeds £70m (**Turnover Test**)
- Any other substantial lessening of competition

The CMA has up to 40 days to complete its initial study (phase one). If it believes there is a substantial lessening of competitions, it will move to phase two.

In phase two, the CMA has the power to prevent a takeover or merger proceeding, or impose restrictions on the takeover or merger.

8. The Takeover Panel

8.1. EU Takeover Directive

The EU Takeover Directive was implemented in the UK in 2006, by means of a combination of interim statutory provisions and amendments to the existing City Code. It aims to create a level playing field across the European Union to ensure equal treatment for shareholders during takeovers.

Some countries will continue to use their existing rules though. In the UK, the Takeover Panel (also known as the Panel on Takeovers and Mergers, or POTAM) remains the regulator of takeover and merger activity (see next section for details of the Takeover Panel).

The Directive applies to all EU companies that trade on any EU regulated market. The Directive states that it is necessary to protect the interests of holders of the securities of companies governed by the law of a member state when those companies are subject to takeover bids or to changes of control.

8.2. The Takeover Panel

The Takeover Panel (Panel on Takeovers and Mergers POTAM, or **the panel**) administers the Takeover Code (also commonly known as the City Code).

The Panel is concerned with ensuring that all shareholders in a takeover are treated fairly and equally. It is not concerned with issues such as competition policy, which is the responsibility of the Competition Commission.

The Panel is funded by the receipt of levies on large transactions in UK equities. There is currently a flat levy of £1 on all transactions in UK equities with consideration in excess of £10,000. The levy is paid by the purchaser and the seller.

The Panel is an independent, statutory body.

The Chair of the Panel is appointed by the Governor of the Bank of England. Many of the Panel members are seconded from industry, e.g. insurers, bankers, accountants, corporate finance professionals, etc.

Certain professional bodies, such as the British Bankers' Association, the Association of Investment Companies and The National Association of Pension Funds are also nominated members of the Panel.

The Takeover Code (City Code) is based on certain articles in the Takeover Directive and the power to create these rules is given to the panel by the Companies Act Part 28. These powers are as follows:

The Takeover Panel has the power to impose sanctions set out in the City Code, such as:

- To issue a private reprimand
- To issue a public censure
- To report the offender to another regulatory authority, such as the BIS, the LSE or the FCA. This is the most effective power since offenders may find themselves being denied market facilities (e.g. suspension of a company's shares) or authorisation
- To order a person to pay compensation
- To seek approval from the court to ensure compliance with the rules or to seek an injunction

8.3. The status of the Takeover Code (City Code)

General concepts

Application

The Takeover Code (also commonly known as the City Code, or the Code) applies in respect of the takeover of listed and unlisted public companies which are resident in the UK, Isle of Man or Channel Islands.

The responsibilities imposed by the Code apply equally to company directors of both the bidding and target companies and to all the professional advisors involved (e.g. accountants, corporate finance houses, etc).

Six general principles

The Code consists of six General Principles (broadly worded statements setting out acceptable standards of commercial behaviour), key definitions and a series of rules which apply the Principles to specific practical situations.

- All shareholders of the same class of the target company must be given equivalent treatment by the predator and if a person acquires control of the company the other shareholders must be protected
- Shareholders must be given sufficient time and information to reach a decision on the bid. When the target company board advises shareholders it must give its view on the impact of the bid on employment, conditions of employment and the location of the place of business
- The board of the target company must act in the interests of the company as a whole and must not deny the shareholders the opportunity to decide on the merits of the bid
- False markets must not be created in the shares of the predator, target or any other company affected by the bid in a way that the rise or fall of prices becomes artificial and the normal functioning of markets is distorted
- The predator must announce a bid only after ensuring that it can fulfil in full any cash consideration, if offered or required, and after taking reasonable steps to secure implementation of other types of consideration
- The target company must not be hindered in the conduct of its affairs for longer than is reasonable by the bid

Key definitions

Control

Legal control is determined by influence over more than 50% of the voting shares. The panel, however, uses a benchmark of 30% as **effective** control; many of the rules start to apply at this level.

Offer period

Offer period means the period from the time when an announcement is made until the date when the offer becomes unconditional or lapses.

8.4. Main provisions of the Takeover Code

Timing and revision rules

Before the bid

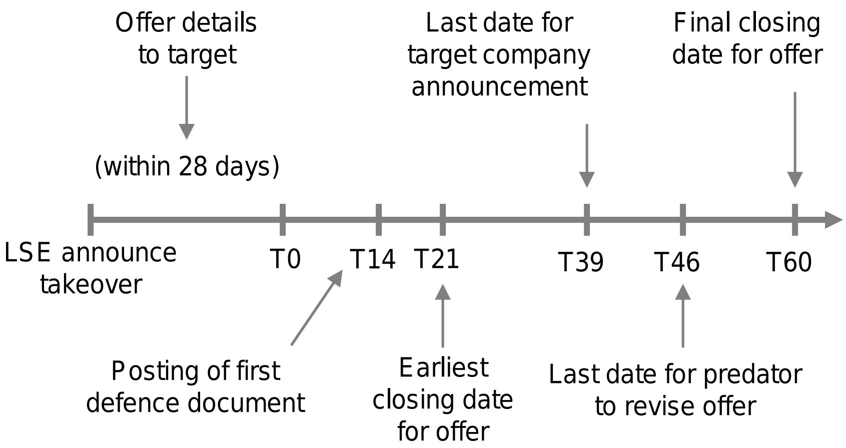
Before a public announcement is made, the predator company must first approach the target company's board or its advisors.

It possibly goes without saying that any information announced must be accurate and fairly presented. It is the responsibility of the directors of the offeror and offeree to take a duty of care to ensure this is so and also to ensure that omissions that could mislead the market are avoided.

Once the bid has been announced, the rules on timing (below) then apply.

Timing

The City Code sets out a framework within which events must take place during a takeover.



From the above diagram, the final closing date for the offer is T60. If the bid lapses on this date then the predator company will be unable to make another offer for 12 months.

Offer consideration and compulsory bids

Offer consideration

The offer consideration may consist of:

- Cash only
- Shares or loan stock (a paper offer)
- A choice offering a number of alternatives

Whichever form of consideration is specified, the **minimum price** to be offered is the highest price paid by the offeror in the last **three months**.

Compulsory bids

If a predator (and others acting in concert with it) acquires influence over 30% or more of the voting rights of a company, it must make an offer for all the remaining shares of the company (a **compulsory** or **mandatory** bid).

A predator already having influence over 30% or more of the voting rights of a company must, if it acquires any further influence, make an offer for all the remaining shares.

The City Code states that a mandatory offer will become unconditional once the predator gains influence over more than 50% of the target company. The predator is then obliged to purchase the shares of all those who have accepted the offer. The offer period remains open for another 14 days after becoming unconditional.

Offers must be in cash or accompanied by a cash alternative at not less than the highest price paid by the predator during the offer period and within the **12 months** prior to its commencement.

Squeeze out

The Companies Act contains provisions which enable a bidder to acquire compulsorily the shares held by shareholders of the target who do not accept the offer. Where the bidder has received acceptances in respect of 90 per cent or more of the shares to which the offer relates, it may, subject to any court order to the contrary, acquire the outstanding shares on the same terms set out in the offer. It can also, in these circumstances, be forced by the minority shareholders themselves to acquire their outstanding shares. This rule applies to both mandatory and voluntary bids.

9. Summary

9.1. Key concepts

Flotation

- 1.5.2 - The listing rules in FSMA 2000, and relevant EU directives

Listing on the LSE

- 1.5.1 - The role of the FCA as the UK listing authority
- 1.5.4 - The purpose of the requirement for prospectus or listing particulars
- 1.5.5 - The main exemptions from listing particulars
- 1.5.3 - The main conditions for listing on the Official list, AIM and ISDX
- 1.6.4 - The London Stock Exchange (LSE) requirements for listed companies to disclose corporate governance compliance

Continuing obligations for LSE traded companies

- 1.6.5 - The continuing obligations of LSE listed companies regarding information disclosure and dissemination
- 1.6.2 - The purpose of corporate governance regulation and the role of the FRC in promoting good corporate governance
- 1.6.3 - The scope and content of corporate governance standards in the UK

Company meetings

- 1.6.6 - The UK company law requirements regarding the calling of general meetings
- 1.6.7 - Annual general meetings and other types of company meetings
- 1.6.8 - The types of resolution that can be considered at company general meetings
- 1.6.9 - The voting methods used at company meetings
- 1.6.10 - The role and powers of a proxy

Notifiable interests

- 1.6.1 - The disclosures required under the disclosure and transparency rules relating to directors' interests and major shareholdings

Statutory control of takeovers and mergers

- 3.2.6 - The function of the following bodies / persons: the Panel for Takeovers and Mergers, the Department for Business Innovation and Skills, and the Competition and Markets Authority

The Takeover Panel (Panel on Takeovers and Mergers POTAM)

- 3.2.7 - The make up of the Panel on Takeovers and Mergers (the Takeover Panel) and how it is financed

- 3.2.8 - The regulatory status of the City Code on Takeovers and Mergers
- 3.2.9 - The main provisions of the City Code including the bid timetable

Now you have finished this chapter you should attempt the chapter questions.

Client objectives and advice

1. Introduction

1.1. Chapter overview

Most of the chapters in this manual are all about knowledge, but this one is about application. It is likely that you will be given a short client scenario and asked to make a recommendation. Remember that the clues will be in the case study to guide you to the most suitable recommendation. One of the main clues to watch out for is a client's overall risk tolerance.

The end of this chapter brings in some familiar regulatory knowledge, such as the FCA Principles, complaint handling and the approved persons rules. These regulatory areas tend not to appear that often, with the main exam focus being on the rest of the chapter.

1.2. Learning outcomes

On completion of this module you will:

An adviser's duty to clients

- 5.1.1 - Describe and compare different types of investors
- 5.1.2 - Explain the obligations of a firm towards retail clients
- 5.6.1 - Describe the need for advisers to communicate clearly, assessing and adapting to the differing levels of knowledge and understanding of their clients.
- 3.5.23 - Identify circumstances where own authority or expertise is limited and there is a need to refer to specialists

Assessing the needs of the client

- 5.1.3 - Explain the main need for retail clients and how they are prioritised
- 5.3.1 - Explain the importance of the fact find process in establishing a client's current financial circumstances and requirements
- 5.3.2 - Identify the factors shaping a client's circumstances
- 5.2.1 - Explain the importance of establishing and quantifying a client's objectives
- 5.2.2 - Explain the need to prioritise objectives to accommodate a client's affordability

Establishing an investor's risk tolerance

- 5.4.1 - Analyse the main types of investment risk as they affect investors
- 5.4.3 - Analyse the impact of timescale on a client's attitude to risk
- 5.4.4 - Explain the key methods of determining a client's attitude to risk
- 5.4.2 - Explain the role of diversification in mitigating risk

Advice and recommendations

- 5.5.1 - Explain why asset allocation always comes before investment or product selection
- 5.5.2 - Explain the key roles of charges and the financial stability of the provider as criteria within the fund selection process, and the use of past performance
- 5.5.3 - Explain the importance of stability, independence and standing of trustees, fund custodians and auditors in the fund selection process
- 5.5.4 - Identify benchmarks and other performance measures
- 5.5.5 - Explain the importance of reviews within the financial planning process

Legal concepts

- 4.1.1 - Explain legal persons and power of attorney
- 4.1.2 - Explain basic law of contract and agency
- 4.1.3 - Explain the types of ownership of property
- 4.1.4 - Explain insolvency and bankruptcy
- 4.1.5 - Explain wills and intestacy
- 4.1.6 - Describe the main types of trusts and their uses
- 3.2.10 - Explain the purpose and scope of the Trustees Act 2000: the rights and duties of the parties involved, the nature of the trust deed and the investment powers of trustees

The principle agent problem

- 1.8.1 - Explain how capital markets allow the beneficial ownership, and the control of capital, to be separated
- 1.8.2 - Distinguish between beneficial owners (principals) and the various agents involved in the capital allocation process
- 1.8.3 - Explain how conflict between the interests of agents and principals gives rise to the 'agency' or 'principal-agent' problem
- 1.8.4 - Identify examples of agency costs such as: expropriation, perquisites, self-dealing, and higher cost of capital, which arise when the agency problem is known to exist
- 1.8.5 - Identify the main reasons why it is argued that reducing the agency problem benefits the investment profession and society as a whole

2. An adviser's duty to clients

2.1. Different types of investor

Investors can be broadly divided in to two categories: individual investors and institutional investors.

Individual investors

Individual investors are typically categorised by financial services firms based on their wealth – in order to better allocate products that are affordable – and their knowledge and experience – in order to meet regulatory requirements.

There is no official categorisation of individual clients, but terms such as retail investor, private client, high net worth client and ultra-high net worth clients are common.

The FCA does identify some distinction in individual clients.

- High net worth individual – Income of over £100,000 per year and/or net assets of at least £250,000
- Sophisticated investor – an individual who has been certified by their financial service provider as understanding the products they are involved in

Institutional investors

These include pension funds, insurance companies, collective investment schemes and investment trust companies.

Regulatory classification of all clients

As we saw in the conduct of business rules, all clients will be categorised into three key areas:

- Retail client – deemed to have least knowledge and experience so offered most protection
- Professional clients – deemed to have knowledge and experience so protection is less than for retail clients
- Eligible counterparties – deemed to have the same knowledge and experience as the firm providing the financial service, so receive the least protection

2.2. Obligation of a firm towards retail clients

Throughout the financial regulations section, emphasis was placed on the protection of retail clients and always acting in the clients' best interests. Key, in respect of financial advice, was suitability:

Suitability

All personal recommendations and all investment management decisions must be suitable to the investor. Suitable means gathering sufficient information to assess the following:

- Does the advice meet the client's objectives?
- Is the client able to afford the financial risks?
- Does the client understand the financial risks?

Also very pertinent to the the protection of the retail clients were the six outcomes of Treating Customers Fairly, which will be repeated here.

Treating customers fairly

The FCA's Treating Customers Fairly (TCF) initiative is intended to reinforce Principle 6 (Customers' interests). It is a core part of the FCA's move to a more principles-based approach to regulation. The TCF initiative aims to introduce a step-change in the behaviour of the financial services sector and to deliver six improved outcomes for consumers.

These outcomes are:

- Outcome 1: Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture
- Outcome 2: Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly
- Outcome 3: Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale
- Outcome 4: Where consumers receive advice, the advice is suitable and takes account of their circumstances
- Outcome 5: Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect
- Outcome 6: Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint

The need to refer to specialists

It is unlikely that an adviser will have total knowledge and experience to answer all client questions. When dealing with clients, if a situation arises that goes beyond the adviser's knowledge and experience they will need to refer to specialists in that area. These specialists are likely to come from within the firm, and advisers must take advantage of these specialist sources of information.

3. Assessing the needs of a client

3.1. The fact-find process

Hard facts

A fact find will cover personal information, such as full name(s), date(s) of birth, state of health, marital status, residence and domicile status, national insurance number(s), address, employment details, family details. These are all examples of hard facts.

Soft facts

In addition to hard facts, the fact find process should involve the advisor listening to the client and asking questions to form a better understanding of exactly what the client is trying to achieve. This information can only be collected face-to-face, and by the advisor asking open questions of the client and listening carefully to the replies.

Letter of authority

Many clients will not have the necessary details within their own files, and it is therefore necessary to collect information from relevant third parties. The advisor will need a 'letter of authority' from the client which authorises the third party to release information regarding the client to the advisor.

3.2. Establishing, quantifying and prioritising objectives

We know that the fundamental principal of financial advice is to find out a client's needs and wants and then to match these needs with suitable solutions.

The Investment Policy Statement (IPS) summarises the client's investment needs and wants into clear objectives and details any investment constraints.

Investment objectives and constraints

An IPS is formulated for each client at the start of the advisor/client relationship. It is developed after a thorough fact-find process and summarises the following client requirements:

- Risk objective – how much risk the client is willing and able to take
- Return objective – the required return needed from the portfolio
- Liquidity needed – at what points withdrawals are intended e.g. a regular income
- Time horizon – how long the funds are to be invested
- Tax – the tax position of the investor
- Regulatory issues – trusts, charities and pension funds have regulatory constraints
- Other unique circumstances – investor preferences and existing holdings

Risk and return

In the IPS the advisor will establish the client's required level of return from the portfolio. The client's required rate of return is important as it will heavily influence the recommendation of asset classes for the investor.

The higher the required level of return, the greater the risk needed to be taken.

The greater the risk needed to be taken, the greater the level of volatility of the portfolio.

Generally speaking, the higher the required rate of return, the greater the allocation to equities.

4. Establishing an investor's risk tolerance

4.1. Risks faced by investors

Capital risk

Think for a moment, in which types of investments is your original capital invested at risk of a potential fall in value?

- Equities can fall in value
- Bonds can fall in value – even ones bought below par if they are traded prior to maturity
- Gilts and bonds bought above par will certainly incur a capital loss if held to maturity
- Property can fall in value
- Most alternative assets can also fall in value

Which investments do not have the risk of a capital loss?

- National Savings and Investments products are backed by the UK Government
- UK gilts bought below par and held to maturity

Notice that Bank and Building Society deposits still have some deposit institution risk as illustrated by the Northern Rock crisis. Experience has shown that should a deposit institution get into financial difficulties and lose the confidence of its depositors, both the institution and the depositors may be at risk of capital losses.

Remember, also, that inflation is the invisible risk to cash deposits. If the cash returns are less than inflation, then the real value of the investment is falling over time.

Shortfall risk

Shortfall risk is the risk that the investment return will literally fall short of the amount required for the investor to achieve their objectives.

- Dividends from equities are not guaranteed as they depend on a company making profits and agreeing to pay some of them to shareholders
- Coupons from corporate bonds are also not guaranteed as they depend upon the issuer being able and willing to pay them – often referred to as issuer risk
- Variable rate cash deposits in Building Societies and Banks have income risk – that interest rates fall reducing the amount of interest payable
- Variable rate National Savings & Investments products also have income risk – such as the investment accounts, easy-access savings accounts, income bonds and direct ISAs

It is also worth mentioning that it is the after tax income that is important for many investors.

Inflation risk

As we know, inflation erodes future values unless the investment earns a return in excess of inflation i.e. a real return. Investors who choose cash deposits as their type of medium- to long-term investment are most at risk from the effects of inflation.

- Equities aim to provide a return in excess of inflation, but aiming is no guarantee to do this every year. Markets can of course fall as well as rise and be prone to periods of high volatility in both directions.
- Index-linked gilts do provide some inflation protection.

It is possible for a country to suffer from deflation risk i.e. falling prices. Japan has experienced a period of falling prices which carries the risk that people stop buying goods and services, waiting for prices to fall further. This fall in demand can be very damaging to an economy.

Interest rate risk

Interest rate risk relates to the fact that the bank base rate is likely to change over time and ultimately feed through to the rates of interest paid on deposit accounts. The rate is set by the Monetary Policy Committee (MPC) of the Bank of England. Normally, the rate will be increased during times of inflation, but this is not always the case.

Currency risk

We have talked about currency risks already in this chapter.

Individuals face the risk that their foreign currency investment depreciates relative to sterling when they convert their investment back to pounds.

UK companies that import goods face the risk that the sterling depreciates, making the cost of the imports more expensive.

One way to hedge currency risk is with forward contracts. A forward contract is a type of derivative that can lock in a forward exchange rate in a foreign currency. Should the foreign currency depreciate, a gain will be made on the forward contract which will offset the loss on the foreign asset.

Hedging has a risk itself. ‘Basis risk’ is the risk that the gain from a hedge will not perfectly match the loss of the portfolio.

Operational risk

Whether we invest in deposits, in equities, in bonds, or in property there is the potential for operational risk. Operational risk covers four areas:

- People
- Processes
- Systems
- External events

Mistakes by financial advisors, investment administrators, banks, buildings societies and investment companies do happen. There is the risk that due to such errors an investor is disadvantaged or, in the worst case scenario, is the victim of an investment fraud.

4.2. Ability and willingness to take risk

Introduction

Financial advisors need to consider an investor's ability to take risk, as well as their willingness to take risk in establishing the client's overall risk tolerance.

It is very important to spend time getting this right at the start of the client/advisor relationship so that the most suitable advice can be given.

There are broadly two ways of determining a client's attitude to risk: by examining their existing investments and by asking specific questions.

Ability to take risk

Factors to consider that help to establish a client's ability to take risk are:

- The client's level of existing wealth
- The client's level of liquidity needed from the portfolio
- The client's time horizon
- The client's level of financial flexibility i.e. availability of other sources of income and capital
- The client's spending requirements
- The client's level of existing and future financial commitments
- The client's age and family situation i.e. they may have other urgent financial needs

The expression ‘only invest what you can afford to lose’ is relevant here.

Willingness to take risk

‘What do you want from your investment?’ asks a financial advisor. ‘What level of risk are you prepared to take?’

As individuals we all have our own opinions as to what we want and what we do not want from our savings and investments, and we have our own understanding of investment risk. The trouble is that many private investors have no real knowledge of modern portfolio theory and are making investment decisions based upon their own perceptions rather than knowledge and experience.

A client's willingness to take risk may be better understood from the following:

- The client's views, feelings and preferences
- The client's answers to a risk and reward questionnaire
- The client's previous investment experience
- Whether the client has taken risks in other areas of life e.g. running a business

Agreeing an overall risk tolerance

Often financial advisors aim to match clients into risk categories such as cautious, balanced or speculative. Alternatively other labels can be used such as ‘below average’, ‘average’ and ‘above average’ as an overall risk tolerance.

If a client's willingness to take risk matches their ability to take risk, then the advisor's job is fairly straightforward. But what if a client has a very high willingness to take risk, but has a low ability to take risk? Alternatively a client may have a very low willingness, but a much higher ability.

It is up to the advisor to educate the client and ensure that the client receives the most suitable investment advice for their circumstances. Ultimately the money belongs to the client and they can choose to accept or reject advice given.

It is often the client's overall risk tolerance that drives the next stage in the process - asset allocation.

4.3. Reducing portfolio risk

Introduction

It is well known that holding many assets in a portfolio reduces the overall portfolio risk compared to holding a small number of risky assets.

A typical equity fund may have 80 or more individual holdings, with some funds having considerably more than this. If a particular company held in the portfolio falls on hard times and profits fall, it is only a small proportion of the overall portfolio. If this company was our only holding this could be disastrous.

We can diversify a portfolio in the following ways:

- Increasing the number of holdings
- Investing in different asset classes e.g. equities, bonds, gilts, property, commodities
- Investing in different industries
- Investing in different countries

Modern portfolio theory allows an investor to combine assets together, aiming to optimise the risk return trade-off i.e. to obtain as high a return as possible for a given level of risk.

Systematic and non-systematic risk

When we hold a diversified portfolio what happens to the levels of systemic and non-systemic risk?

- Diversification vastly reduces the level of non-systemic or specific risk within the portfolio
- Diversification does not take away the systemic risks of a portfolio

Scenario 1

ABC plc is one of 100 equities in a UK equity fund. ABC falls on hard times due to losing two important national contracts and also losing a number of key staff to a competitor. As a result ABC's share price falls.

Notice that the specific risk or non-systemic risk of ABC is much reduced as it is only one of 100 equity holdings. Although the drop in ABC's share price cannot be avoided, the effect on the portfolio is small.

Specific risk includes industry risk, management risk and business risk.

Scenario 2

Imagine if the UK economy began to suffer higher and higher levels of inflation. The Bank of England starts to put up interest rates to aim to keep inflation in check. Many UK firms will be affected by higher borrowing costs, perhaps putting off new projects and making cost cutbacks. The majority of the UK equities (including ABC plc) are affected by this systemic risk of interest rates rising. The impact on the portfolio may be large.

Therefore diversification reduces specific risk, but systematic risks remain.

Systematic risk includes interest rate risk, inflation risk and currency risk.

Correlation and diversification

Correlation describes the extent that two assets move together.

- Positive correlation – assets generally move in the same direction
- Negative correlation – assets generally move in the opposite direction

The lower the correlation between assets in a portfolio the greater are the diversification benefits.

5. Advice and recommendations

5.1. Financial planning process

The financial planning process should ideally adopt the following sequence of steps:

1. Identify and quantify the client's financial objectives

2. Collect data to establish the client's current circumstances

3. Analyse different options to meet any identified shortcomings

4. Prepare a report and arrange a meeting with the client

5. Implement the plan

5.2. The importance of asset allocation

Asset classes

Let's start by looking at the range of asset classes:

- Cash
- Government bonds (UK and international)
- Corporate bonds (UK and international)
- Shares (UK, European, US, Asia and other global)
- Property (UK and international)
- Commodities (international)
- Other alternatives (private equity, hedge funds, antiques, timber etc)

Asset allocation

The key decision for the investor and for the advisor is which asset classes to choose and in what combination. Many academic studies have concluded that asset allocation is the single most important factor in determining returns of an investment portfolio.

The client's IPS will assist with this, providing clear requirements such as:

- The required return
- The specified level of risk
- The required level of liquidity to meet spending

Most retail investors' portfolios are often constructed using a mix of shares and bonds. Alternative investments such as commodities and private equity, although attractive, have traditionally been used by institutional rather than retail investors. There is, however, an increasing interest in alternative asset classes in the investment marketplace.

A spectrum of risk and reward using shares, bonds and cash

Once a client's risk tolerance is established, many companies then tailor a suitable asset allocation to meet the client's objectives using a mix of shares, bonds and cash.

Cash is used to establish an emergency fund for the client and is also a home for short-term planned expenditure. It is essential that the asset allocation takes account of the client's planned and emergency liquidity needs.

The balance of the fund is therefore available for investment according to the client's investment horizon. Changing the mix of shares and bonds can result in a wide spectrum of portfolios that can be suitable for a wide range of clients.

Portfolio managers often use computing power to determine the weights to invest in different assets. The computer program aims to optimise the risk and return relationship i.e. to maximise the return (the mean) and to minimise the risk (the variance). This process is called **mean variance optimisation** (MVO).

5.3. Investing in funds

Retail clients will often choose to hand over the investment decisions to an expert by choosing a collective vehicle to invest in. Examples are unit trusts, investment companies with variable capital and investment trust companies. However, even here there are important considerations, such as:

- Past performance
- Charges
- Stability of the product provider
- Stability and independence of the trustee/custodian

Most of the relevant information can be gained from the fund management group in the form of a Key Features Document (KFD), or, in the case of a UCITS fund, a Key Investor Information Document (KIID).

5.4. Comparing charges

Put yourself in the position of an independent financial advisor (IFA). Assuming two investment funds have a comparable asset mix and comparable performance, how do you choose which is the most suitable fund for your client?

One of the key criterion in making this choice must be to compare the level of and impact of charges in each fund. There are many elements that can impact on charges that could be implicit or explicit.

Explicit fees can include:

- Advisor fees
- Broker fees
- Initial and management fees of the product providers
- The bid/offer spread on an investment

Implicit fees can include:

- The cost of dealing within a fund

- Capital gains tax issues for actively managed funds

Other costs can include:

- Stamp duty reserve tax
- PTM levy on the London Stock Exchange to fund the Takeover Panel

5.5. Impact of borrowing

During a client fact-find, the advisor collects further information about these borrowings to build a more detailed picture of these financial commitments. Typical information collected would be:

- The lender
- The term of the loan
- The repayment method i.e. capital and interest or interest only
- The interest rate and APR
- The monthly repayment
- Check if any early repayment penalties apply – if yes, what level

Many clients do not always consider the cheapest way to borrow and often end up with expensive borrowings, such as high credit card or store card balances charging very high rates of interest. Advisors can assist clients in re-organising borrowings to restructure these kinds of debts and reduce monthly repayments.

Considering repaying or part repaying borrowings

Let's consider the cost of our borrowings for a moment i.e. the interest rates that we pay to the lender. Rates will vary depending upon your credit history, but here is a rough estimate for clients with a clean credit history. Remember also that many lenders also charge fees that have the effect of increasing the APR.

Bank of England base: 0.5% (as at October 2014).

Mortgage rates: 2.5% – 6% (APRs will be higher once we take into account fees).

Unsecured loan rates: 7% – 15%.

Credit cards: 15% – 20%.

Store cards: 20% – 35%.

Consider a client that wants to invest a lump sum but also has some of these borrowings. How should the advisor proceed? Clearly it is quite possible that the return on any investment may be less than the cost of the borrowing. If this is the case the client would be best advised to repay the borrowing.

Other considerations on the repayment of debt

In exploring with the client the option of repaying or part repaying debts, here are some important additional considerations:

- Wanting access to the money in the future – if repayment is made to a mortgage, the client no longer has access to the funds in the future unless they sell the property or raise a new loan

- The client's overall risk tolerance – if the client is not willing to take investment risk then it is likely that repaying debts would be advisable
- Important to avoid paying early repayment penalties
- Useful to firstly repay the debts with the highest rate of interest
- Important for a client to retain sufficient liquid funds for emergencies/unplanned expenditure
- When comparing investment returns with borrowings remember to compare the 'after tax' investment return

To sum up, the advisor and client should explore the option of paying off debt before investing. Where the cost of borrowing is higher than the likely investment return, it is advisable to consider paying off the debt before investing.

5.6. Benchmarks and reviews

Assessing performance

How can we assess the performance of a fund or an investment manager? Investment performance is usually monitored by comparing it to a relevant benchmark.

There are three main ways in which portfolio performance is assessed:

- Comparison with a relevant bond, stock market or custom (composite) index.
- Comparison to similar funds or a relevant sector comparison.
  - Comparable funds should have similar investment objectives and constraints.

Monitoring and review

Financial planning is not a one-off process. In part, this is because of the possibility of change. A client's plans can change because:

- The environment changes, for example, the tax regime or loss of employment
- The client changes their circumstances, needs, wants and aspirations. For example, marriage or divorce, or has a child
- The client changes their attitudes to finance becoming more or less risk-averse

It is also important that people review their investment policy statement (IPS) in order to monitor how well they are sticking to them and how likely the goals are to be achieved.

The adviser should agree early on whether ongoing monitoring and review is going to fall within his remit. If so, the adviser should advise the customer of how frequently he can expect to see an update of the plan and any new recommendations. Periodic reviews to clients should include the up-to-date value of the customer's investments.

The CFA Institute has developed the Global Investment Performance Standards (GIPS). GIPS apply to investment management firms. They are intended to serve existing and prospective clients of investment firms by standardising the format in which performance is communicated to those clients. This enhances comparability.

6. Legal concepts

6.1. Legal terminology

It is useful to start with some legal definitions:

Persons

'Natural person' – is the legal term to describe individuals.

'Legal person' – is the legal term to describe a collection of natural persons who have gathered together to form a single entity for legal purposes. These persons have rights, such as protections and privileges, and responsibilities, such as legal and tax liabilities, under law. They can also shield their members and shareholders from liabilities, such as bankruptcy and other law suits.

'Partnership' – is a business relationship between two or more parties. Note that a partnership does not have a distinct legal entity, meaning that the partners are individually liable for partnership debts.

'Agent' – an agent acts on behalf of the principal. For example, an independent financial advisor (IFA) is the agent of the client.

'Principal' – gives the legal power to be bound by actions of the agent.

Contracts

'A contract' – a contract is made when an offer stating specific terms and conditions is made and unconditional and willing acceptance is agreed. These could be (and generally are) written or verbal.

'A void contract' – means the contract is unenforceable. Reasons for this could be many, including:

- Lack of intention to create a legally binding contract
- Unclear or ambiguous terms and conditions
- No mutual consideration was included, i.e. there was no apparent benefit for one of the parties

'A voidable contract' – means the contract can continue in force until one of the parties bound by the contract declares it void and decides not to be bound by it.

'Discharge of contract' – this is where the terms and conditions agreed within the contract come to an end. This could be due to several reasons:

- Discharge by agreement – where both agree to terminate the contract
- Discharge by performance – where the terms and conditions in the contract have been met in full
- Discharge by frustration – where external events prevent the contract being fulfilled
- Discharge by breach – where one party does not fulfil their side of the agreement. This can lead to legal disputes

Wills

'Wills' – it is important that everyone has a will to ensure that their wishes are carried out in the event of their death. All parents should ensure that their wills specify who should look after their children in the event of their early death. Also unmarried partners will not be entitled to assets unless they are specified in the will of their partner.

'Testate' – having a valid will.

'Intestate' – not having a valid will.

'Executors' – act when there is a valid will to obtain the 'grant of probate' i.e. organise the estate of the deceased and arrange to pay any inheritance tax due.

'Administrators' – act when there is no will or a will that is not valid. Instead of a grant of probate they obtain 'letters of administration' and again arrange to pay any inheritance tax due.

'Letters of administration cum testamento annexo' – means 'with the will annexed' and is needed when a will was left but, owing to a small defect probate, could not be given its full authority.

Property

'Real property' – refers to land, buildings and rights over property: hence the term 'real estate'. Real property can also be thought of as immovable property.

'Personal property' – refers to moveable property such as personal possessions.

Personal property is also known as 'personalty'.

Trusts

'Trust' – is a legal arrangement governed by a trust deed. A trust is not a separate legal entity. Trusts are used in IHT planning and to make gifts to people.

'Settlor' – monies are settled into a trust by the 'settlor', for the benefit of the trust.

'Beneficiaries' i.e. those who benefit from the trust's funds.

'Trustees' are charged with managing and distributing the fund's assets to the beneficiaries according to the terms of the trust deed.

6.2. Contracts

Capacity to contract

A financial advisor must ensure that each client has the capacity to enter into a binding contract. Capacity to contract is a legal term meaning the client has the power to enter into a binding contract.

Individuals

The law protects certain people from entering into binding contracts when they are deemed unable to make important financial decisions.

Examples of people unable to enter certain contracts are as follows:

- A bankrupt person
- A mentally incapable person
- A drunk person
- A minor (someone under 18)

Note that the Mental Capacity Act 2004, which came into force on 7 April 2005, states that it is possible for a person to be mentally incapable for some purposes but not for others.

Companies

Companies sometimes have defined powers to enter into contracts in their Memorandum and Articles of Association. Alternatively, they can be given very wide powers by the same documents. Counterparties with companies will often require copies of board meeting minutes, giving the power for the company to enter into a binding contract.

6.3. Ownership and title documents

Title documents: background

A **document of title** is evidence that an investor has legal ownership of an asset, e.g. land, real estate or financial securities.

The title document may be held in different forms, as described below.

Registered

A registered document is one whose ownership is recorded on a central register.

This is the case for cars, real estate and most securities, where the asset is registered in the owner's name. Registration denotes **legal** ownership.

The Driver and Vehicle Licensing Agency (DVLA) record the registered owner of cars, the Land Registry registers real property and a company maintains a register of shareholders.

Bearer

Bearer instruments are **anonymous** and freely transferable. They do not show the owner's name, no register is maintained of legal title and proof of title is in physical possession.

Most bearer instruments have intrinsic value of their own; for example, gold or diamonds. However, there are many bearer documents in the financial world, such as eurobonds, depositary receipts and bank notes.

Although bearer instruments are not registered in the name of the legal owners, they are typically registered in the name of the issuer: a five pound note, for example, is registered in the name of the Bank of England. Even items like gold and diamonds come with a stamp or certificate of authenticity.

Nominee accounts

Traditionally, investments are registered in the name of the investor and the investor's name appears in the register of members. However, to reduce the burden of administering these, it has become increasingly common for investments to be held in the name of a **nominee company**.

With shares held in this way, the nominee appears on the register of members as the **legal** owner. However, the investor retains **beneficial/equitable** ownership, and it is the beneficial owner who receives the rights in relation to a share (e.g. voting and dividends).

We will see this split between legal and beneficial ownership many times. With collective investment schemes we see the trustee as the legal owner of assets, but the unit holders as the beneficial owners. We will see it again later in the section on a more personal level when discussing trusts.

Joint ownership

It is important to realise that, in law, assets can be held jointly in two legal ways:

- Joint tenancy
- Tenants in common

Each method has a different legal implication on death of one of the joint owners.

Here is what happens on death for each legal method of joint ownership:

Joint tenants

Imagine a jointly held deposit account held on a joint tenancy basis. On death of one of the joint holders, the deceased person's interest in the account automatically passes to the survivor.

This means that the survivor now owns all the proceeds of the account.

Most joint accounts are automatically set up on a joint tenancy basis unless specifically changed. Inheritance tax planning often involves changing the ownership basis to tenants in common.

Tenants in common

Using the same scenario, let's now assume that the joint account is held in a tenants in common basis. This time, on death, the deceased person's interest does not go to the survivor but instead goes to their estate and is distributed according to their will.

6.4. Powers of attorney

A power of attorney is where a donor gives powers to a donee to act on their behalf. It must be signed by deed and in the presence of two witnesses.

These powers often include:

- Power to sign documents
- Power to make purchases
- Power to dispose of property
- Power to handle financial affairs

Types of power of attorney

Specific – only gives very specific powers to the POA.

General – gives more general discretionary powers to the POA.

Lasting – replaced enduring powers of attorney in 2007, implementing changes outlined in the Mental Capacity Act 2005.

A lasting power of attorney (LPA) is made by a person in sound mind to appoint an attorney to handle their affairs if and when they become incapable of making their own decisions. Notice that this must be made in advance, when the donor is in sound mind, and must be registered with the Office of Public Guardian to be effective.

A difference between an enduring power of attorney and the new lasting power of attorney is that a lasting power of attorney has wider powers to make not only financial decisions (property and affairs LPA) but also decisions concerning the donor's personal welfare (personal welfare LDA).

A power of attorney can be revoked in the following circumstances:

- The donor dies
- The donor revokes the POA
- The donor becomes bankrupt

6.5. Insolvency, bankruptcy and individual voluntary arrangements

Insolvency

Insolvency relates to companies and is the term used when a company cannot pay its debts. We often talk about the solvency of a company being the excess of its assets over its liabilities. If a company is insolvent it has more liabilities than assets i.e. it owes more than it owns.

When a company is insolvent there are a number of alternative approaches:

- **Liquidation** – the courts rule the company should be wound up; its assets sold and creditors paid back
- **Company voluntary arrangement (CVA)** – a formal agreement to make repayments is established by the court
- **Informal arrangement** – as above, but in an informal context i.e. not via the court
- **Administration** – the courts grant an order to give a company some temporary breathing space i.e. protection from creditors until a plan can be put in place

Bankruptcy

Bankruptcy relates to companies and individuals as defined in the Insolvency Act 1986. Bankruptcy applies when a person is unable to pay their debts when they fall due and is unable to pay them in the near future. The minimum level of debts involved is £750.00.

Bankruptcy is intended to be a fair process to distribute whatever assets the individual has to their creditors. This process will be administered by the official receiver.

Not everyone can be made bankrupt. Here are some examples:

- A deceased person
- An infant
- A spouse of a bankrupt person is treated as a separate individual, meaning the creditors have no claim over their assets

Individual voluntary arrangement

An individual voluntary arrangement is a less expensive alternative to bankruptcy for individuals. The debtor will formally agree a repayment plan with creditors.

6.6. Wills

Having a will is very important as it:

- Specifies how you want your assets to be distributed
- Specifies who you want to be responsible for your children
- Specifies who you want to benefit from your estate

The will must be:

- In writing
- Willingly made
- By a person of mental capacity
- By a person over 18 years of age
- The person must not have made it as a result of pressure from someone else
- Signed and witnessed

Terminology

The terminology is very important in this area:

- Died **testate** – having a valid will
- Died **intestate** – not having a valid will or not having a will at all
- **Executors** – carry out the terms of the will and obtain the 'grant of probate'. Probate is the agreement from the tax authorities to release the estate to the beneficiaries. Probate is only granted once any IHT that is due has been paid
- **Administrators** – carry out the administration when there is no will. They have the same role as executors but rather than obtain a grant of probate they obtain letters of administration
- **Letters of Administration** Cum Testamento Annexo (with the will annexed) – a will is left, but due to a small defect it is not valid. The deceased is considered intestate, so administrators will be appointed by the courts to distribute the assets. However, the invalid will is annexed to the letter of administration for reference.

In the event that an individual has died intestate (without a valid will) the National Intestacy Rules apply. These rules dictate how the deceased person's estate is to be divided up.

Deeds of variation

Some wills are not very inheritance tax efficient. Deeds of variation can change the will of a deceased person to save the family thousands of pounds in inheritance tax.

This can only be done if all the family members who would have benefited agree, and if there is no financial consideration involved. A deed of variation must be completed within two years of death.

The deed must be signed by all parties, who must be over 18 and of sound mind.

National intestacy rules

An important part of inheritance tax planning is making sure a client has a valid will. Not having a will can cause many problems:

- The National Intestacy Rules rather than you dictate how your assets are to be distributed
- The courts rather than you decide who is to be the guardian of your children

This clearly causes delays in distribution of assets and uncertainty for family members.

- The rules date back to the Administration of Estates Act 1925 and so many of the figures specified may seem low in today's terms. There are two main variations, depending upon whether the deceased left a spouse or not

6.7. Trusts

Introduction

A trust is a way of holding or managing money or investments on behalf of a beneficiary who may not be ready or old enough to do it themselves.

For example, if a parent wishes to ensure that their child receives certain investments should that parent die, they could place those investments in trust until the child is old enough to benefit fully from those assets. If the parent dies, then the investments would be held in trust by a trustee who would manage the investments until the child reaches a specified age. Once the child reaches a specified age, the investments would pass into their possession.

The terms of this agreement would be set out in a legal document called a trust deed.

Terminology

There are various terms necessary to understand when considering trusts.

Trustees

Trustees are the 'legal owners' of the trust property and must deal with it in the way set out in the trust deed - the legal document setting out how the trust property is managed. They also deal with the trust administration. There can be one or more trustees.

Settlor

The settlor creates the trust and puts property into it at the start - in our example this would be the parent - possibly adding more later. The settlor says in the trust deed how the trust's property and income should be used.

Beneficiary

This is anyone who benefits from the trust - in our example this would be the child. The trust deed may name the beneficiaries individually or define a class of beneficiary, such as the settlor's family. The beneficiaries are the 'beneficial owners' of the investments.

Trust property

This is the property that is put into the trust by the settlor. It can be anything, including land, property, securities, cash, antiques, etc.

Types of trust

Discretionary trusts

These trusts give the trustees the right to distribute the trust property - both capital and income - to the beneficiaries as they see fit. It gives the trustee the flexibility to respond to unforeseen events when considering the distribution of the property.

Interest in possession (life interest)

In this kind of trust the beneficiaries have the legal right to all the income of the property, but not to the property itself. They are said to have interest in possession. After a specified event, such as the death of the beneficiaries, the asset will pass to the reversionary interest or remainderman.

An example of this would be where a settlor leaves the income from investments to their spouse, but the investments to their children once the spouse dies.

Bare trusts

This is where the trustee takes on a nominee role only for the beneficiaries. Although the trustee holds and manages the investments, the beneficiaries are at liberty to take the trust property - both capital and income - from the trust at any time.

Charitable trust

Charities may be established either as legal trusts or as companies (usually limited by guarantee). If a trust, a settlor sets up a trust for charitable deeds. The trustees become responsible for the distribution and investment of the assets.

Charities enjoy a wide range of tax benefits; they do not pay capital gains tax, income tax, inheritance tax or stamp duty. However, they can be liable for value added tax (VAT) on purchases.

In the UK, the Charity Commission, together with the Charity Acts of 1992 and 1993, provide the regulatory structure in which charities operate.

Charities will typically seek investments that give real capital protection and supply income to spend on charitable causes. They are much more likely to be buy and hold investors, than traders. Suitable investments are likely to be income generating shares and property that can be rented or leased out.

6.8. Trustee Act 2000

A trust is a legal arrangement whereby the creator of the trust, known as the 'settlor', puts aside property in the form of cash, real estate etc. for the benefit of others, known as 'beneficiaries'.

The settlor appoints a trustee to act as **legal owner** of the assets while the assets are held 'in trust'.

The trust deed, also known as the trust indenture, specifies trustees' permitted powers of investment.

If the trust deed does not clarify the position, trustees are governed by the Trustee Act 2000.

Under the Trustee Act:

- Trustees have a statutory duty of care in selecting investments
- Trustees are expected to act with a degree of skill and care which is appropriate to their knowledge, experience and professional status. They should take proper advice where appropriate

- Trustees may, subject to these duties, exercise their powers of investment over the same range of investments as they would if they were the beneficial owner of the investments within the trust

Under the act, trustees are given two main powers of investment:

- The general powers of investments: this allows the trust to invest in most types of assets (including shares and bonds) except land
- The specific power to invest in freehold and leasehold land in the UK

Note that the investment powers of trustees as defined by the Act do not apply to:

- Life insurance companies
- Occupational pension funds
- Authorised unit trusts

7. The Principal-agent Problem: Separation of Ownership and Control

7.1. Introduction

We see the separation of ownership and control in many situations. In the financial markets, there are two key areas where this could occur:

- The shareholders of a company (**principal**) and the management of the company (**agent**)
- An investor (**principal**) and a financial firm, such as an adviser or wealth manager (**agent**)

In government, there is also a separation of this sort between the voters (**principals**) and the politicians (**agents**).

7.2. The principal-agent problem

In all of the examples given, the separation of ownership and control can cause a conflict through the division of interests, referred to as the principal-agent (or agency) problem.

- The principal wants to achieve the best overall return from their ownership. This return may be a profitable company, a portfolio that meets specified objectives or a society that allows for a long, happy, productive life
- The agent wants to achieve the most from the agency. Their return may be the salary they are paid, the commissions they generate or the plaudits they receive from policy decisions

These interests are not necessarily aligned, and could be in direct conflict with each other: higher salaries for managers reduce the returns available to the shareholders; higher commissions for advisers can lead to unsuitable recommendations for the investor; policy decisions by politicians could simply be vanity projects that do not benefit society.

Agency costs

Employing an agent to act on behalf of a principal will clearly add an additional layer of cost. However, in addition to the obvious costs, there can be other costs if an agency problem exists.

Explicit costs include:

- Managers are paid a salary for managing a company. If managers' remuneration is disproportionate to their contribution, this depletes the company profits
- Some advisers charge a fee for their advice, giving the investor a clear picture of the cost. Some product providers offer advisers commissions taken from the investor's contributions. The latter can lead to commission bias, where advisers recommend products that do not meet the investor's objectives but pay a large commission

Implicit costs include:

- The cost of producing company accounts to identify the fundamentals of the company
- The need to have financial statements audited by an independent body
- Losses incurred through projects that generate high short-term returns at the expense of long-term stability

- **Perquisites** (perks), such as healthcare, company cars, etc., used as incentives for managers are also a drain on the profits of the company
- Losses incurred through **self-dealing**, for example, managers appointing an uncompetitive contractor because they own a beneficial interest in that contractor
- **Expropriation** of company assets for personal use, such as using company vehicles or labour-force
- The cost of implementing and enforcing regulations for the financial services
- The opportunity cost of slow actions of agents
- The cost of not meeting objectives

All of these increase the costs and reduce the return owed to the beneficial owners.

7.3. Reduction of the agency problem

Companies

From a company perspective, the **Combined Code** and more recently the **Stewardship Code** have highlighted major issues caused by the agency problem and suggested ways of reducing them.

The recommendations range from assessing the remuneration of the managers in the Combined Code, often linking remuneration to the long-term profits of the company by rewarding managers with shares or options on the shares of the company they manage. This aligns the interests of the managers with those of the shareholders. The code suggests that companies appoint executive and non-executive directors that are appropriate to the business. The Stewardship Code advocates active participation of all shareholders (**shareholder activism**), particularly those large institutional shareholders that often passively hold large proportions of a company's shares.

Many exchanges, such as the London Stock Exchange, insist that companies trading on their markets comply with the codes or explain non-compliance.

Financial services

From a financial services perspective, the conduct of business rules govern how the agents should behave. This focuses on the client's best interests and the need to act honestly, fairly and professionally. More recently, there has been the implementation of the Retail Distribution Review, which prohibited the provision of product provider commission and enforced the need for advisers to subscribe to an established code of conduct, such as the CFA Standards of Professional Practice.

How reducing the agency problem can benefit the investment profession and society

Reducing the agency problem increases the trust in the companies, and the financial firms that give people access to those companies. This trust makes the people more willing to invest, allowing those companies access to more capital at a cheaper cost, thus increasing returns. Where there is an alignment of interests between the principal and agent, the cheaper capital can be used more efficiently and effectively, increasing returns further. If shareholders become more actively involved in the decision-making of the company at general meetings, the beneficial owners become more involved in the controlling of the company. This reduces the need for external controls and the cost incurred through their implementation.

8. Summary

8.1. Key concepts

An adviser's duty to clients

- 5.1.4 - Different types of investors
- 5.1.5 - The obligations of a firm towards retail clients
- 5.6.1 - The need for advisers to communicate clearly, assessing and adapting to the differing levels of knowledge and understanding of their clients.
- 3.5.23 - Circumstances where own authority or expertise is limited and there is a need to refer to specialists

Assessing the needs of the client

- 5.1.6 - The main need for retail clients and how they are prioritised
- 5.3.1 - The importance of the fact find process in establishing a client's current financial circumstances and requirements
- 5.3.2 - The factors shaping a client's circumstances
- 5.2.3 - The importance of establishing and quantifying a client's objectives
- 5.2.4 - The need to prioritise objectives to accommodate a client's affordability

Establishing an investor's risk tolerance

- 5.4.1 - The main types of investment risk as they affect investors
- 5.4.3 - The impact of timescale on a client's attitude to risk
- 5.4.4 - The key methods of determining a client's attitude to risk
- 5.4.2 - The role of diversification in mitigating risk

Advice and recommendations

- 5.5.1 - Why asset allocation always comes before investment or product selection
- 5.5.2 - The key roles of charges and the financial stability of the provider as criteria within the fund selection process, and the use of past performance
- 5.5.3 - The importance of stability, independence and standing of trustees, fund custodians and auditors in the fund selection process
- 5.5.4 - Benchmarks and other performance measures
- 5.5.5 - The importance of reviews within the financial planning process

Legal concepts

- 4.1.1 - Legal persons and power of attorney

- 4.1.2 - Basic law of contract and agency
- 4.1.5 - The types of ownership of property
- 4.1.6 - Insolvency and bankruptcy
- 4.1.5 - Wills and intestacy
- 4.1.6 - The main types of trusts and their uses
- 3.2.10 - The purpose and scope of the Trustees Act 2000: the rights and duties of the parties involved, the nature of the trust deed and the investment powers of trustees

The principle agent problem

- 1.8.1 - How capital markets allow the beneficial ownership, and the control of capital, to be separated
- 1.8.2 - Beneficial owners (principals) and the various agents involved in the capital allocation process
- 1.8.3 - How conflict between the interests of agents and principals gives rise to the 'agency' or 'principal-agent' problem
- 1.8.4 - Agency costs such as: expropriation, perquisites, self-dealing, and higher cost of capital, which arise when the agency problem is known to exist
- 1.8.5 - The main reasons why it is argued that reducing the agency problem benefits the investment profession and society as a whole

Objectives of funds

1. Introduction

1.1. Chapter overview

Institutional investors make up the vast majority of the investors in the financial market. Of these pension funds are the largest institutional investors, followed by insurance companies, collective investment schemes (such as unit trusts) and then investment trust companies.

The factors affecting by these funds when considering asset allocation are much the same as the factors affecting individuals: primarily the fund objectives – their expectations on risk and return – and the constraints put upon them by time horizon, liability structures, liquidity requirements, tax obligations and legal requirements.

This chapter does not investigate the structure of the institutions themselves, but instead focuses on the likely objectives and constraints on these funds. It also considers how this is likely to have an impact on the asset allocation within the portfolios under management.

The greatest emphasis in the exam, as you will see, is on the pension funds.

1.2. Learning outcomes

On completion of this module you will:

Major funds in the UK

- 5.7.3 - Explain the return objectives of the major fund types
- 5.7.4 - Classify funds by their income / capital growth requirements
- 5.7.5 - Explain the effect of each of the following on a fund's asset allocation: time horizons, liability structure, liquidity requirements
- 5.7.7 - Explain the effect that taxation legislation may have on the stock selection and asset allocation of a fund

Objectives and constraints of pension funds in the UK

- 5.7.1 - Explain the features and objectives of the following funds in the UK: pension funds (defined benefit (DB) and defined contribution (DC))
- 3.2.11 - Explain the significance of the Pensions Act 2004: scheme specific funding requirement, the Pensions Regulator, the Pension Protection Fund
- 3.2.12 - Explain the purpose of a Statement of Investment Principles
- 5.7.8 - Identify other types of legal requirements that affect pension funds

Objectives and constraints of insurance companies in the UK

- 5.7.1 - Explain the features and objectives of the following funds in the UK: pension funds (defined benefit (DB) and defined contribution (DC)), life assurance, general insurance

- 5.7.8 - Identify other types of legal requirements that affect insurance funds

General comments

- 5.7.2 - Distinguish among the typical asset allocations for DB and DC pension funds, life assurance and general insurance funds

2. Major funds in the UK

2.1. The return objectives of major funds types

Like individual investors, funds will have set objectives that they wish to achieve. These will be set down in the constitutional documents for that particular institution, for example the trust deed for a unit trust or a statement of investment principle for an occupational pension scheme.

These objectives can be divided into two broad categories:

- Maximising returns
- Matching liabilities

If we consider the major fund types in the UK (pension funds, insurance companies, collective investment schemes and investment trusts), we can make the following groupings.

Table 5.

Maximising returns	Meeting liabilities
Defined contribution pension scheme	Defined benefit pension scheme
Collective investment scheme	Life assurance company
Investment trust company	General insurance company

Liability driven investment

Those funds that need to meet liabilities are said to engage in liability driven investment or asset and liability matching strategies. Institutions will try to ensure that the returns generated by any investment will meet the liabilities due on their due date.

Many liability driven investment strategies make use of fixed income securities, such as government bonds. These give predictable cash flows that can be matched with the timings of liabilities; a process called dedication or cash flow matching.

It is also important to identify what types of liabilities the fund faces. Again, these can be broadly divided into two categories: real liabilities and nominal liabilities.

Real liabilities are those that are affected by inflation. For example, if we consider a defined benefit pension scheme linked to an employee's final salary. The employee is not due to retire for 20 years. In this scenario the liability that the pension fund needs to meet is exposed to the impact of salary inflation – one would imagine that over the next 20 years, the employee's salary will increase. Clearly, this will not always be a long-term liability, and, in 15 years, the liability becomes more imminent. Most long-term liability driven funds will adjust their asset allocation accordingly when the liabilities draw near.

In these situations, cash flow matching may not be appropriate, as the investor would need to anticipate inflation over a long period of time. Often investors facing real liabilities to match will use real assets – those that typically increase with inflation – such as equities and index-linked instruments.

2.2. Influences on fund asset allocation

As mentioned in the chapter on client objectives, asset allocation is considered to have the greatest impact on the returns of a portfolio. This is as true for institutions as it is for individuals. Elements that could impact on a fund's allocation include:

Time horizons

The length of time a fund is able to commit its resources to investments is key to asset allocation. The longer term the investment horizon, the more short-term risk a fund will be willing to take. In addition, a longer investment horizon will have an impact on the funds attitude to liquidity and, possibly, inflation.

For example, consider a whole-of-life assurance policy for a healthy person in their thirties. Probability would suggest that the liability faced by the insurance company on this particular policy is a long way in the future. This would allow the company to take an increased level of short-term risk without too much concern about liquidity, possibly opting for equity and property within the portfolio.

Compare this with a general insurance company offering car insurance. Car accidents occur all the time, and the general insurance companies will pay out immediately. These immediate and uncertain liabilities would lead the company to take a short-term view of investments, possibly choosing cash deposits or money market instruments.

Tax

The tax status that a fund is subject to has a major impact on the assets used for investment. Insurance companies are liable for tax on their investments, so consideration needs to made.

Mutual funds in the UK, such as unit trusts and investment trust companies, also pay tax, but typically only on interest income from bonds and deposits or property income, if relevant.

Some funds, such as pension funds and charities, pay no tax on investment returns (income or gains). However, there will be tax implication. Where investments are received net of tax, the manager will need to factor in the time to reclaim the tax. In addition, these funds are likely to avoid tax-free investments. Investments, typically, are tax free for a reason, and that is typically an additional risk to capital.

Legal and regulatory restrictions

Many funds have restrictions placed upon them by laws and regulations.

Authorised collective investment schemes in the UK must adhere to the FCA collective investment scheme sourcebook, which restricts the asset classes and the concentration of those assets within a fund.

General insurers are required to keep solvency margins, expressed as a percentage of net assets to net premiums.

All funds will be governed by their constitutional documents, which once filed, become binding on the fund.

Other considerations

Many funds restrict the allocation of assets in other ways. Socially responsible investment funds will place restriction on investing in unethical firms, eliminating investment issued by, among others, arms companies, tobacco companies or countries with questionable human rights records.

3. Objectives and constraints of pension funds in the UK

3.1. Features of pension funds

A pension fund is an investment scheme where the contributors are saving for retirement.

Provided the pension scheme is approved by the HMRC Pensions Schemes Office, it will enjoy certain tax benefits:

- Contributions to an approved pension fund are free of tax
- Whilst investments are in the fund, any capital gains or income are not subject to tax
- However, when the pension fund begins to pay out a pension, the recipient will be subject to income tax on their pension income

In the UK, National Insurance payments contribute towards a state pension scheme.

There are also pension schemes provided by companies (‘sponsoring’ companies) for their employees - these are known as **occupational pension schemes** (OPSs).

Alternatively, an individual may take out a **personal pension plan** from a private pension provider.

3.2. Stakeholder pensions

Stakeholder pensions were introduced on 6 April 2001. They allow a low cost pension alternative to the self-employed and to middle-income employees.

Employers are generally obliged to offer stakeholder pensions to their staff unless they already offer adequate pension arrangements or have less than five employees. Alternatively, the pensions can be bought directly from pension providers.

3.3. Occupational pension schemes

Types of occupational pension scheme (OPS)

There are two types of OPS: **defined contribution** schemes and **defined benefit** schemes.

Defined contribution schemes

These are schemes where the sponsoring company contributes a set amount to the fund on the employee's behalf.

These contributions are invested and grow over time.

The returns from the investments determine the pensions paid.

Defined benefit schemes

These are schemes that guarantee to pay a pension of a certain size once the employee retires, i.e. a fixed percentage of the employee's final salary.

The returns from the investments in defined benefit schemes are known as 'actuarial' returns.

In the US and the UK, there has been a noticeable shift towards defined contribution and away from defined benefit schemes by employers. Personal pensions are usually of the defined contribution type.

Many defined benefit schemes, have switched away from equities towards bonds. A number of schemes have adopted liability-driven investment (LDI) strategies that involve not just a switch to bonds, but the use of swaps and other derivatives to more accurately match assets to liabilities. The sponsoring company must first appoint a trustee.

Approval of an OPS

The schemes are approved by the HMRC Pensions Scheme's Office.

Approved pension schemes enjoy tax benefits, e.g. no income or capital gains tax liabilities.

The trustee

The trustee will be appointed by the sponsoring company to oversee the running of the fund and take legal ownership of the scheme's assets. They are responsible for the creation of the statement of investment principle, setting out the nature of the fund. The trustee also has the final say over decisions regarding the scheme and essentially is the representative of the beneficiaries of the scheme.

Although we will see later that the trustee can delegate some of his roles to others, the trustee retains overall responsibility.

The trustee will consult with the sponsoring company to draw up a **statement of investment principles** (SIP).

The investment manager

The trustee appoints the investment manager.

The trustee must take every care in selecting and supervising the investment manager, as it will be the trustees who will be held ultimately responsible for any losses or criminal acts that are perpetrated by the investment manager.

The trustee must ensure that the investment manager adheres to the regulations and objectives of the fund.

However, the investment manager maintains responsibility for the investment strategy i.e. achieving the objectives set by the trustee.

Investment strategy

The age of the fund's members is an important consideration regarding the investment strategy of the fund.

If the members of the pension fund are, on balance, older, then the investment manager might consider moving into bonds and fixed interest securities. This increases the reliability of payments to the fund and hence its ability to meet imminent liabilities.

Equities also have their place in pension portfolios. For instance, a higher tolerance of risk from the trustees would result in the portfolio moving towards equities. UK pension funds, typically, are more heavily weighted towards equity than their European counterparts.

The fund may wish to invest in the shares of the sponsoring company. Although this is permitted, it is limited to a maximum investment of 5% of the sponsoring company's share capital.

3.4. The statement of investment principles

When creating an occupational pension scheme, the sponsoring company must first appoint a trustee.

The trustees of most schemes must draw up a written statement of investment principles (SIP). The SIP sets out the principles governing how decisions about investments must be made.

What the SIP must include

The SIP must include the trustee's policy on:

- Choosing investments
- The kinds of investments to be held and the balance between different kinds of investment
- Risk, including how risk is to be measured and managed, and the expected return on investments
- Realising investments
- The extent, if at all, taken into account of social, environmental or ethical considerations when taking investment decisions
- Using the rights (including voting rights) attached to investments if they are available

Reviewing and revising the SIP

A trustee will need to review the SIP regularly - at least every three years and whenever there has been a significant change in investment policy.

Legal requirements when choosing investments

Regulations set out how trustees or fund managers must exercise their investment powers. This includes exercising those powers to ensure:

- Security, quality, liquidity and profitability of the fund
- Due consideration towards the nature and duration of the expected future retirement benefits of the scheme
- Diversification in the choice of investments for the scheme
- The scheme assets are invested mainly in regulated markets

When choosing investments, the trustee (or the fund manager acting on his behalf) must exercise his investment powers in line with the scheme's statement of investment principles (SIP).

Holding scheme assets securely

The trustee has a duty to make sure that the scheme's investments are held securely.

If the services of a custodian are not used, a trustee should check that the arrangements in place for holding the scheme's assets are satisfactory.

Trustees must be able to clearly identify scheme funds. They must keep scheme money received in a suitable account with a bank or building society separate from the employer's account.

Appointing a custodian

If a custodian is appointed to hold the scheme's assets, the trustee should ensure they have adequate insurance arrangements and that, if the custodian uses sub-custodians, sufficient guarantees are in place.

The trustee should also check the arrangements in place between the custodian and the fund manager for making sure the assets the custodian holds are the same as those reported by the fund manager.

3.5. The Pensions Regulator

The Pensions Regulator was established by the Pensions Act 2004.

Objectives of the Pensions Regulator

The objectives of the Pensions Regulator are to:

- Protect the benefits of members of work based schemes
- Reduce risk of situations requiring compensation from the Pension Protection Fund
- Promote good administration and improve understanding of the schemes it regulates
- Maximise employer compliance with employer duties

Powers of the Pensions Regulator

The Pensions Regulator's principal aim is to prevent problems from developing. Where possible, they will provide support and advice to trustees, administrators, employers and others where potential problems are identified.

The Pensions Act 2004 provides the Regulator with a range of powers - as well as those it inherited from its predecessor OPRA - to enable it to meet its objectives.

The powers fall into three broad categories:

- Investigating schemes: gather information to help identify and monitor risks
- Putting things right where problems have been identified
- Acting against avoidance: ensure that employers do not sidestep their pension obligations

Investigating schemes

The Pensions Regulator collects data through the scheme return. It also expects to receive reports of significant breaches of the law from 'whistleblowers', and reports of notifiable events from trustees and employers.

Trustees or scheme managers are also responsible for notifying the Regulator promptly of changes to information such as the scheme's address, details of trustees, or the types of benefit provided by the scheme.

Protecting the benefits of scheme members

Where the Pensions Regulator believe that a scheme is deliberately avoiding their obligations, they have the power to issue:

- **Contribution notices** - where there is a deliberate attempt to avoid a statutory debt, those involved must pay an amount up to the full statutory debt, either to the scheme or to the Board of the Pension Protection Fund.
- **Financial support directions** - these require financial support to be put in place for an under-funded scheme.
- **Restoration orders** - if there has been a transaction that under-valued the scheme's assets, the Regulator can take action to have the assets (or their equivalent value) restored to the scheme.

Scheme funding

The Regulator also expects to receive reports where a scheme is unable to comply fully with the new scheme funding framework. If a scheme has a shortfall, the Regulator expects to receive scheme funding information.

Scheme specific funding requirement

The Pensions Act 2004 also requires that the trustees prepare a **statement of funding principles** specific to each scheme explaining how the statutory funding objective will be met. The statutory funding means that the fund has sufficient resources to meet an amount required for the fund to meet its obligations. This amount is based on actuarial calculations.

The scheme specific funding requirement must include details on:

- Regular actuarial valuations and reports: how they will be made and how often
- Preparing a schedule of contributors, showing the rates of contributions payable to the scheme and the dates on which they are to be paid
- Putting in place a recovery plan for when the statutory funding objective is not met. This must set out the steps to be taken to meet the funding objective and the period within which this will be done
- This must be reviewed every three years

3.6. Pension Protection Fund (PPF)

The Pension Protection Fund's main function is to provide compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer, and where there are insufficient assets in the pension scheme to cover the Pension Protection Fund level of compensation.

The Pension Protection Fund is a statutory fund run by the Board of the Pension Protection Fund, a statutory corporation established under the provisions of the Pensions Act 2004.

To help fund the Pension Protection Fund, compulsory annual levies are charged on all eligible schemes.

The Pension Protection Fund is also responsible for the Fraud Compensation Fund - a fund that will provide compensation to occupational pension schemes that suffer a loss that can be attributable to dishonesty.

Compensation

In summary, if an employer is insolvent and the pension scheme cannot meet its liabilities then the PPF will provide compensation of:

- Up to 100% of benefits to existing pensioners

- Up to 90% of benefits to those who have not yet retired

Existing pensioners

For individuals that have reached their scheme's normal pension age or, irrespective of age, are either already in receipt of survivors' pension or a pension on the grounds of ill health, the Pension Protection Fund will generally pay 100% level of compensation. This means a starting level of compensation that equates to 100% of the pension. This can even be index-linked: increasing each year in line with the retail price index, capped at 2.5%.

For those yet to retire

For the majority of people below their scheme's normal pension age, the Pension Protection Fund will generally pay 90% level of compensation. This means 90% of the pension an individual had accrued can be paid out. This compensation is subject to an overall annual cap, which, as at April 2010, equates to £29,748.68 at age 65 after the 90% has been applied, but is again index-linked.

The Pension Protection Fund has the ability to alter the levy to meet its liabilities. However, in extreme circumstances, compensation could be reduced.

Levels of compensation could also be reduced by the Secretary of State on the recommendation of the Pension Protection Fund.

The Pension Protection Fund is funded by a levy on all defined benefit pension schemes.

4. Objectives and constraints of insurance companies in the UK

4.1. Life insurance

A **term insurance policy** covers the life of an individual over a specific period (usually ten years or more). In the event that the insured person survives the period, no payment is made.

A **whole of life policy** will insure the life of an individual and pay a capital sum on the policyholder's death, whenever the death should occur.

An **endowment policy** combines a savings element with a life insurance element. In return for regular premiums, an endowment policy will pay a fixed sum of money (the basic sum assured) in the event of the policyholder's death, or at least the same fixed sum if the holder survives for a pre-specified period. Endowments policies were popular in the 1980s and 1990s, often taken out as insurance cover for mortgages where the sum assured is equal to the outstanding value of the mortgage. If the holder dies during the life of the mortgage, the mortgage provider receives the sum assured, thus paying off the mortgage. Alternatively, if the holder survives the period of the mortgage, the value of the endowment is designed to be equal to the value of the mortgage when the mortgage is due to be redeemed.

With-profits endowment policies give the opportunity for a surplus to be accrued over and above the basic sum assured. The rate of bonus passed on to investors is not directly related to the performance of the underlying managed fund. The objective of with-profits funds is to deliver a smoothed return by means of bonuses rather than returns directly linked to the markets, which may be volatile. This will mean putting funds into reserves during periods of strongly positive investment returns and drawing on reserves during periods of poorer performance. It is clear to see that if a life office continued to pay bonuses in excess of actual returns, it would deplete its reserves, and this could jeopardise the sustainability of future bonuses.

4.2. General insurance

Most of the element s on general insurance have been covered in previous sections of this chapter. In summary:

- Includes insurance cover for cars, homes, contents of homes, pets, etc.
- Typically short-term investment horizon
- Low tolerance of risk
- Highly liquid assets
- Solvency requirements

5. General Comments

5.1. Summary of typical asset allocations

Table 6.

	Young DB pension fund	Mature DB pension fund	Life assurance company	General insurance company
Investment horizon	Long-term	Short-term	Long-term	Very short-term
Attitude To short-term risk	Positive	Negative	Positive	Very negative
Liquidity	Low	High	Low	Very high
Liabilities	Real	Real/Nominal	Nominal	Nominal
Asset choice	Equities; Property; Index-linked gilts	Bonds	Equities; Property; Bonds	Cash; Money market instruments

6. Summary

6.1. Key concepts

Major funds in the UK

- 5.7.3 - Explain the return objectives of the major fund types
- 5.7.4 - Classify funds by their income / capital growth requirements
- 5.7.5 - Explain the effect of each of the following on a fund's asset allocation: time horizons, liability structure, liquidity requirements
- 5.7.7 - Explain the effect that taxation legislation may have on the stock selection and asset allocation of a fund

Objectives and constraints of pension funds in the UK

- 5.7.1 - The features and objectives of the following funds in the UK: pension funds (defined benefit (DB) and defined contribution (DC))
- 3.2.11 - The significance of the Pensions Act 2004: scheme specific funding requirement, the Pensions Regulator, the Pension Protection Fund
- 3.2.13 - The purpose of a Statement of Investment Principles
- 5.7.8 - Other types of legal requirements that affect pension funds

Objectives and constraints of insurance companies in the UK

- 5.7.1 - The features and objectives of the following funds in the UK: pension funds (defined benefit (DB) and defined contribution (DC)), life assurance, general insurance
- 5.7.8 - Other types of legal requirements that affect insurance funds

General comments

- 5.7.3 - The typical asset allocations for DB and DC pension funds, life assurance and general insurance funds

Now you have finished this chapter you should attempt the chapter questions.

Financial markets

1. Introduction

1.1. Chapter overview

This chapter explains the purpose and role of markets in general, as well as the role of the London Stock Exchange (LSE), in providing a trading platform for the securities market. As you will see, it is not only shares that are traded on the Exchange, but also corporate bonds, UK Government bonds (gilts), American Depositary Receipts (ADRs), warrants and a selection of other instruments. Importantly, you will learn some of the different trading systems the LSE operates and understand different roles played by LSE member firms.

We will then move onto the debt markets. The trading of debt uses systems and markets, much the same as equity. However, the debt market is a predominantly quote driven market.

The chapter ends by looking at the derivatives markets. These investments are heavily traded on exchanges such as LIFFE, but there is also a very large and liquid over-the-counter market. Both these methods of trading will be looked at in this chapter.

1.2. Learning outcomes

On completion of this module you will:

The role of the financial market

- 1.2.1 Differentiate between a financial security and a real asset
- 1.2.2 Identify the key features of: -a common equity share, a bond, a derivative contract, a unit in a pooled fund, and a foreign exchange transaction
- 3.4.1 Explain the role of an investment exchange
- 1.2.3 Identify the functions of securities markets in providing price transparency and liquidity
- 1.2.7 Define liquidity risk and identify why it is important
- 1.2.4 Identify the reasons why liquidity and price transparency are thought to be important for the efficient allocation of capital costs when trading in securities markets
- 1.2.5 Calculate round trip transaction costs incorporating bid-ask spreads, dealing commission and transaction taxes, both in percentages and in absolute amounts
- 1.2.6 Identify the types of securities and the market conditions where price transparency, liquidity and depth are likely to be high / low

Trading

- 3.4.5 Identify and distinguish the roles of LSE, NYSE Liffe, and LCH.Clearnet
- 1.3.1 Identify the main dealing systems and facilities offered in the UK equities market
- 1.3.2 Identify the nature of the securities that would be traded on each of the main dealing systems and facilities

- 1.3.8 Explain the roles of the various participants in the UK equity market
- 1.3.7 Distinguish between a quote-driven and an order-drive market
- 1.3.6 Distinguish between the following alternative trading venues: Multilateral Trading Facilities, Systematic Internalisers and Dark Pools
- 1.3.9 Explain high-frequency trading, its benefits and risks

Bond markets

- 1.3.3 Explain the structure and operation of the primary and secondary UK markets for gilts and corporate bonds

Derivatives markets

- 3.4.6 Identify the features of trading systems for derivatives
- 3.4.9 Explain the arrangements for market transparency and transaction reporting in the main derivative markets
- 3.4.7 Identify the main features of the regulation of derivatives

Settlement

- 1.4.1 Explain the clearing and settlement procedures for UK exchange traded securities
- 3.4.8 Identify the main features of clearing and settlement for trading on derivatives exchanges, and when trading over-the-counter (OTC)
- 3.4.10 Explain the impact of MiFID and International Accounting Standards on the regulation of derivative markets
- 1.3.5 Compare and contrast exchange traded and over-the-counter (OTC) markets

International markets

- 1.7.2 Explain the structure and operation of the primary and secondary markets for Eurobonds
- 1.7.1 Explain the structure, features, regulatory and trading environment of international markets, including developed markets and emerging markets
- 1.7.3 Explain the settlement and clearing procedures overseas, including the role of international central securities depositories, and the different settlement cycles and challenges in managing global assets

2. The role of the securities markets in providing liquidity and price transparency

2.1. Differentiate between a financial security and a real asset

Real assets

Real assets are tangible. These include land, buildings, machines, and knowledge that can be used to produce goods and services. Other common examples of investments in real assets are paintings, antiques, precious metals and stones, classic cars etc. Due to the physical nature and variability in quality of these assets, real assets often suffer from illiquidity and difficulty in pricing.

Financial assets

Financial assets or securities include shares, bonds, units in unit trusts, etc. These represent a legal claim on future financial benefits. Although they do not contribute directly to the productive capacity of the economy they are the means by which individuals hold their claims on real assets and the income generated by these real assets.

2.2. Key features of asset classes

Shares

Ordinary shares

Ordinary shares are the most common form of equity and are sometimes called **common shares** or **equity**.

Ordinary shares give shareholders the following basic rights:

- **Right to vote** in company general meetings (although non-voting ordinary shares do exist)
- **Right to a dividend** reflecting the profits of the underlying company. Dividends payable to ordinary shareholders will only be paid **after** all interest and preference dividends have been satisfied. Therefore, if a company is unprofitable, the ordinary shareholders are most likely to lose out. However, should the company generate profits, ordinary shareholders can expect a good return in order to compensate for this risk
- **Right to a surplus on winding up**. In the event of the winding up of a company, ordinary shareholders are entitled to a share of the remaining (i.e. surplus) assets of the company after **all** other liabilities have been paid
- **Preference shares** are less common. They offer a fixed dividend (payable before the ordinary share dividend) and no voting rights. Most preference shares allow the dividend to roll up if it is not paid out (**cumulative preference shares**) and some allow conversion into ordinary shares (**convertible preference shares**). Other forms include participating and redeemable.

Bonds and bills

Bonds and bills are a form of debt raised by governments and companies. Debt involves borrowing money with a firm commitment to repay both the capital and associated interest in the future.

Debt securities are tradable instruments issued to investors in return for borrowed funds. These instruments typically pay a rate of interest (or **coupon**) on a six-monthly or annual basis. The capital amount (or **principal**) is repaid in full at some point in the future often referred to as the **redemption date**.

A bond is a way of describing a medium- to long-term debt security. Typical maturity (i.e. repayment) of a bond is more than one year from its original issue date.

A bill is a short-term debt security: a security maturing in less than one year.

Derivatives

Derivative products 'derive' their value from other products – often called the underlying asset. Examples of derivatives are **futures** and **options**.

Futures

A future is an agreement (or contract) between two parties who agree to buy or sell a specific quantity of a specific asset to be delivered on a specific date in the future for an agreed price. The person agreeing to buy the asset in the future takes the **long position**. The person agreeing to sell the asset in the future takes the **short position**.

The terms and conditions of the future transaction (i.e. price, size, quality etc) are agreed **now**. The price agreed for the asset, however, is paid on the agreed future delivery date.

Options

An option gives the buyer the right (not the obligation) to buy (**call option**) or sell (**put option**) an underlying asset at a fixed price on, or before, a given date in the future.

Notice that the buyer has a choice whether to buy or sell: with futures, both the long and short have an obligation. Only the seller of an option has a potential obligation.

Another difference is that the buyer of an option pays a premium to the seller. There is no premium paid when buying futures.

Units in collective investment schemes

Collective investment schemes are large pooled funds that include **unit trusts** and **investment companies with variable capital** (also called open-ended investment companies). These collective investment schemes manage large portfolios of assets on behalf of many investors. The investors receive a security called a **unit** in these schemes. Each unit reflects a small percentage of the assets under management by the scheme. The units will generate capital gain and income for the investors. The interests of the unit-holders are represented by the Trustee, who will be independent of the fund management group.

Foreign exchange

The foreign exchange (FX) market is a global **over-the-counter** (OTC, or **off-exchange**) market in the world's different currencies.

It is a **quote driven** market in which major international banks are the only participants. It is not a market in which private investors or companies act directly. Even large companies and investment funds use banks to access the FX markets.

There is a spot market, where settlement occurs T+2, and forward market for longer settlement periods. To avoid default risk (called Herstatt risk in the FX market) many trades are settled through **continuous linked settlement** (CLS), which offer **payment versus payment** (PvP) protection against default (essentially a money back guarantee).

Investment in foreign currencies could be for transactional purposes – companies needing to settle an invoice in a foreign currency – or speculative purposes – investors gambling on the appreciation or depreciation of a currency.

2.3. Role of an exchange

As with equity and debt exchanges, a derivatives exchange is a marketplace on which traders can meet to agree prices on various investments. The exchange is generally regulated by the local regulator, but is also given a specific regulatory role itself in monitoring transactions and the participants to ensure that regulatory protocol has been followed. The exchanges will also ensure a transparent market, where all trades are reported and published so that participants know the current market prices and the trends for those prices.

2.4. Liquidity and transparency

Liquidity is the ease with which investors can enter into and out of an investment. The greater the number of buyers and sellers for a particular product, the greater the liquidity will be. Buyers and sellers that are well informed about the prices of assets will be more willing to enter the marketplace for those assets. For this reason, transparency of prices and volumes plays a vital role in the liquidity of markets.

How markets provide liquidity

Exchanges, such as the London Stock Exchange and NYSE.Liffe play a vital role in the liquidity and transparency of markets. Listed below are some of the key reasons.

1. An exchange provides a central market place for buyers and sellers to meet; they concentrate the liquidity in one place.
2. An exchange provides systems that can give investors access to real-time price and volume information, keeping them well informed about market information.
3. An exchange regulates its members, giving an additional layer of confidence. This in itself increases the willingness of participants to trade, adding further to the liquidity of the markets.
4. Where derivatives are concerned, an exchange standardises contracts, to ensure everyone is trading the same type of product.
5. Exchange will give members access, and often insist on the use of, systems to reduce the risk of default on the trade, e.g. LCH.Clearnet and Euroclear UK and Ireland's CREST

Pre-/Post-trade disclosure requirements

MiFID has laid down a framework of disclosure requirements for trading activities. The pre-trade requirements apply to those trades conducted on regulated markets and multi-lateral trading facilities (MTF) and the post-trade requirements apply to all firms conducting trades either on or off exchange.

Pre-trade disclosure

This refers to information displayed by execution venues to investors, whereby an exchange or MTF must display current prices and daily trading volumes to all investors on its trading screens. This allows the investors access to this real-time information before they input their trades.

Post-trade disclosure

All firms are required to report their completed transactions as soon as possible after completion, whether they are conducted on a regulated market, multilateral trading facility (MTF) or other market. The publication may be subject to a delay, dependent on the size of the trade.

If the execution venue is an order book, there is no need for the member to make a trade report as the system will do this automatically. Publication will immediately occur on the order book where the best five prices for both buying and selling orders with trading volumes must be displayed.

2.5. Why liquidity is important for the efficient allocation of costs

Introduction

Markets that are decentralised, such as over-the-counter (OTC) markets, or fractured, such as much of the corporate bond market, tend to suffer from less liquidity. Lower levels of liquidity are a disadvantage explicitly – leaving investors unable to crystallise profits or limit losses – or implicitly – through the additional costs involved in the transaction.

Liquidity risk is the risk that an investor may be unable to sell an asset they own when they wish to do so at a price that is fair. In the securities markets, this could leave an investor unable to crystallise a profit if their asset has risen in value but there are no willing buyers. It could also mean that they are left holding an asset that continues to fall in value, losing the investor more money.

These risks also exist in the derivatives markets, but there is the additional risk of unwanted delivery situations. If the investor is unable to close out a physically delivered derivative before the delivery date, they may be obliged to take or make delivery on the contract.

There is also a link between liquid markets and efficient pricing. Liquid markets, with many buyers and sellers, tend to have efficient price discovery, where the price at which the asset trades is the price agreed upon by many well-informed participants. Having all prices displayed on order driven platforms, such as the London Stock Exchange’s SETS platform, adds to the clarity in pricing and the certainty of receiving the best price available. Illiquid markets, typically, do not have this level of transparency.

Liquid markets not only contribute to the efficiency in pricing but also incur lower transaction costs. These could be costs built into a bid offer spread and/or additional cost imposed through broker/adviser fees. Where markets are illiquid, the spreads tend to be wider and the additional costs higher. These higher costs are to compensate those making a market for the additional risk caused by the uncertainty in pricing and the possibility of being unable to exit any position they enter into with their clients.

Impact of transaction costs on returns

When considering the returns generated through an investment, it is common for an investor to forget to consider the transaction costs involved in generating that profit. These additional costs can significantly erode the returns.

Costs suffered could be:

- Bid/offer spreads on the market itself
- Broker/adviser fees to gain access to the market
- Stamp duty reserve tax charged at 0.5% on purchases of chargeable securities
- Takeover Panel levy charged on all LSE transactions above £10,000
- Foreign exchange rate movements if investing in a foreign currency

Example

An investor buys 2,000 shares quoted at £4.70/£4.78 on the 10th July. Six months later the shares are sold at a market price quoted at £5.10/£5.22. The investor's broker charges a commission of 0.75% on all trades. Assume no dividends were paid during the holding period. After considering all costs, including SDRT and the PTM levy, what is the investor's return?

Without costs

The investor's return would be:

- Cost of shares = 2,000 x £4.78 = £9,560
- Proceeds from sale of shares = 2,000 x £5.10 = £10,200
- Total return = £10,200 / £9,560 - 1 = 6.69%

Note: even here, there is the cost implied by the spread on the quote.

With costs

Total cost of purchase

- Cost of shares = 2,000 x £4.78 = £9,560
- **PLUS**
- Broker's commission = £9,560 x 0.0075 = £71.70
- SDRT = £9,560 x 0.005 = £47.80
- Total cost = £9,560 + £71.70 + £47.80 = £9,679.50

Net proceeds on the sale

- Proceeds from sale of shares = 2,000 x £5.10 = £10,200
- **MINUS**
- Broker's commission = £10,200 x 0.0075 = £76.50
- PTM levy = £1
- Net proceeds = £10,200 - £76.50 - £1 = £10,122.50

Total return after all costs = £10,122.50 / £9,679.50 – 1 = 4.58%

2.6. Impact of the type of security or market on transparency and liquidity

As mentioned before, liquidity on exchanges tends to be very good. This is due to:

- The number of buyers and sellers trading in a central location
- The confidence in the efficiency of the market through the use of:
  - Efficient information systems providing transparency in prices and volumes
  - Electronic order books, such as the LSE's SETS, giving members access to all trading volumes at that point in time and immediate execution at agreed prices
  - Clearing houses, to register and confirm trades, and settlement agencies, to arrange delivery and payment, giving confidence that any agreed trade will proceed to delivery

However, even on exchanges, some securities are less liquid than others are. Securities can become illiquid for many reasons. It could be down to:

- The price becoming too high, creating a large entry cost to the investment
- The price becoming too low, leading to proportionally large bid/offer spreads

- The company becoming unfashionable/uninteresting

Exchanges attempt to create liquidity in less liquid stocks by adapting the crossing platforms they use. For example, the LSE has done this with SETSqx, which provides a series of periodic auctions instead of continuous order book trading.

Market makers also provide liquidity in the markets where there is no natural liquidity. Exchanges may appoint these market makers as part of exchange systems, or they may be systematic internalisers – firms providing a market making (and crossing) function directly to their clients. As a market maker, the firm offers a bid/offer spread to investors and commits to buy/sell at those prices. If an investor cannot find a buyer or seller, they can approach a market maker and trade at the prices quoted. As mentioned above, the less liquid the stock, the wider the bid/offer spread is likely to be.

3. Trading securities in the UK

3.1. LSE: introduction

The LSE's origins go back to the 17th century, when people wishing to invest in joint-stock companies met in coffee houses to strike deals.

The headquarters are now at Paternoster Square, next to St Paul's Cathedral, and the LSE has grown into one of the major stock exchanges of the world. The LSE provides a marketplace where over 3,000 company securities, both domestic and international, are traded.

The main purpose of an exchange is to provide a centralised market place at which buyers and sellers can meet, and in doing so create the maximum possible liquidity for those products.

It is not just liquidity, however, that exchanges provide. All exchanges in the UK need to be **recognised** by the Financial Conduct Authority (FCA). In acquiring recognised status, an exchange has proved that it has adequate rule making and monitoring facilities to govern its members and their trading activities. In this way an exchange also provides orderly markets on which to trade.

3.2. The main dealing systems for UK securities

The list of securities is as follows:

Table 7. The main dealing systems for UK securities

Name of system	Function
Trading systems	
SETS	Continuous order book execution system for FTSE All Share index and most liquid AIM and Irish shares
SETSqx	Hybrid system. Periodic order book execution with market maker support for most other UK shares.
SEAQ	Quote driven system for any shares too illiquid for SETS or SETSqx as well as corporate bonds
International Order Book	Order driven system for international depositary receipts
European Quoting Service	Quote driven system for European listed securities
Order book for Retail Bonds (ORB)	Retail focused order book trading for gilts, supranational bonds and corporate bonds
International Board	Facilitates reciprocal trading arrangements between LSE and other exchanges. Currently only the Singapore Stock Exchange has joined.
Other systems	
European Trade Reporting	Enables members to meet their post-trading obligations
LCH.Clearnet	Central counterparty to all trades executed on the SETS order book. Manages default risk on behalf of members.

Name of system	Function
CREST	Settlement system for UK and Irish securities. Owned by Euroclear UK and Ireland

3.3. Participants in the markets

In order to trade on and investment exchange a firm must be a member of the exchange. However, there are differing forms of membership and a range of roles and obligations that can be taken on in addition to the basic membership.

Broker/Dealers

A broker/dealer can trade in one (or both) of two ways: buy and sell securities on behalf of clients (act as **agent**), and/or buy and sell securities for their own account (act as **principal**).

Dealing (principal trades)

By acting as principal, the firm is taking a position itself, i.e. 'running a book'. The aim is to make a **turn** on the trade (buy low, sell high). When acting as principal the trade will be assigned to the firm's house account.

Broking (agency trades)

Alternatively, the firm may act as agent on behalf of a client. In these circumstances, the firm will **not** take a position but instead earns commission on the trade. When acting as agent, the trade will **usually** be assigned to a segregated account which is separate from the firm's own account. Some clients may, however, consent to their trades being allocated to a non-segregated account.

Dual capacity

Due to the fact that a member firm may act either as agent or principal to a trade, they are said to have **dual capacity**.

Market makers

Market makers are member firms that have volunteered to provide liquidity (make a market) in a security.

A broker/dealer on the London Stock Exchange will apply to the LSE to register as a market maker. They will register to provide a market in a specific security.

They provide continuous liquidity in the markets by providing buy prices (**bid**) and sell prices (**offer**) to the market throughout a set time called the **mandatory quote period** (MQP). During this time the market maker is obliged to trade with clients at the prices quoted.

This means that the market maker is a guaranteed buyer and seller of the security in which they are registered.

Market makers registered to provide liquidity in the bond market are referred to as fixed income market makers (FIMMs).

Market makers registered to provide liquidity in the gilt market are referred to as gilt edged market makers (GEMMs).

Inter-dealer brokers (IDBs)

An inter-dealer broker, or IDB, is a firm that has registered with the exchange to provide intermediating services between other firms.

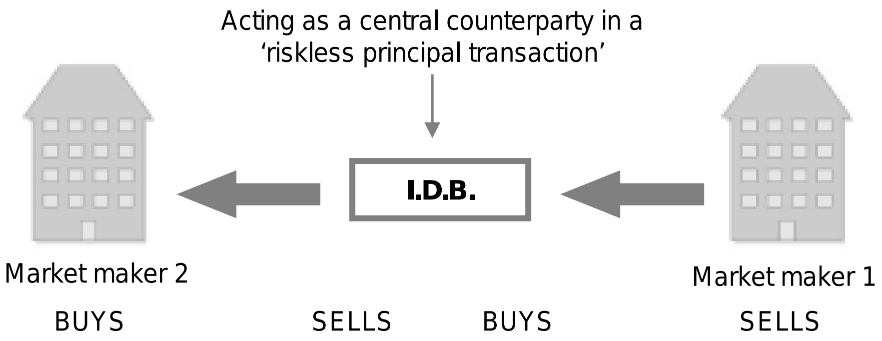
An IDB is used, primarily by market makers, to allow **complete** anonymity when either taking on, or off-loading, a position in a security.

Anonymity can be useful when a firm wishes to expose itself to substantial risk, and this is when IDBs are primarily utilised.

The IDB provides information to its users though screen-based systems or over the telephone.

When the users of an IDB agree a trade, the IDB would act as central counterparty to the trade, in order to maintain its clients' anonymity. This means that the IDB **buys** from MM1 and **sells** to MM2. The IDB is not making a spread on this trade as it earns its profit from fees and commission.

As the IDB agrees the price at which it will buy and the price at which it will sell before the trade is effected, it is said to have performed a **riskless principal transaction**



Stock borrowing and lending

A Stock Borrowing and Lending Intermediary (SBLI) is used to provide liquidity in the secondary market and can assist firms with short positions in a security.

For example, suppose a market maker sells 1,000 shares of a security in which it is registered without owning the shares.

Although this may sound strange, it is very common. Because settlement of that trade is usually T+3, as long as the market maker has the stock to deliver in three days' time, the trade will settle as normal.

In order to achieve this, the market maker could contact an SBLI who will have access to large blocks of institutionally held stock.

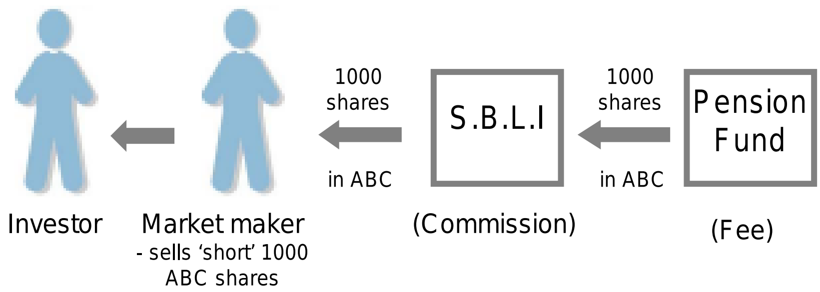
For a fee, an institutional investor, for instance a pension fund, will lend the securities out to the market maker via the SBLI. Collateral may be required by the pension fund.

Lenders of securities tend to be institutional investors with large portfolios that are passively held. These include:

- Pension funds
- Insurance and life companies
- Mutual funds and unit trusts

It is possible that active funds might also lend but there is more chance that the securities will be recalled, thus making it less attractive to borrowers.

SBLI: example



After the market maker has sold the shares 'short', it will borrow stock via an SBLI so that it can settle its position with the investor.

Key points on the SBLI diagram

The pension fund loses the benefits attached to the securities, i.e. voting rights. All rights are now attributable to the investor. The investor will become the registered owner of the shares.

If this means the pension fund loses out on any dividends paid on the shares during the time the stock is being lent out, an artificial dividend will be manufactured into its fee.

The pension fund is only lending the stock out, and will therefore want it returned at some point in the future. It is the responsibility of the market maker to return the equivalent shares to the pension fund at a pre-determined future date.

3.4. Quote vs. order driven

Quote driven

Quote driven markets need price makers, such as market makers, providing continuous quotes during a mandatory period. The market makers offer spreads on the stocks available – a price at which they are prepared to buy (the bid) and a price at which they are prepared to sell (the ask or offer).

Quotes are usually displayed on trading screens and firms will trade on these quotes via telephone. These trades will need to be reported to the exchange.

The LSE runs a pure quote driven system called SEAQ, although several systems run by the LSE use market maker quotes.

The major advantage of quote driven markets is the continuous liquidity provided by the market makers.

Order driven

Order driven markets have no price makers. Buyers and sellers will simply enter their order on to the system and wait for automatic execution. The stocks are bought and sold at the prices at which buyers and sellers can agree.

Open outcry markets and many electronic trading platforms are order driven. There are no open outcry markets for securities in the UK; although in the US NYSE.Euronext does offer this style of trading. The London Metals Exchange (LME) is an oddity in the UK, offering open outcry trading in derivatives.

As there is no price maker in an order driven market, there is no guarantee of execution. The major advantage, however, is the single price trading. That is, the investor does not suffer from a market maker's bid/offer spread.

Hybrid systems

Order driven markets work well where there is plenty of liquidity – many buyers and sellers – as this leads to a large number of orders where price agreement is likely.

Quote driven markets are needed where this liquidity is not naturally present in the market, requiring the presence of a market maker.

However, some securities have sufficient liquidity at times, so would benefit from an order driven market, but suffer from illiquidity at other times, so would benefit from market maker support. For this reason the LSE also has hybrid systems, which run the two types of markets simultaneously.

3.5. Order book example: SETS

The Stock Exchange Electronic Trading Service (SETS) is the central trading mechanism for the constituents of the FTSE All Share index, the most liquid AIM shares and some euro-denominated Irish securities.

Only member firms authorised to use SETS can place orders on the SETS order book, either for their own account or on behalf of clients. However, anybody is able to view the order book to see the orders being placed.

Once an order has been placed on the order book, it will automatically be matched against a corresponding order. If there is no such corresponding order to match against, the order will either stay working on the order book for future execution or will be returned (in full or in part) to the member who originally entered the order, depending on the type of the order.

SETS screen

Tesco TSCO Currency GBX
NMS 50 000
Prev 210 209 211 210 210
SETS Volume 3.41m
Total Volume 10.2m
BUY Total Volume 22,000 Total Volume 22,000 SELL

5,000	210 – 214		3,000
5,000	210	214	3,000
1,000	209	215	5,000
11,000	208	216	7,000
3,000	207	217	6,000
2,000	206	218	1,000

The SETS screen represents an electronic medium for expressing interest in a particular share; in this example, Tesco plc. It divides into two halves: the bottom half (including the middle, or **touch**, strip) and the top half.

The bottom half represents a list of typically anonymous orders to buy (on the left-hand side) and sell (on the right-hand side).

Order management is by price (primary factor), and then time (secondary factor). Better priced orders are placed higher on the screen, and will be matched and executed sooner. If two orders are placed at the same price, the earlier order is placed higher.

The **market price**, or best price offered by the order book, is repeated in the touch strip, i.e. 210-214 for Tesco plc in this example. It is the highest priced order to buy (bid) and the lowest priced order to sell (offer).

If no orders to buy and/or sell are input into the SETS order book, the best bid and/or offer is displayed as **nil**.

Continuous order book trading

Many orders can be placed on the order book during continuous order book trading. The two most common are tested in the exam: limit orders and market orders.

Limit order

A limit order specifies the volume of shares to be traded and a limit price (a 'no worse than' price).

When the order is placed, SETS will determine whether the order can be **matched** (or **executed**) against another order recorded on the system. Any unexecuted portion of the order is added to the order book to await subsequent matching.

During the continuous trading period, a limit order is normally the only type of order that will be seen on the order book.

Example of a limit order

Tesco	TSCO		Currency GBX
5,000	210 - 214		3,000
5,000	210	214	3,000
1,000	209	215	5,000
11,000	208	216	7,000
3,000	207	217	6,000
2,000	206	218	1,000

LIMIT ORDER:
Sell 6,000 at 210 limit

Note: The touch price now reflects the new offer at 210

Tesco	TSCO		Currency GBX
1,000	209 - 210		1,000
1,000	209	210	1,000
11,000	208	214	3,000
3,000	207	215	5,000
2,000	206	216	7,000
		217	6,000
		218	1,000

At best (or 'market') order

An **at best** (or '**market**') order only specifies a volume of shares to be traded. It does **not** specify a price. An at best order requests that a specified volume of shares be executed at the best price currently on the order book.

From a seller's point of view, the best price is the **highest** buy price shown on the order book.

From a buyer's point of view, the best price is the **lowest** sell price shown on the order book.

As with an execute and eliminate order, an at best order will execute, in full or in part, against eligible orders on the order book, and any unexecuted part of the order will be **rejected** from the system.

Example of a market order

Tesco	TSCO		Currency GBX
11,000	208 - 210		1,000
11,000	208	210	1,000
3,000	207	214	3,000
2,000	206	215	5,000
		216	7,000
		217	6,000
		218	1,000

AT BEST:

Buy 8,000 at best

Tesco	TSCO		Currency GBX
11,000	208 - 215		1,000
11,000	208	215	1,000
3,000	207	216	7,000
2,000	206	217	6,000
		218	1,000

3.6. Order driven example: SEAQ

The Stock Exchange Automated Quotation System (SEAQ) is a screen based, competitive market making system used for the trading of shares, as well as corporate bonds.

SEAQ acts as an electronic price list, displaying market makers' firm two-way quotes to the market. A firm quote is one that is binding on the market maker.

Should another market marker or broker dealer wish to trade on a quote displayed on SEAQ, the trade is conducted over the telephone.

The role of market makers

Market makers, as we have mentioned, are broker dealers that have volunteered to provide quotes. Market makers provide liquidity in the marketplace.

A member firm may choose in which securities it wishes to make a market. For instance, a firm might wish to be a registered market maker in A plc and B plc, but not C plc. There must be at least two market makers registered for each stock on SEAQ.

Once a firm has registered as a market maker in a security, it is obliged to display continuous two-way prices during market hours. This is the **mandatory quote period.**

Market makers will display prices at which they will buy (**bid**) and sell (**offer**) a stock. The difference between the bid and the offer is the **bid/offer spread.**

Market makers can limit the size of trade at which the quoted prices are ‘firm’ (or binding). However, the exchange does not allow them to limit this size below the normal market size (NMS) of the share. In the example below, the NMS is 5,000. This means the market maker quotes must be firm on any order up to 5,000 shares. For orders above 5,000 shares, the market maker can use the displayed prices as indicative prices. Some market makers are happy to make their prices firm for higher volumes. This will clearly be stated in the bottom half of the screen.

Normal market size is an measure of liquidity provided by the exchange and is based on the average number of shares traded per day.

Example of a quote driven screen:

ABC ORD 5p	**ABC**		Currency GBX
NMS 5 000			CREST
Last	103		
Prev	101.5M 106 105 105.5X		
Volume	340 000		
1	GH 101 - 104	EF JK	2
AB	100 – 105 5 X 5 08.50	GH	101 – 106 5 X 5 08.37
DC	100 – 105 10 X 10 08.44	JK	99 – 104 10 X 10 08.44
EF	99 – 104 5 X 5 08.26		

The top half of the screen displays the stock code, normal market size, trading currency and historic trading information.

The bottom half of the SEAQ screen (below the 'touch strip') shows an alphabetical list of market makers registered in ABC. Each market maker is displaying a bid offer spread (e.g. 100-105), a volume quote (e.g. 10 x 10, in thousands) and the time the quote was input (e.g. 08.50).

The touch strip itself shows the best bid and offer prices and identifies the market makers offering those prices.

3.7. Hybrid system example: SETSqx

SETSqx stands for the Stock Exchange Electronic Trading Service – quotes and crosses.

It is used for the trading of domestic listed securities that are not traded on SETS.

SETSqx is a hybrid system combining a central order book displaying buy and sell orders with two-way prices quoted by market makers.

There is no required minimum number of market makers (there could be zero for a certain stock). If there are market makers, they provide continuous liquidity throughout the day with a mandatory quote period running from 8.00am to 4.35pm. These must quote firm prices up to the normal market size for the share.

There is no continuous order book trading on SETSqx. Execution on the central order book happens during four uncrossing periods (periodic auctions) throughout the day which are designed to concentrate liquidity. These occur at 8.00am, 11.00am, 3.00pm and 4.35pm.

3.8. Equity markets: alternative trading venues

Introduction

As well as exchange-traded and pure over-the-counter trades, there are a range of alternative trading venues. The main venues can be grouped into three distinct types:

- Multi-lateral trading facilities (MTF)
- Dark pools of liquidity
- Systematic internaliser

Multi-lateral trading facilities (MTF)

A multi-lateral trading facility is a privately owned market place that provides an alternative execution venue for buyers and sellers. Most run an order driven market, much the same as SETS.

The Markets in Financial Instruments Directive (MiFID) treats MTFs as it treats an exchange. This means that any pre- and post-trade disclosure requirements must still be met. It also means that the price transparency regime and best execution needs to be applied.

The major benefits of these systems are availability and accessibility. As they do not need to be recognised by a regulator, whereas an exchange would, they are quicker and cheaper to set up. This means that although a country may not have an established exchange on which companies can raise capital, there may well be an MTF. This creates the benefits of exchange-traded without the need for an exchange.

An MTF can be seen as a mid-point between exchange-traded and over-the-counter.

Dark pools

Dark pools of liquidity, or simply dark pools, are another privately owned market place providing an execution venue for buyers and sellers. However, where a dark pool differs from a multi-lateral trading facility is in the transparency of the market.

A dark pool allows investors, usually large funds, to place large orders on an order book, but, unlike SETS for example, no price is revealed. This allows block trades to be placed and executed without the price of the order or the identity of the firm being revealed to the open market.

Due to the lack of transparency on these markets they are still considered over-the-counter.

Systematic internaliser

Earlier in this chapter we looked at members of the London Stock Exchange and their capacity to act as both broker and dealer (if the firm were to regularly act as dealer, dealing in principal with its clients and linking clients together through cross trades). The Markets in Financial Instruments Directive (MiFID) created the term systematic internaliser to make this role distinct from other trading business and harmonise the rules followed by these firms with those of an exchange or multi-lateral trading facility.

Summary

Table 8. Alternative trading venues summary

	MTF	Dark pool	Systematic internaliser
Description	Central market place	Central market place	Firms performing principal trades or cross trades
Purpose	Alternative to exchanges	Exchange-traded liquidity with OTC confidentiality	Allows investment firms to match orders of clients

	MTF	Dark pool	Systematic internaliser
Operated by	Investment firm or market operator	Investment banks, stockbrokers and private organisations	Investment firms
Regulatory	Treated as exchange-traded	Considered OTC	Considered as a mini-exchange
Users	Banks, mutual funds, insurance companies	Funds	Clients of investment firms
Benefits	Can give access to capital where there is no established exchange	Anonymous trading – neither price nor identity revealed	Creates a direct source of liquidity without the need for external markets
	Improves liquidity and transparency over OTC markets	Ability to move large volumes without revealing themselves to the open market	Benefits from the pre and post-trade disclosure requirements
Examples	Chi-X. Turquoise. NYSE Arca Europe.	Instinet. Liquidnet. Many banks and stockbrokers run their own dark pools	Any investment firm

3.9. Algorithmic trading and high-frequency trading

Algorithmic trading

Algorithmic trading is a form of automated electronic trading performed by institutional investors. It involves creating electronic algorithms that use various metrics, such as price, volume and volatility, and attempts to identify predictable patterns. These will trigger buy and sell signals for the investors, who can then choose to act on the information or not. In more extreme cases, computer systems will automatically execute the trades based on these triggers without the need for a human to place these orders.

Algorithmic trading, where computer systems automatically execute the trades, has led to an evolution in the trading of investments, called high-frequency trading.

High-frequency trading

Introduction

High-frequency trading (HFT) involves the automatic execution of trades where holding periods can be as short as a fraction of a second, but the volumes are of such a significant size that large profits can be made on the smallest price movement.

Advantage

The supporters of HFT, mainly the market participants using the systems, claim that it increases liquidity and drives down the costs and commissions associated with execution. Many automated markets, such as NASDAQ and the LSE have seen volumes increase due to this trading.

Disadvantage

The critics of HFT, mainly regulators, claim that it increases the volatility of the markets and can lead to systemic risk. Many have proposed that exchanges should impose speed or frequency restrictions on traders, or position limits on how many positions that traders can hold in a day.

HFT strategies

There are many HFT strategies. Four identified in the syllabus are:

Market making

This is where the algorithm is programmed to place both buy and sell limit orders closely around the current price to create a bid-offer spread. If the market falls slightly, it triggers the buy order. If the market rises slightly, it triggers a sell order. After the order is triggered, the original orders are removed and a new bi-offer is placed around the new price.

Ticker tape trading

This is where the algorithm is programmed to analyse the information being released, at the moment of release, and react immediately. Systems can be programmed, for example, to recognise large orders being placed on the market, through analysis of price movement and volumes, and trade on this information.

Event arbitrage

Certain recurring events, such as the announcement of a profit warning, generate predictable short-term responses in a selected set of securities. High-frequency traders take advantage of such predictability, before the regular market user has had time to react, generating short-term profits.

Statistical arbitrage

A more traditional form of arbitrage, where the systems are programmed to identify price discrepancies among assets and trading on this mispricing. Due to the nature of HFT and the computer models used, mispricing can be identified in increasingly complex scenarios and traded on very quickly.

4. Bond markets

4.1. UK government gilts

Participants

Gilt-edged market makers (GEMMs)

GEMMs are specialist gilt trading firms, also referred to as primary dealers, who undertake to the Debt Management Office (DMO) to make a market in gilt-edged securities.

GEMMs register with the DMO but are supervised by the FCA.

GEMMS provide liquidity to the market by being obliged to quote two-way prices at which they are committed to deal, in appropriate sizes discussed in advance with the DMO. The quotes will be structured to the nearest £0.0001 per £100 nominal value.

GEMMs are obliged to quote prices to broker-dealers acting for clients and other clients known to them. They are not obliged to quote to other GEMMs or broker-dealers acting in principal.

GEMMs may make a market in index-linked gilts only, non-index-linked gilts only or all gilts (both index-linked and non-index-linked).

GEMMs are expected to participate in primary gilt issuance, provide the DMO with relevant data about the gilts market and accept the DMO's monitoring arrangements.

Broker dealers

Broker dealers are LSE member firms who can trade gilts on behalf of clients (as agents) and/or on their own account (as principal). They have dual capacity.

Broker dealers acting in the gilt market act in the same way as broker dealers in the equity market.

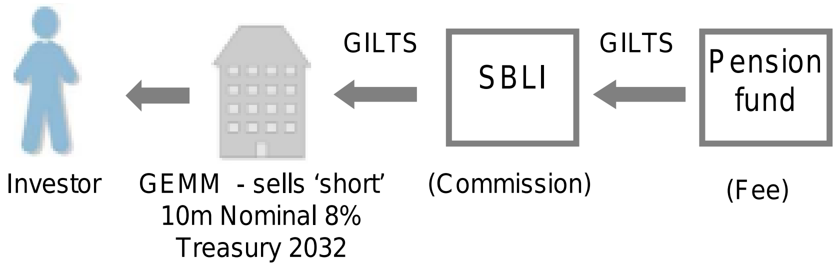
Inter-dealer brokers (IDBs)

A gilt IDB, like an equity IDB, is an LSE member firm which has registered with the Exchange to provide intermediating services between other LSE member firms.

IDBs are used primarily by GEMMs and equity market makers to facilitate anonymous offset of positions in securities.

IDBs settle as principal, i.e. the parties dealing via the IDB are unaware of each other's identity. They cannot take positions in anticipation of finding other parties requiring their services.

Stock borrowing and lending intermediaries (SBLIs)



After the market maker has sold the gilts 'short', it will borrow stock via an SBLI so that it can settle its position with the investor.

SBLIs perform the same function in debt markets as they do in equity markets, namely facilitating stock lending.

Primary issuance

The Government's agent issues gilts, which usually pay coupons semi-annually, to finance the public sector net cash requirement (PSNCR). The Debt Management Office (DMO), manages UK Government's debt it is an agency of the Treasury. Approximately 15% of gilt issues are index-linked gilts (ILGs).

The DMO offers gilts in the primary markets via an auction, where it collects bids from interested parties and issues them to the successful bidders.

Issuing gilts by auction is also the method preferred in a number of other countries, most notably the US.

Although now quite rare, the UK Government has chosen in the past to issue gilts via the 'tap' method, where the issue is announced and investors are invited to tender for the issue. If bidders do not offer the price required by the DMO, that part of the issue not taken up originally can be temporarily withdrawn and released slowly into the market as market conditions become more favourable.

Dealing and reporting

Investors can buy gilt-edged securities either from the DMO auction (in the primary market), or by trading in gilts on the LSE (the secondary market).

The LSE provides an orderly marketplace for the trading of gilt-edged and fixed interest securities. It ensures order through rules and guidance, and the monitoring of trading and market activity. GEMMS will quote prices on their screens and interested parties will contact the GEMMs to execute their trades. GEMMs do not deal directly with retail clients. If retail clients wish to trade with a GEMM, they must do so through a broker.

Gilts are quoted at a clean price, but the price paid on settlement is the dirty price. The dirty price is the clean price of the bond plus any interest that has accrued on the bond over time. When calculating accrued interest over a period, it is done on an actual over actual basis. This means the accrued interest is based on the actual number of days since the last coupon and the actual number of days in the coupon period.

Gilts settle one business day after the trade (T+1) and normally go ex-dividend seven business days before the coupon date.

Although GEMMs offer guaranteed liquidity, much of the trading in gilts is carried out by using e-trading systems between member firms.

STRIPS

STRIPS stands for separate trading of registered interest and principle securities. The STRIPS market allows the cash flows on a gilt (coupons and redemption value) to be traded as separate instruments. This allows investors to trade the STRIPS as if they were zero-coupon bonds.

4.2. Corporate bonds

Primary issuance

When corporate bonds are issued, they may be sold as an open offer for sale or directly to a small number of professional investors (**a private placing**).

The former involves a syndicate of banks with one as lead manager buying the bonds and then reselling them to investors. The sale of these bonds is typically **underwritten** by the banks (who naturally charge for this service). Underwriting offers the issuer a guarantee that a specified level of capital will be raised in the issue – even if this means that the underwriter has to buy some or all of the bonds themselves.

If the lead bank buys all the bonds and sells them to a collection of issuing bonds (the syndicate), this is called a **bought deal**. The syndicate members could then sell the bonds on at varying prices.

More usually, the lead manager and the syndicate buy the bonds together and offer them at a fixed price for a certain period (a **fixed price re-offering**).

Dealing and reporting

The corporate bond market is similar in many respects to the gilt market, except that the DMO is not involved. Market makers register with the LSE and are obliged to quote prices to other member firms, **excluding** other market makers, IDBs and SBLIs.

Market makers in the corporate debt market are essentially the same as GEMMs; however, unlike GEMMS, they make use of SEAQ, a quote driven system in the LSE. Both firm and indicative prices may be available on the SEAQ screen during the mandatory quote period. Note, although corporate debt securities may be quoted on SEAQ, there is no obligation for market makers to use the system in the same way as there is for the trading of equities. In fact, the majority of corporate bonds trade **over-the-counter**.

Market makers may display different prices for different sizes of trade. Trades on the LSE are reported in the same way as equity trades to fulfil post-trade transparency requirements.

As mentioned earlier in the chapter, the LSE has introduced order book trading for corporate bonds on the order book for retail bonds (ORB). Corporate bonds have not generally been an asset class available to the small investor and the introduction of this system is hoped to improve this access.

There is also a decentralised dealer market where dealers make a market amongst themselves, creating pools of liquidity rather than having a centralised exchange. This creates an extra liquidity risk to the price of these bonds.

Corporate bonds can also have a maturity date much longer than is found in gilts, i.e. bonds with maturities of up to 100 years.

5. Derivative markets

5.1. Participants: principal vs. agent

Like equity and debt markets, member firms of derivative exchanges may act either as principal to a trade and/or as agent.

Dealing (principal trades)

By acting as principal, the firm is taking a position itself, i.e. 'running a book'. The aim is to make a **turn** on the trade (buy low, sell high). When acting as principal, the trade will be assigned to the firm's house account. These traders are sometimes referred to as '**locals**'.

Broking (agency trades)

Alternatively, the firm may act as agent on behalf of a client. In these circumstances, the firm will **not** take a position but instead earns commission on the trade. When acting as agent, the trade will **usually** be assigned to a segregated account which is separate from the firm's own account. Some clients may, however, consent to their trades being allocated to a non-segregated account.

Some members of an exchange may execute a trade for other members of an exchange. These trades will usually be allocated, or '**given up**' to the house account of the originating firm.

A trade is 'given up' so that the originating firm can clear the trade on behalf of the client.

Members that can act as either agent or principal to a trade, are said to have dual capacity.**dual capacity**.

5.2. Trading styles: open outcry and screen trading

Historically, most derivatives trading took place face-to-face on a market floor. Traders gathered in pits and 'cried' out prices, hence the term **open outcry** trading. The London Metal Exchange (LME) and New York Mercantile Exchange (NYMEX) are markets where open outcry trading still takes place.

Rather like the securities markets, derivative exchanges have tended to move towards **screen-based order book trading**. Trading takes place electronically based on prices displayed on screens. There is no requirement for an exchange floor as trading takes place remotely via computers. NYSE Liffe uses such an order driven system called **LIFFE's CONNECT**. Execution occurs in very much the same way as we say on the LSE SETS.

When trading derivatives, the participants are entering into legally bonding contracts to perform an action (make or take delivery of an asset) at some point in the future. To ensure the contracts are legally binding, the exchange will construct the contract that is agreed. To ensure the maximum liquidity, the exchange will standardise these contracts; this means every member is trading an equivalent contract within an underlying asset class.

Like all exchanges, derivatives exchanges will set down rules that dictate the requirements of members. Among these are requirement on reporting trades. Adherence to the rules on NYSE Liffe is monitored by the Market Supervision Department.

5.3. Over-the-counter (OTC) trading

Over-the-counter (OTC) contracts are one-to-one (bilateral) agreements between two counterparties where the contract specifications are completely flexible and non-standardised. A great benefit of this is that, when hedging, the contract used can be specifically tailored to the requirements of the underlying position, whereas when using standardised exchange-traded contracts hedges need to be continually rebalanced or rolled on from month to month.

OTC deals are not conducted on a formal exchange, but directly via telephone and screen-based displays. There is less likelihood of a central guarantor (like LCH.Clearnet) to ensure ultimate fulfilment of the contract, so the credit worthiness of both counterparties is extremely important.

OTC contracts bring additional problems in that they are less tradable, so it is difficult to value them and price information is not always available. Because OTC contracts are tailor-made, they are more difficult to trade than exchange-traded contracts. They also require substantial documentation to ensure that the terms of each contract are clear, accurate and agreeable to both sides of the trade. The International Swaps and Derivatives Association (ISDA) oversee the OTC derivatives market and produce standardised formats on which OTC documentation can be based.

They do represent, however, a product that can be designed to meet the exact requirements of market participants.

Summary

Table 9. OTC vs. exchanged-traded summary

	OTC	Traded on Exchange
Contract terms	Bespoke: tailored to meet the needs of the investor	Contract specifications standardised by the exchange
Liquidity	Can be limited leading to slower execution	Excellent on major contracts
Margin	Normally no margin. Collateral process.	Margin normally required
Regulation	Less stringent regulation of products. More stringent restrictions on who may invest in them.	Exchanges subject to significant regulation
Counterparty risk	Typically exposed to default risk	No member default risk due to clearing house
Reporting	Confidentiality	Market transparency
Price	Negotiated or request for quote (RFQ) systems	Best execution
Hedging	Specific hedging requirements can be met	Hedges based on standardised contracts need to be actively managed

6. Settlement

6.1. Settlement of securities

Euroclear UK and Ireland's CREST

Once a deal has been struck and the terms agreed, the transaction must then be settled.

Settlement is the process of organising payment and delivery of the security, and is the point at which legal title changes hands.

CREST is an electronic settlement and registration system operated by Euroclear UK and Ireland, and is used for the settlement of a wide range of corporate and government securities, including those traded on the London and Irish Stock Exchanges. CREST is the Central Securities Depositary (CSD) for the UK and for Ireland. CREST also settles money market instruments and funds, plus a variety of international securities. In the CREST environment, investors are able to hold their securities in dematerialised (electronic) and certificated (paper) form.

CREST provides book entry transfer for dematerialised stock, as well as the ability to facilitate certificated transactions.

CREST operates a **delivery vs. payment** (DvP) settlement system. This means that it records changes in legal title and organises payment simultaneously. DvP lowers settlement risk.

CREST calculates **stamp duty reserve tax** on all relevant transaction on the settlement date and.the tax authorities collect SDRT (on dematerialised transactions) via CREST.

CREST also has links to company registrars, allowing it to inform the registrar of any change in ownership of securities.

The standard settlement time for UK equities and corporate bonds held within CREST is three business days (T+2). Standard settlement for UK government gilts is T+1.

The use of CREST is not mandatory. Settlement can be achieved outside CREST by a paper based method. The seller would complete a **stock transfer form** and send it with the share certificate to the buyer. The buyer would then send these forms to the company registrar who will cancel the old share certificate and issue a new one. This process is lengthy.

6.2. LSEs central counterparty (CCP) service

All securities traded on the SETS order book must be routed through a central counterparty (CCP) to clear the trades.

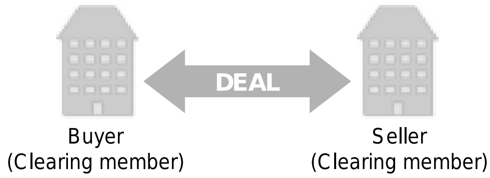
Clearing involves an organisation becoming counterparty to both buyer and seller of the trade. This effectively breaks the initial trade into two separate trades.

In doing so the CCP is guaranteeing settlement of the trade and eliminating default risk for the buyer and seller. This also protects the anonymity of the investors involved as they will never know the identity of the participant on the other side of the trade.

The process is known as **novation**.

Summary: novation

1. Initial trade



2. Novation

This element of risk management, obviously, does not come free of charge as CCPs charge for their services.

The LSE offers members the choice of two CCPs: LCH.Clearnet or X-Clear.

6.3. Clearing derivative trades

Introduction

Clearing takes on its most important role in the derivatives markets. The derivatives markets are where the trading of futures (or forwards) and options occurs.

A derivative is so called as it derives its value from the price of an asset (the underlying) that an investor has the obligation or right to buy or sell.

A future is an agreement to buy or sell a specified quantity of a specified asset on a fixed future date at a price agreed today. A forward is a name for a future when it is not traded on an exchange or traded over-the-counter (OTC).

An option is a right to buy (a call option) or a right to sell (a put option) a specified quantity of a specified asset on a fixed future date at a specified price.

Any detail on these investments is covered in the IMC Unit 2: Investment Practice, but a passing reference is needed here to understand the process and relevance of clearing.

We have seen throughout the regulatory sections of this course that these investments are considered risky or ‘complex’ investments by regulators such as the FCA. One of the reasons for this added risk is that they are highly geared or leveraged.

Derivatives are considered highly geared investments as the profit or loss made occurs at a much greater rate than if the investor had invested in the asset to which the derivative relates.

For example, with a future an investor can agree to buy a particular asset, let’s say a bond, on a fixed future date for an agreed price, let’s say £100. This agreement becomes a contractual obligation, but in its purest sense no money actually exchanges hands until the fixed future date. This leaves the seller on the other side of the agreement exposed to the risk of the buyer not paying (counterparty default risk or credit risk).

If the price of the bond falls to £90, this makes it even less attractive for the buyer to fulfil their obligation of paying £100 and exposes the seller to further risk.

If, however, the price of the bond rises to £110 it now becomes unattractive for the seller to deliver at £100, exposing the buyer to the risk of counterparty default.

To help manage this exposure to counterparty default risk, exchanges will appoint a central counterparty to novate these trades and collect guarantees, in the form of margin, from the participants. The margin collected ensures that the participants involved can meet the obligations they face, and protects the other side of the agreement from loss if the default occurs.

Counterparty risk

Counterparty risk is the risk that, once a contract has been agreed between two parties, at least one of the parties will not meet their obligations.

In most exchange-traded contracts, the risk of counterparty default is managed by a **clearing house** acting as a central counterparty.

The role of the clearing house is two-fold:

- To become the legal counterparty to both sides of the original transaction
- To guarantee the performance of both sides of the contract

The main clearing house in the UK is LCH.Clearnet.

Clearing house as registrar

Clearing houses act as registrars to the marketplace by recording details of all matched trades. Details of trades are passed electronically to a clearing house via some form of electronic communication system; for example, Euronext.liffe uses the Trade Registration System (TRS) for derivative contracts.

Clearing house as guarantor

Principal to principal

A clearing house guarantees its members' obligations to the clearing house. However, this guarantee does not extend to any clients of a member. If a client of a clearing member defaults, the member has no recourse to the clearing house. This guarantee structure is known as **principal to principal**.

Understandably, the clearing house does not want just any firm becoming a clearing member as it will be exposed to losses if a clearing member defaults. The clearing house therefore imposes minimum criteria on capital adequacy and systems requirements for its clearing members.

Risk management

As the clearing house acts as central counterparty to everyone in a particular derivative market, it is exposed to the risk of investors defaulting. The clearing house therefore will put mechanisms in place to safeguard itself.

These mechanisms may include a default fund provided by members (as in the case of LCH.Clearnet), default insurance through, for example, the Society of Lloyd's and the requirement for its members to pay **margin**.

6.4. Margin

Margin covers the clearing house against the risks it faces when acting as central counterparty to a transaction.

Margin is **always** payable on 'contingent liability' transactions. For example, on derivative transactions, these are transactions where investors can lose more than their initial investment: **long** and **short** futures positions and **short** option positions.

The rules on margin are different for long option positions as the potential loss is limited to the premium which is paid by the investor on the agreement.

Again the features of these investments are not the concern of IMC Unit 1: Investment Environment, but they will be explained in more detail in Unit 2: Investment Practice.

There are different types of margin including:

- Initial margin
- Variation margin

Both of these types of margin will now be explained in turn.

Initial margin

Initial margin is described as a **returnable good faith deposit**. It represents the worst **probable** loss that could be made on a bad day (as opposed to the worst possible loss, which could be unlimited).

The clearing house holds initial margin to cover the risk of a clearing member failing to meet a variation margin payment. If the clearing member defaults, the clearing house should have enough initial margin to cover the shortfall.

As the prices of underlying assets are constantly changing, the risk to the clearing house of a member defaulting also changes.

As a result, members may receive additional initial margin bills even if they have not opened any new positions. It is simply that their existing open positions have become more risky.

For example, we have seen in recent years sudden increases in volatility in a particular investment or in the market as a whole. Sometimes, however, this is seen as a short-term change. If the change is deemed by the clearing house to be short-term, instead of increasing the initial margin it will call intra-day margin to cover this volatility.

Initial margin is paid when the contract is opened and return when the obligations in the contract are met, or the contract is closed out.

Variation margin

Variation margin accounts for the previous day's gains and losses made on open derivative positions.

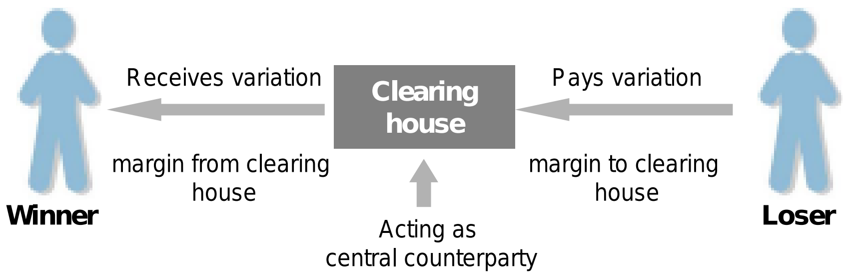
Variation margin is paid by the loser of one open position and received by the winner of another open position. The payment is made by the next business day through a protected payment system.

This means that the 'losers' pay variation margin to the clearing house each day. In turn, the clearing house forwards the margin onto the day's 'winners'.

As all clearing members have accounts with the clearing house, the transfer is made simply by debiting the loser's account and crediting the winner's account. This requires each clearing member to hold an account with a clearing house approved bank so that funds can be securely paid into or withdrawn from the margin account.

Failure to pay variation margin by the due time will result in the clearing house closing out the member's positions and using their initial margin to cover the previous day's losses. Any surplus will be returned to the clearing member.

Summary



All members have accounts with the clearing house. The loser's account is debited and the winner's account is credited with the variation margin, which is then paid across. Variation margin must be paid each business day based on the previous day's market movement.

6.5. Regulation of derivatives markets

We have looked at the process of clearing trades on exchange-traded derivatives, using a central counterparty such as LCH.Clearnet. However, a large number of derivatives trades occur over-the-counter (OTC).

OTC trades are typically done bilaterally between two parties who negotiate and agree terms with each other. This eliminates the need for an exchange, potentially lowering the cost and giving much more flexibility in what details can be written into the contract.

However, one of the major disadvantages of OTC contracts is not having access to an exchange's risk management systems such as the clearing house and its margining and settlement systems. There has been a great effort in recent years by regulators to improve the risk management in this particular market. Some of the regulations are introduced below.

European Markets Infrastructure Regulation (EMIR)

As discussed in the first chapter, EMIR imposes three new requirements on those who trade OTC derivatives:

1. To clear OTC derivatives that have been declared subject to the clearing regulation through a central counterparty (CCP)

2. To put in place risk management procedures for those OTC derivatives that are not centrally cleared

3. To report derivatives to a trade repository

All three obligations apply to financial counterparties. The clearing and risk management obligations apply to certain non-financial counterparties while the reporting obligation applies to all of them.

In the US, the Dodd Frank Wall Street Reform and Consumer Protection Act 2010, building on the Commodities Exchange Act 1936 and the Commodity Futures Modernisation Act 2000, imposes similar requirements. These will be enforced by the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC).

The use of a central counterparty in OTC markets

Although bilateral agreements can expose the investors involved to counterparty risk, there are systems available to eliminate this. The vast majority of OTC trades arrange collateral processes themselves, but central counterparties do hold an appeal to some.

Clearing systems, offering the same services to OTC derivatives as they do for exchange-traded derivatives, are accessible. Most trade capture and confirmation systems have links to a clearing system.

Once a trade has been completed and the conditions agreed, the counterparties to the trade will report the trade to a clearing system. The system will then novate the trade, allowing a clearing house to become central counterparty to the trade.

This benefits the original counterparties in the following ways:

- Netting off transactions and margin to reduce credit risk
- Creating a central and standardised process to reduce operational risk
- The role of central counterparties in the derivatives markets will be looked at in more detail later on in this chapter.

6.6. International Accounting Standards (IAS 39)

International Accounting Standard (IAS 39) dictates how financial instruments, such as derivatives, are valued and recognised in the company's financial statements. This is particularly relevant to derivatives as, particularly in the case of futures, there is no initial outlay involved.

Fair value through profit and loss

Derivatives, and often investments with embedded derivatives, should be valued on fair value through profit or loss (FVTPL). In this way they are marked-to-market at the time of producing the financial statements and any profit or loss, realised or unrealised, is reflected in the profit and loss account.

If the derivative is non-exchange traded and a marked-to-market price is not available, the company should compare its investment with an equivalent exchange-traded investment. In cases where this is not possible, the investments should be valued at an amount that the asset would be exchanged between knowledgeable and willing parties in an arm's length transaction; except in rare circumstances when estimates of fair value are so disparate as to preclude this.

Where FVTPL does not apply

It is worth pointing out that derivative positions used as a hedge are not covered under IAS39, because, in general, a derivative used as a hedge will be held to delivery and therefore to its realisable value. For this reason, the price that was agreed on the creation of the contract will be the value printed on the financial statements.

7. International markets

7.1. International bonds (Eurobonds)

Introduction

An international bond (eurobond) is a security where the denomination of the bond and the country of issue are all different. For example, a company issuing dollar bonds in Paris and Tokyo, or a company issuing yen bonds in Frankfurt and Dublin.

Commonly, eurobonds are issued in the currency and country where the issuer finds it cheapest to raise the finance, and then swapped into the currency the issuer wants.

Features

Eurobonds are bearer bonds i.e. anonymous, freely-transferable securities. Due to the risks of holding bearer documents, many eurobonds are kept in international central securities depositaries (ICSDs) such as Euroclear or Clearstream. This is referred to as **immobilisation**.

Interest is usually paid on eurobond issues (fixed or floating) once per year. Interest is also paid gross of withholding tax. This feature makes eurobonds very attractive to international investors.

Issuance

Most Eurobonds are issued like corporate bonds, using either a **bought deal**, where the underwriter buys up the full issue and sells them to interested parties, or a **fixed price re-offer**, where a syndicate issues the bond.

Trading

Most trading in the eurobond market is conducted OTC via the telephone rather than on domestic exchanges, although exchange-traded eurobonds are becoming increasingly common.

Settlement

Once a deal is struck, it is reported to ICMA (the International Capital Market Association) before it is processed for settlement. Reporting to ICMA takes place T+1, ready for settlement of the Eurobond trade T+2.

Euroclear and Clearstream settle Eurobond transactions. ICMA also regulates the international bond market.

7.2. International markets trading

International markets are becoming increasing attractive to investors, both institutional and individual, as it adds to diversification benefits. The access to these markets is also becoming easier. As exchanges adopt electronic order books systems, interconnectedness of these exchanges becomes possible. Also, investments such as depositary receipts, exchange traded funds (ETF) and eurobonds allow investors to get exposure to overseas markets in their own currency.

European

Trading in the EEA is considered less risky for UK investors from a regulatory perspective, as many of the regulations in the financial services have been harmonised through various directives,such as MiFID, EMIR, etc.

This means the mechanisms for trading and settlement and delivery will be very similar to those in the UK. The main exchange in France is Euronext and in Germany, Deutsche Borse. However, many of the stock trading on these and other European exchanges can be accessed through European Quoting System on the LSE.

US

Trading in the US is also very similar to the UK, in that it is a very liquid and heavily regulated market.

Trading of equities takes place on three main markets in the US: the New York Stock Exchange (NYSE), the National Association of Securities Dealers Automatic Quote System (Nasdaq) and the American Stock Exchange (AMEX).

The NYSE is the largest US equity market. Trading is undertaken by member firms' floor brokers and local brokers, who trade through **designated market makers (DMM)**. Specialists are assigned specific stocks and act in a way which maintains an orderly market. They quote two-way prices throughout the day. Orders are passed to specialists for matching using the Universal Trading Platform (UTP).

The NYSE is primarily a domestic market. International trading is confined to American depositary receipts (ADRs), which facilitate the trading in the US of shares in non-US companies.

Nasdaq is an electronic market for second line stocks.

AMEX is a floor-based physical exchange. It is where most trading in international equities takes place in the US.

Emerging markets

Emerging markets are considered to be those that are not fully developed, including much of Asia, Africa and South America. The key benefits of these markets is the potential for economic growth and the fact that the economic cycles of these nations tend to differ greatly form the developed nations – often referred to as decoupling.

Key disadvantages are the potential volatility in the markets, as much of the value is based on expectation, and the less rigorous regulation of the participants and the infrastructure. This is one of the key reasons many investors choose to access these markets via ETF and depositary receipts.

7.3. International markets settlement

International central securities depositaries

Euroclear UK and Ireland is the central securities depositary for the UK. However, for those investors investing internationally, using a local depositary in each country will give the investor a market expert, but can be problematic. These difficulties could include:

- Domestic exchanges and securities only
- Communication problems due to language
- Local regulations governing custody may differ

Many investors that have large international investment portfolios may use an international central securities depositary (ICSD). These ISCDs, such as Euroclear, Clearstream and the DTCC, offer:

- A one-stop shop for all activities
- Global membership

- Consolidated reporting
- Economies of scale

Settlement summary

We should assume for the exam that settlement in the UK and rest of Europe will be T+2 for most asset classes. There are, however, some exceptions to this. These are listed in the table below.

Table 10.

Country/Region	Instruments Settled	Settlement Period	System Name
UK	Listed equities and corporate bonds	T+2	Euroclear UK and Ireland
	Government bonds (gilts)	T+1 (cash settlement)	Euroclear UK and Ireland
EU (Particularly Germany)	Listed German Equities	T+2	Clearstream
	International Bonds	T+2	Clearstream/Euroclear
US	Listed Equities	T+3	Depositary Trust Clearing Corporation (DTCC)
	Government bonds	T+1	DTTC
Japan	Listed equities and convertible bonds	T+3	Japan Securities Depositary Center (JASDEC)

8. Summary

8.1. Key concepts

The role of the financial market

- 1.2.1 Differentiate between a financial security and a real asset
- 1.2.2 Identify the key features of: -a common equity share, a bond, a derivative contract, a unit in a pooled fund, and a foreign exchange transaction
- 3.4.1 Explain the role of an investment exchange
- 1.2.3 Identify the functions of securities markets in providing price transparency and liquidity
- 1.2.7 Define liquidity risk and identify why it is important
- 1.2.4 Identify the reasons why liquidity and price transparency are thought to be important for the efficient allocation of capital costs when trading in securities markets
- 1.2.5 Calculate round trip transaction costs incorporating bid-ask spreads, dealing commission and transaction taxes, both in percentages and in absolute amounts
- 1.2.6 Identify the types of securities and the market conditions where price transparency, liquidity and depth are likely to be high / low

Trading

- 3.4.5 Identify and distinguish the roles of LSE, NYSE Liffe, and LCH.Clearnet
- 1.3.1 Identify the main dealing systems and facilities offered in the UK equities market
- 1.3.2 Identify the nature of the securities that would be traded on each of the main dealing systems and facilities
- 1.3.8 Explain the roles of the various participants in the UK equity market
- 1.3.7 Distinguish between a quote-driven and an order-drive market
- 1.3.6 Distinguish between the following alternative trading venues: Multilateral Trading Facilities, Systematic Internalisers and Dark Pools
- 1.3.9 Explain high-frequency trading, its benefits and risks

Bond markets

- 1.3.3 Explain the structure and operation of the primary and secondary UK markets for gilts and corporate bonds

Derivatives markets

- 3.4.6 Identify the features of trading systems for derivatives
- 3.4.9 Explain the arrangements for market transparency and transaction reporting in the main derivative markets

- 3.4.7 Identify the main features of the regulation of derivatives

Settlement

- 1.4.1 Explain the clearing and settlement procedures for UK exchange traded securities
- 3.4.8 Identify the main features of clearing and settlement for trading on derivatives exchanges, and when trading over-the-counter (OTC)
- 3.4.10 Explain the impact of MiFID and International Accounting Standards on the regulation of derivative markets
- 1.3.5 Compare and contrast exchange traded and over-the-counter (OTC) markets

International markets

- 1.7.2 Explain the structure and operation of the primary and secondary markets for Eurobonds
- 1.7.1 Explain the structure, features, regulatory and trading environment of international markets, including developed markets and emerging markets
- 1.7.3 Explain the settlement and clearing procedures overseas, including the role of international central securities depositories, and the different settlement cycles and challenges in managing global assets

Now you have finished this chapter you should attempt the chapter questions.

Taxation

1. Introduction

1.1. Chapter overview

This chapter mostly focuses on the taxation of UK individuals with the taxation of UK companies mentioned very briefly.

In this chapter we will look at three main areas:

- How UK individuals are taxed
- How financial products are taxed (tax wrappers)
- Tax planning

The types of tax that we will discuss are as follows:

- Income tax
- Capital gains tax
- Inheritance tax
- Corporation tax
- Stamp duty reserve tax

Before we start it is important to note that this version of the Fitch Learning Unit 1 IMC – Investment Environment manual is valid for exams from 1 December 2014. Exams taken from this date will be tested on the tax year 2014/15.

This chapter is often the one area that many delegates have not seen before. It is one of the most useful topics to cover as tax affects us all. The main advice in studying for this chapter is as follows:

- There will be tax calculations in the Unit 1 IMC exam, but the majority of the questions will be testing the understanding of the concepts, so pay more attention to the facts in this chapter
- It is helpful to focus on tax from a client's point of view, as many of the questions will look at tax from a tax planning perspective
- Think about your own tax situation - it can help to use your situation as a real example and think how the rules apply to you
- Finally, you are not expected to be a tax accountant to answer the questions in this section, nor should this chapter be taken as a complete guide to tax law. A sound understanding of concepts and an ability to calculate basic tax liabilities is required

1.2. Learning outcomes

On completion of this module you will:

Introduction to UK taxation for individuals

- 6.1.8 Explain the implications of residence and domicile in relation to liability to income, capital gains and inheritance tax

- 6.1.9 Describe the system of UK tax compliance including self assessment, Pay As You Earn (PAYE), tax returns, tax payments, tax evasion and avoidance issues

Income tax

- 6.1.1 Describe the principles of income tax applicable to earnings, savings and investment income in the UK
- 6.1.2 Describe, in relation to income tax, the system of allowances, reliefs and priorities for taxing income
- 6.1.3 Explain the taxation of the income of trusts and beneficiaries

National Insurance

- 6.1.4 Describe the system of national insurance contributions (NICs)

Capital gains tax (CGT)

- 6.1.5 Describe the principles of capital gains tax (CGT) in the UK

Inheritance tax (IHT)

- 6.1.6 Describe the principles of inheritance tax (IHT)
- 6.1.7 Explain the limitations of lifetime gifts and transfers at death in mitigating IHT

Taxation of investment income

- 6.1.14 Analyse the taxation of direct investments including cash and cash equivalents, fixed interest securities, equities and property
- 5.7.6 Explain the taxation of the various types of funds in the UK

Stamp duty

- 6.1.10 Describe the principles of stamp duty land tax (SDLT) as applied to property transactions buying, selling and leasing
- 6.1.11 Describe the principles of stamp duty reserve tax (SDRT)

Corporation tax

- 6.1.12 Explain how companies are taxed in the UK

Value added tax (VAT)

- 6.1.13 Describe, in outline, the principles of Value Added Tax (VAT)

Tax wrappers

- 6.1.15 Analyse the key features and taxation of indirect investments including pension arrangements, New Individual Savings Accounts (NISAs), Junior ISAs and Child Trust Funds, onshore and offshore life assurance policies, Real Estate Investment Trusts (REITs), Venture Capital Trusts (VCTs) and Enterprise Investment Schemes (EISs)

Tax planning

- 6.2.1 Evaluate the tax considerations shaping clients' needs and circumstances
- 6.2.2 Analyse the key principles of income tax planning
- 6.2.3 Analyse how the use of annual CGT exemptions, the realisation of losses, the timing of disposals, and sale and repurchase of similar assets can mitigate CGT
- 6.2.4 Calculate the most common elements of income tax and NICs, CGT, and IHT, including the impact of lifetime transfers and transfers at death
- 6.2.5 Select elementary tax planning recommendations in the context of investments and pensions advice

2. Introduction to UK taxation for individuals

2.1. The tax year and the financial year

The tax year (or fiscal year) relates to individuals and the financial year relates to companies.

The tax year starts on 6 April one year, and ends on 5 April the next year.

Tax year = 6 April to 5 April

Each tax year has its own set of tax rules that apply to UK individuals during the tax year.

Proposed changes to the tax rules are announced in the autumn Pre-budget Report by the Chancellor, and then finalised in the actual budget statement in March. This provides an opportunity for consultation with interested parties, meaning that proposals for change can be amended if necessary.

The finalised Budget changes are implemented by the passing of the Finance Act each year that makes the changes to UK tax law.

The tax year is very important in financial planning for the following reasons:

- Individuals are assessed on their total income received during each tax year for income tax
- Individuals are assessed on any capital gains made during each tax year for capital gains tax
- Each tax year brings new allowances for UK individuals such as a new personal allowance and a new capital gains tax allowance
- Changes to financial products are often made and come into effect in a new tax year

The financial year relates to companies and provides the tax rates, rules and allowance for UK companies for a 12-month period.

The financial year starts on 1 April one year, and ends on 31 March the next year.

Financial year = 1 April to 31 March

We will return to UK companies later in the chapter.

2.2. Residence

Whether a person is resident in the UK is vital to how income tax and capital gains tax will be charged on that individual. Her Majesty's Revenue and Customs (HMRC) have created a thorough test to assess whether a person is resident in the UK or not. This test comprises two categorical statements – 'automatic overseas resident' and 'automatic UK resident' – and a sufficient ties test for those that do not meet the categorical statements.

Automatic Overseas Resident

To qualify as automatic overseas resident there are three tests, and an individual need only meet one of these:

First overseas test

- An individual is present in the UK for fewer than 16 days in a fiscal year

Second overseas test

- If an individual has not bee present in the UK during the previous three years, and are present in the UK for fewer than 46 days in this fiscal year

Third overseas test

- An individual works full-time overseas. They must not have a place of residence in the UK available to them for more than 90 days and must spend no more than 30 days working in the UK

Meeting any of these three tests will qualify the individual as automatically resident.

Automatic UK Resident

An individual can qualify automatically as a UK resident is the meet one of the following three tests:

First UK resident test

- An individual is present in the UK for at least 183 days in a fiscal year

Second UK resident test

- The individual's only (or main) home is in the UK. This home must be available to them for 91 days or more and must be used for at least 30 days

Third UK resident test

- An individual works full-time in the UK

Sufficient ties test

If an individual meets neither of the automatic tests, they should apply the sufficient ties test to assess whether they are UK resident or not. This test is based on any ties an individual may have in the UK. These ties are:

- Family tie
- Accommodation tie
- Work tie
- 90-day tie

The finer details of the sufficient ties test are not test in the IMC syllabus.

2.3. Domicile

The concept of residency is based on the amount of time that an individual spends in the UK or the ties that an individual leaves in the UK. Domicile is a different concept; it is not based on residence, nationality or citizenship of an individual.

Domicile is considered to be where the individual ‘belongs’. An individual can be resident in more than one country. However an individual can only be domiciled in one country at a time.

UK tax law has various different versions of domicile:

- Domicile of origin which is acquired at birth, normally from the individual's father. It does not have to be the country in which the individual was born
- Domicile of choice. A domicile of choice cannot be acquired until the individual is at least 16 years old. Even then changing one's domicile is not straightforward. It involves the individual cutting links with their former domicile and settling permanently in the new country. HMRC will review the facts of each case

Domicile is important in determining the basis of income tax. It is also important in determining the liability to inheritance tax.

Income tax basis

The general rule is that an individual is liable to income tax on his worldwide income, i.e. income earned in the UK and overseas. The table below summarises any deviations from this general rule.

Table 11. Domicile summary

Status	Liability
UK resident	Worldwide income and gains on an arising basis.
UK resident but non-UK domiciled	UK income and gains on an arising basis. Overseas income and gains on an arising basis or on a remittance basis.
Overseas resident	UK income on an arising basis. Overseas income is not subject to tax.

The basic rule to remember is that an individual will be liable to tax on income earned in the UK regardless of their status.

Remittance basis

Some non-domicile residents can opt to pay UK tax on a remittance basis. This means their UK income and gains will be taxed as normal, but their overseas income and gains will be taxed only if they bring the money in to the UK. Generally, remittance basis taxation would involve reclaiming tax from Her Majesty’s Revenue and Customs (HMRC).

There are additional rules for long-term residents of the UK. If the individual is resident in the UK for seven out of the past ten years, they may have to pay a remittance basis charge (RBC) if they want their overseas income and gains to be taxed on a remittance basis. The RDC is an annual charge of £30,000 that compensates HMRC partially for the lost revenue from this resident.

Where the individual is resident for longer than 12 out of the last 14, the RBC increases to £50,000 per year.

A non-domicile UK resident would neither need to reclaim tax from HMRC nor pay the RBC if their overseas income did not exceed £2,000 in any fiscal year.

2.4. Collecting tax

Income tax is collected in three ways:

- Tax on non-savings income from employees is collected under the pay as you earn (PAYE) system
- Tax on non-savings income from the self-employed is collected twice a year by payments on account
- Tax on savings income and dividend income, and property income is collected under self-assessment via a tax return

Think about this for a moment. The tax authorities ensure our earned income is fully taxed, so how do they ensure our savings and investments are taxed – they need us to declare to them what investment income we receive each tax year on a tax return.

Tax returns are sent to certain individuals at the end of each tax year to remind them that it is their responsibility to complete it and pay any tax due. Not every individual will receive a tax return as not everyone has additional tax to pay on their savings and investments. Higher rate taxpayers will be the main category of individual that will receive a tax return, but also those who receive gross income, from property of gilts, for example, or those who have capital gains above the annual exemption

Self-assessment

In this section we discuss how an individual is required to pay their tax through the UK self-assessment system administered by Her Majesty's Revenue and Customs (HMRC).

Self-assessment for employees

The majority of employees pay their income tax through the pay as you earn (PAYE) system. Basic rate income tax on savings income is deducted at source by banks and building societies. Some higher rate taxpayers will be required to complete a tax return if they have significant investment income or income from other sources (such as rental income).

Any records must be retained for six years.

Payments on account

Some individuals are required by HMRC to make instalment payments. This applies to the self-employed and individuals who paid less than 80% of last year's income tax at source.

The payments for 2014/15 are due on the following dates:

- 31 January 2015
- 31 July 2015

The payment is calculated as 50% of the previous year's income tax liability. If the payments are insufficient to meet this year's liability a sweep-up payment is due on 31 January 2016 (including any capital gains tax due).

Tax return deadline dates

The self-assessment system requires the individual to submit details of their income for the fiscal year and to keep sufficient records to justify it (if required to do so by HMRC). Records need to be kept for 22 months after the end of the relevant fiscal year.

The deadlines for submission of the 2014/15 tax return are as follows:

- Taxpayer submits details of their income and gains for the year and HMRC calculates the tax payable or repayable – 31 October 2015
- Taxpayer submits their return and calculates the tax liability themselves – 31 January 2016

For employees who submit their returns by 31 October any further tax due is collected through PAYE. For other individuals the tax is due by 31 January 2016.

Failure to submit a return by the deadline results in a fine of £100.

The advent of online return submissions has made the tax return process much more straightforward for the majority of taxpayers as the calculation of the tax liability is done automatically.

2.5. Important dates in the UK tax calendar

6 April – start of a new tax year.

5 April – end of the tax year. Higher rate taxpayers are sent their tax returns to be completed, received and paid by 31 January next year.

31 October – individuals can ask HM Revenue & Customs to calculate their tax due for free until 31 October each year.

Alternatively you can fill it in yourself, do it online or pay an accountant to do it for you.

31 January – tax returns must be received by the following 31 January or a late penalty will be due. All tax due in a tax year must also be paid by this date or else interest will start accruing. In our example of the 2014/15 tax year, tax must be paid by 31 January 2016.

3. Income tax

3.1. Types of income

We can separate an individual's income into three categories:

- Non-savings income
- Savings income
- Dividend income

Non-savings income

The two main categories of non-savings income are:

- Income form employment
- Property income

Income from employment

Income from employment can also be assessed in two parts:

- Employed
- Self-employed

Employees – have income tax deducted by the employers via the pay as you earn (PAYE). This means that employees will have paid all income tax due on their earnings automatically each tax year.

Note that employees may have savings and dividend income as well – see below.

Self-employed – have no income tax deducted by their customers and so are paid gross. They need to complete a tax return to tell the tax authorities how much tax they are due to pay. The self-employed pay their tax twice a year in January within the tax year to which it applies and in July after the tax year has ended. These are termed 'payments on account'.

Property income

Income from property comprises the following types of income:

- Income from commercial property (direct property investment)
- Incomes from a real estate investment trust (indirect property investment)

We will see later in this chapter that income from non-savings uses the following tax rates 20%, 40% and 45%.

Under 'rent a room relief' an individual can rent out a room in heir primary residence and receive up to £4,250 per tax year tax-free. Rent received above this limit will be taxed at either 20%, 40% or 45% depending upon the level of an individual's statutory total income.

It is also worth mentioning that distribution from real-estate investment trusts (REITs) are also classed as property income distributions (PIDs) and are taxed at this level.

Savings income

Individuals may well receive income from their savings. Most savings income is taxable.

Dividend income

Individuals may receive income from their equity investments. Most dividend income is taxable.

Dividend income – income from dividends from UK companies. Dividends received from UK companies come with a 10% tax credit. This is because when UK companies declare a dividend they pay these dividends out of profits after tax.

As we will see later in this chapter, this 10% tax credit meets the dividend tax liability for basic rate taxpayers. Higher and additional rate taxpayers still have more tax to pay over and above this 10% on UK dividends.

3.2. Statutory total income

As we have seen, an individual may have a number of sources of income such as:

- Non-savings income – this is taxed first
- Savings income – this is taxed second
- Dividend income – this is taxed third

Income from these sources is added together to find an individual's statutory total income.

Note that income is taxed in the order shown above, starting with earned income. It is important to note the following:

- Each source of income has its own rates of tax – see below
- All sources of income use the same tax bands e.g. if an individual has statutory total income from any source above £31,865 they will be a higher rate taxpayer and pay higher rate tax on each £1 above this threshold

A higher rate taxpayer will generally pay higher rate tax at 40% on each £1 above this higher rate threshold of £31,865, except for dividend income that has a different higher rate tax rate:

- Non-savings income – higher rate tax = 40%
- Savings income – higher rate tax = 40%
- Dividend income – higher rate tax = 32.5%

It is worth noting at this stage that there is an **additional rate of tax** for those earning more than £150,000. This rate is 45% for non-savings, and savings income and 37.5% for dividend income.

Reducing total statutory income

Total statutory income can be reduced through certain payments. Primarily:

- Pension contributions – subject to a basic amount of £3,600 and a maximum amount of £40,000 per year
- Donations to charity

Table 12. Income tax rates summary for FY 14/15

2013/4	Non-Savings income	Savings income	Dividend income
Starting rate for savings: £0-£2,880	N/A	10%	N/A
Basic rate: £0-£31,865	20%	20%	10%
Higher rate: £31,866-£150,000	40%	40%	32.5%
Additional rate: over £150,000	45%	45%	37.5%

3.3. Tax rates and the personal allowance

Notice that the income tax rates on our earned income are different from the income tax rates on our savings income and on our dividend income in the 2014/15 tax year.

Let's start with looking in more detail at our earned income and we will return to any savings and dividend income later.

Earned income includes:

- Money received – salary, overtime, bonuses, commission, profit share, etc
- Benefits received – the monetary value of these benefits is called 'benefits in kind' e.g. company car, health insurance, preferential loans, etc.

The income tax personal allowance

Every UK resident is entitled to a new personal allowance each tax year. The personal allowance is an amount of income that can be earned tax-free each tax year. Once an individual's income exceeds this personal allowance then every additional pound over the personal allowance starts incurring income tax.

Note that the first three digits of the personal allowance form an individual's tax code.

The personal allowance increases for those under age 65 is £10,000.

Reduction of personal allowance

This personal allowance is, however, at risk for high income earners. Once an individual's income reaches £100,000, the personal allowance begins to be taken away at a rate of £1 for every £2 earned above that figure.

This means, for FY 14/15, anyone earning £120,000 or more has no personal allowance at all.

3.4. Calculation of income tax

In the UK our non-savings income is potentially taxed at four rates – 45%, 40%, 20% and 0%.

The following examples will illustrate how each tax band works:

Example 1:

Denise, aged 25, has a part time job and earns £10,560 pa. What income tax will she pay?

Denise pays no tax on her first £10,000, as this is the tax free personal allowance. This leaves £560 of Denise's income to be taxed at the 20% (basic rate) band.

Denise's total tax will be:

Table 13. Denise tax example

Total income	£10,560		
Personal allowance	(10,000)	@ nil%	= £0
Taxable income	£560	@ 20%	= £120
Total tax			**£120**

Example 2:

Holly, aged 33, earns £75,000 pa. What income tax will she pay?

Holly’s income tax can be calculated as follows:

Table 14. Holly tax example

Total income	£75,000		
Personal allowance	(10,000)	@ nil%	= £0
Taxable income	£65,000		
Basic rate	(£31,865)	@ 20%	= £6,373
Higher rate	33,135	@ 40%	= £13,254
Total tax			**£19,627**

Taxation of property income

Income from property is looked at alongside non-savings income.

Income from commercial property and real estate investment trusts (REITs) are taxed at either 45%, 40% or 20%.

It is allowable to offset certain costs and expenses against property income, such as loan interest costs.

Assessing income for self employed or partnerships

When assessing income for the self-employed and partnerships, tax is paid on net income. Net income can be reduced with **deductible interest**.

Deductible interest can be used if the loan is in relation to qualifying purposes. These include:

- Investing in a partnership or co-operative
- Buying an interest in business assets, such as plant or machinery, or an unquoted employee controlled company

3.5. Taxation of trusts

Trusts are subject to income tax and the trustee is responsible for meeting the tax liabilities of the trust. These tax liabilities will be paid out of the trust assets. However, trusts are not taxed in the same way as individuals.

For most trusts, the first £1,000 of income is taxed at the basic rate of tax: 20% for savings and property income and 10% for dividend income. This is called the **standard rate band**.

Any income above £1,000 is taxed at the additional rate: 40% for savings and property income and 37.5% for dividend income. This is referred to as the **trust rate** (dividend trust rate when referring to dividend income).

The sequence of assessing income is the same as for individuals: non-dividend income first and dividend income last.

It is also worth emphasising that the £1,000 standard rate band is based on the settler, not the trust. If an individual sets up two trusts, the standard rate band is £500 for each trust.

Where a beneficiary receives income from the trust, they will receive that income net of the rate paid by the trust. As this is the additional rate of tax for any trust generating income above £1,000, there is the possibility that the beneficiary may need to reclaim tax from Her Majesty's Revenue and Customs (HMRC).

Bare trusts

Bare trust give absolute vested interest in the assets to the beneficiaries. For the taxation of these trusts, the trust is ignored. Instead the tax is paid at the beneficiaries marginal rate of tax. This tax charge is liable on the trust asset, whether the income is paid out or not.

4. National Insurance

4.1. Who pays National Insurance?

National Insurance contributions are paid by employees and the self-employed once aged 16 and over, as long as their earnings are more than a certain level.

State benefits that are linked to your National Insurance contributions are known as 'contributory benefits'. Notably, these benefits include the State Pension.

State Pension age is 65 for men born before 6 April 1959 and 60 for women born before 6 April 1950. But it will gradually increase to 65 for women by 2018. It is proposed that both men and women will then have a State Pension age of 66 by 2020.

4.2. What type of National Insurance do you pay?

The amount and type of National Insurance Contributions (NICs) paid depends on whether an individual is employed or self-employed and how much they earn.

For those employed – Class 1

An employed person pays Class 1A NICs.

Contributions are deducted from your wages by your employer.

The employer also contributes Class 1B NICs.

For those self-employed – Class 2 and Class 4

A self-employed person pays Class 2 and Class 4 National Insurance contributions.

- Class 2 NICs are paid at a flat rate
- Class 4 NICs are paid as a percentage of annual taxable profits

Voluntary National Insurance contributions

Some people also pay voluntary NICs. For example, an individual might choose to pay them if they:

- Are not working and are not claiming state benefits
- Have not paid enough NICs in a year to count for the State Pension or other long-term state benefits
- Live abroad and want to maintain their state benefits entitlement

Class 3 voluntary contributions are paid either monthly by Direct Debit or by quarterly bill. But if you have gaps in your National Insurance contributions record you can make one-off payments of voluntary contributions to fill these.

As a rule of thumb, an individual will need to have made 30 years worth of NICs to qualify for the full state pension.

5. Capital gains tax

5.1. Introduction to capital gains tax

We have looked already at the taxation of income; we now move on to the taxation of capital gains.

Here are some important facts to remember:

- A UK resident is liable for capital gains tax on gains arising anywhere in the world
- Each UK resident has a new CGT allowance each tax year (£11,000 2014/15)
- Capital losses made in any one year can be carried forward indefinitely to set against future gains
- There is no capital gains tax on qualifying bonds (bonds that pay coupons) – this includes gilts, corporate bonds, local authority bonds, PIBS etc.

5.2. Calculation of a capital gain

Overview

For the exam you need to understand an overview of how to calculate a capital gain as well as perform the actual calculations. We will show a detailed example just to illustrate how it works.

Before we calculate a capital gain it is important that you are familiar with:

- Annual CGT exemption
- The rates of CGT

Annual capital gains tax exemption

There is also an annual capital gains tax exemption (£11,000 in 2014/15).

Every UK resident receives a new CGT exemption each tax year, but it is a 'use it or lose it' exemption; unused exemptions cannot be carried forward.

Only capital gains above £11,000 each tax year are chargeable to capital gains tax. Remember that this exemption is applied after any gain has been reduced by other costs and losses.

The process of assessing the amount liable to CGT is as follows:

- Proceeds on disposal
- Reduced by:
  - Cost of asset
  - Losses carried forward
  - Any other allowable costs
  - The CGT annual exemption
- Capital gains tax is now chargeable

Capital gains tax exemption – for married couples and civil partners

A transfer between spouses or civil partners is not a chargeable transfer in respect of CGT. This means that if spouses or civil partners transfer assets to each other, it will not incur CGT.

This leads to a common tax planning strategy. If an asset was held in the name of one spouse, they can add on the other spouse to the register of owners before they sell the asset. This will allow the investors to benefit from two lots of CGT exemptions i.e. 2 x £11,000 = £22,000.

Unmarried couples are not able to do this.

Capital gains tax rates

If a capital gain still exists after all of the costs and allowances described, it is taxed at a flat rate of 18%. For higher and additional rate taxpayers the rate is 28%.

The only exception to these rates is on disposal of certain business assets. This will attract entrepreneurs' relief, which results in an effective rate of CGT at 10%.

Calculation of capital gains tax

Mary bought an asset for £12,000 in 2008. She sells it in FY14/15 for £28,000. She also sold another asset at a loss of £1,000 in the same year. As a higher rate taxpayer, what is her CGT liability?

Table 15. Calculation of CGT

	£	**Tax liability**
Proceeds from main asset	28,000	
Cost of asset	(12,000)	
Capital gain	16,000	
Capital loss in same year	(1,000)	
Annual exemption	(11,000)	
Taxable gain	4,000	**@ 28% = £1,120**

Capital gains tax on other assets

Here is quick summary of the assets to which CGT is and is not due:

Table 16. CGT on assets summary

Exempt assets include:	Primary residence
	Betting and Lottery wins
	Shares in enterprise investment fund schemes and seed enterprise investment schemes sold for the first time, having been held for the relevant holding period
	Gilts and qualifying bonds
	National savings certificates and premium bonds
	Private motor cars
	Life assurance policies
	Currency bought for holidays
	Gifts to charities
Liable assets include:	Company shares and non-qualifying bonds
	Second property or an subsequent properties
	Other chattels above £6,000 – antiques, art, stamps, etc.
	Currency bought and sold for gain
	Units in CIS

Capital gains tax and NISA wrappers

Shares, collective investment schemes and property can all be NISA wrapped - meaning that they would not be subject to capital gains tax.

This is a considerable benefit over time as each year more and more of a client's portfolio can be NISA wrapped.

6. Inheritance Tax

6.1. Overview

Inheritance tax (IHT) is mostly a tax on assets on death, but there is one situation where IHT is payable in life as we will see shortly. Chargeable persons are considered not on residence, as we saw for income tax and capital gains tax, but on domicile.

6.2. Three types of transfer

There are three types of transfer relating to inheritance tax:

- Potentially exempt transfers
- Chargeable lifetime transfers
- Exempt transfers

Potentially exempt transfers

When a gift is made to another person (in excess of the nil-rate band) it is termed a 'potentially exempt transfer'. It is potentially exempt because the donor (the giver) needs to survive seven years from the date of the gift, or else some inheritance tax will be due to be payable on this gift (by the receiver).

This seven-year rule in the field of inheritance tax is called the 'seven-year clock'. It is designed to stop individuals trying to give away assets just before their death to avoid paying inheritance tax. The result of the seven-year clock is that to legally avoid paying inheritance tax, assets should be given away earlier in life when the donor is in good health.

On death, Her Majesty's Revenue and Customs (HMRC) looks back seven years to find any potentially exempt transfers. Remember that transfers totalling less than £325,000 are exempt.

Chargeable lifetime transfers

Almost all transfers are 'potentially exempt'. However, a transfer into a discretionary trust is deemed a chargeable lifetime transfer. This will incur an immediate IHT charge of 20%, and could be liable for more if the donor dies within seven years of the gift.

Exempt transfers

There are a number of transfers that are totally exempt from inheritance tax:

- Individual's annual IHT exemption - £3,000 per tax year. If not used this can be carried forward one year only (giving a potential maximum of £6,000 in any single year)
- Gifts in contemplation of marriage - gifts to a bride and groom are exempt to these limits: parents, £5,000; grandparents, £2,500; anyone else, £1,000
- Transfers between spouses and civil partners - fully exempt unless one spouse is a non-UK domicile then a £55,000 limit applies
- Transfers to charities - exempt from IHT. If more than 10% of the estate is left to charity, the IHT rate is reduced by 10% to 36% for the remainder of the estate

6.3. Calculation of inheritance tax

Inheritance tax is payable on the value of a deceased person's estate. All a deceased person's assets are valued and any liabilities are deducted.

Each UK domiciled individual receives the nil-rate band of inheritance tax, currently £325,000. This means that the first £325,000 of an estate is charged at 0%. Inheritance tax is then charged on the excess above the nil-rate band at 40%.

6.4. Gifting the nil-rate band

The unused percentage of the nil-rate band can be transferred between spouses and civil partners. This works as follows:

- If one spouse of a married couple died in July 2012 and did not use their nil-rate band at all, then 100% of it is available to the other spouse on their death whenever that occurs. If, for example, the other spouse dies five years later when the nil-rate band has risen to £350,000, the other spouse will receive both their own and their deceased spouse's nil-rate band of £350,000 + £350,000 = £700,000.
- If part of the nil-rate band has been used then the unused percentage can be transferred in the same way.
- This change has effectively given married couples and civil partners up to £650,000 (2 x the nil-rate band) of IHT protection without the need to pay solicitors to set up a tax efficient will.

Non-married couples do not benefit from this change.

6.5. Gifts with reservation

Under the rules of inheritance tax it is not possible to 'pretend to give away' assets and keep using them as your own.

This is called a 'gift with reservation of benefit'. It occurs when the giver (the donor) of an asset is still able to use the asset for free i.e. still gaining a benefit from the asset.

A good example is an expensive family home. Imagine an expensive family home that is valued well over the combined nil-rate band of £650,000 and likely to incur quite a sizeable IHT bill. What if the parents decided to gift this home to their children and yet still live in the home themselves?

If the parents continue to live in the house as before then the tax authorities would class the gift as a gift with reservation – because they are still obtaining the benefit from their home by living in it. This means that the seven-year clock mentioned above will not start ticking, and on death of the parents the house will be included within their assets for IHT purposes.

On the other hand, if the parents were to pay a market rent, this would not be a gift with reservation and the seven year clock would start ticking. Note that the amount of the asset above the nil rate band would be classed as a PET – meaning that the parents would need to survive seven years or some IHT would be payable on their early death.

7. Taxation of investments

7.1. Summary

Taxation of direct investments

Table 17. Taxation of direct investments

	Income	Capital	Withholding	Stamp duty
Cash	Yes	No	20%	No
NS&I	Variable	No	Variable	No
Gilts	Yes	No	No	No
Corp. Debt (qualifying)	Yes	No	20%	No
Corp. Debt (convertible)	Yes	Yes	20%	Yes
Equity	Yes	Yes	10%	Yes
Property (primary res.)	N/A*	No	N/A	Yes
Property (investment)	Yes	Yes	No	Yes
Chattles	No	Yes†	N/A	No

* Rent-a-room scheme allows £4,250 p.a. tax-free

† Chattles below £6,000 in value are tax free

Taxation for indirect investment

From the perspective of the fund managing the portfolio, the tax liabilities are as follows:

Table 18.

	Income	Capital gain	Stamp duty
Equity CIS	Yes at 20%	No	Yes
Debt CIS	Yes at 20%	No	Yes (on equity)
ITC	CT rate applicable	No	Yes
REIT	No	No	Yes (SDLT)
VCT	CT rate applicable	No	Yes

From the perspective of the investor, who has invested in the fund, the tax liabilities are as follows:

Table 19.

	Income	Withholding tax	Capital gain	Stamp duty
Equity CIS	Yes (Div)	Yes 10%	Yes	No
Debt CIS	Yes (Sav)	Yes 20%	Yes	No

	Income	Withholding tax	Capital gain	Stamp duty
ITC	Yes (Div)	Yes 10%	Yes	Yes
REIT	Yes (Sav)	No	Yes	Yes
VCT	No	N/A	No	Yes

CIS = collective investment scheme including unit trust and investment company with variable capital (ICVC)

ITC = investment trust company

REIT = real estate investment trust company

VCT = venture capital trust

What if income is not paid out, but is reinvested in the CIS?

Sometimes income from a collective investment scheme is not paid out to the investor but instead is reinvested to purchase more units/shares in the fund. How is this taxed (as the investor has not received it)?

Although the investor has not received it through the post or in their bank account, their fund has received it so they are taxed on income reinvested back into their fund each tax year. The investor will receive a statement from the company detailing how much income has been reinvested to enable them to declare this on their tax return.

8. Stamp Duty

8.1. Stamp duty reserve tax

Introduction

Stamp duty is a form of UK taxation payable on transfers of assets such as real estate and certain securities.

In relation to securities, **stamp duty** is payable on **certificated** shares. Traditionally the transfer document is stamped in order to evidence the payment of the tax.

More typically nowadays, there is no transfer document as shares are held in dematerialised (electronic) form. For transfers on these securities, the tax is known as **stamp duty reserve tax** (SDRT). SDRT is payable on:

- Securities held within CREST (e.g. company shares)
- Options on company shares
- Purchases of renounceable letters of acceptance
- Shares purchased and re-sold the same day
- UK convertible loan stock

It is only the **buyer** of the securities who is liable to pay the tax.

Exempt investments

Stamp duty or SDRT is not payable on the following investments:

- Gilts
- Corporate bonds (including eurobonds) and debentures (unless convertible)
- Units in unit trusts
- OEIC shares

Note: stamp duty is only paid on the purchase of the underlying shares in unit trusts/OEICs, not on buying into the unit trusts/OEIC itself.

Other exempt transfers

The following transfers are also exempt from both stamp duty and SDRT:

- Bearer securities
- Overseas securities
- New issues

The following persons are exempt from both stamp duty and SDRT:

- Recipients of gifts

- Registered charities
- LSE member firms (who are not fund managers) and are granted intermediary status by the LSE e.g. market makers

Stamp duty reserve tax (SDRT) rate

The rate of taxation is the same for both stamp duty and SDRT (0.5%), and is rounded to the **nearest penny**.

8.2. Stamp duty land tax (SDLT)

Overview

SDLT is a transaction tax on land in the UK; it is a charge on documents that transfer property.

Unlike most modern taxes SDLT is not collected directly from taxpayers by assessment. The purchaser of land is responsible for making a land transaction return and paying the SDLT within 30 days of the effective date of the transaction.

The rate of tax is a percentage of the purchase consideration for the transaction (rounded-down to the nearest pound). SDLT on residential land or property - freehold or leasehold – is as follows:

Table 20. SDLT rates summary for residential property

Purchase price/lease premium or transfer value	SDLT rate
Up to £125,000	Zero
£125,001 to £250,000	1%
£250,001 to £500,000	3%
£500,001 to £1,000,000	4%
£1,000,001 to £2,000,000	5%
Over £2,000,000*	7%

Notes

*If residential property purchased for more than £2,000,000 is bought by a non-natural person, for example a company, there is a special anti-avoidance SDLT of 15%.

SDLT for commercial property

Table 21. SDLT rates summary for commercial property

Purchase price/lease premium or transfer value	SDLT rate
Up to £150,000*	Zero
£150,001 to £250,000	1%
£250,001 to £500,000	3%
Above £500,000	4%

Notes

*The rate is 1% where the annual rent is £1,000 or more.

SDLT for leased property

SDLT for leased property is based on the net present value (NPV) of the lease. If this is below £125,000 for residential property or below £150,000 for commercial property, there will be 0% SDLT.

If the NPV is above £125,000 for residential property and above £150,000 for commercial property SDLT is 1% of the NPV.

9. Corporation tax

9.1. Overview

This chapter only contains a brief overview of corporation tax as the main focus is on personal tax planning.

As an introduction it is important to distinguish between limited companies, sole traders and partnerships. Only limited companies pay corporation tax based upon their business profits over a 12-month period (their financial year).

Corporation tax:

- Is self-assessed
- Most companies pay 9 months and 1 day after the end of their accounting period
- Large companies pay in 4 quarterly instalments

Profits made by sole traders and by partnerships are assessed against each individual's share in the business. This share of the profits is then taxed as income tax rather than corporation tax.

9.2. Companies chargeable

Corporation tax is payable by UK resident companies on their worldwide profits, and by companies resident overseas on their profits arising in the UK.

The tax is payable on income, such as operating profits and interest receivable, and gains, such as the profit arising from the sale of a building or shares.

9.3. Profits chargeable to corporation tax

Taxable profit or profits chargeable to corporation tax (PCTCT) is the amount on which corporation tax is calculated. It is not the same as the profit disclosed in the accounts. This is because the HMRC disallows for tax purposes certain items of expenditure, such as entertaining and depreciation. In place of depreciation they give a fixed rate allowance known as a capital allowance.

9.4. Corporation tax rates

There are two rates of corporation tax:

- The small company rate – profits up to £300,000 pay 20%.
- The main rate – profits over £1.5m pay 21%.
- There is a gradual transition from the 20% to the 21% rate of corporation tax as profits increase above £300,000. This transition is called marginal relief.

9.5. Losses

A company's trading losses can normally be set against:

- Income and gains of the same accounting period.
- Income and gains of the previous year.

- Trading profits from the same trade in future years.

Losses of the final 12 months of a trade can be carried back three years. Losses are set against more recent periods before earlier periods.

10. Value added tax (VAT)

10.1. Overview

VAT is a tax charged on the provision of many goods and services in the UK. It is designed to be a tax on the end consumer, i.e. a sales tax.

For VAT to be chargeable there has to be a taxable supply of goods or services by a taxable person in the course of business carried on by him.

A taxable supply includes goods and services in the UK and the importation of some goods.

A taxable person is a legal person (such as a company or sole trader) registered for VAT purposes.

The rules outlined below only apply in England, Scotland, Wales and Northern Ireland. The Isle of Man has a slightly different system and there are no sales taxes in the Channel Islands.

10.2. How does VAT work?

VAT is an ad valorem tax i.e. it is added to the sales price of goods and services. Not every good or service has VAT added to the price, only those goods or services which are deemed to be taxable supplies.

The detail of which supplies are or are not taxable is beyond the scope of the syllabus other than brokerage fees (see below). Supplies include items that are sold or gifted. Broadly there are three categories of supply:

Table 22. VAT summary

Taxable supplies	Rate of VAT charged
Standard-rated	20%
Zero-rated	0%
Reduced	5%

The type of supply is important because it determines whether a business can reclaim the VAT it has suffered on purchases.

Only those businesses making taxable supplies can reclaim VAT. A business making exempt supplies or supplies outside the scope of VAT cannot reclaim the VAT it has paid on purchases of goods and services. The rules on ‘exempt supplies’ typically includes charities, which results in charities paying VAT.

A business can only reclaim VAT if it is a taxable person. A taxable person is a business that is either making taxable supplies or intending to make taxable supplies over a certain threshold. Businesses can register voluntarily to charge VAT to allow themselves to reclaim the VAT they have suffered.

10.3. VAT for stock brokers

Services traditionally provided by stock brokers are classified differently for VAT purposes. The classifications are as follows:

Table 23. VAT for stock brokers

Type of service	Type of supply
Portfolio management fees	Standard rated
Advisory services	Standard rate but only if unbundled (i.e. invoiced separately)
Commissions	Exempt
Nominee services	Exempt

11. Tax wrappers

11.1. Overview

We have seen already that NISAs are a form of tax wrapper in that they wrap around many types of investment and make them much more tax efficient.

In this chapter we will look at the following tax wrappers:

- NISAs
- Child Trust Funds (CTFs) and Junior ISAs
- Life Company Funds
- Venture Capital Trusts (VCTs)
- Enterprise Investment Schemes (EISs)
- Pensions

Each of these tax wrappers have their own limits and key characteristics that are important to know for the exam.

11.2. New Individual Savings Accounts (NISAs)

New Individual Savings Accounts (ISA) have a big impact on investment income.

NISAs are not products themselves, they are tax wrappers. If someone says they have a NISA we would not know what type of investment they have other than it is wrapped in a NISA.

In the tax year 2014/15, £15,000 in total can be contributed to a NISA.

NISAs are very tax efficient but not always tax-free

In this chapter we have looked at three types of income:

- Non-savings income
- Savings income
- Dividend income

We can NISA wrap most of these incomes (with the exception of income generated through employment) which will make almost all the income received tax-free as follows:

Property income – all becomes tax-free

Income from REITs and from commercial property is tax-free when they are NISA wrapped.

The saving for each type of taxpayer is therefore:

- Additional rate taxpayer saves 45%
- Higher rate taxpayer saves 40%
- Basic rate taxpayer saves 20%

- Non-taxpayer does not save anything

Savings income – all becomes tax-free

Interest from cash deposits, from gilts, from bonds, from PIBS, from local authority bonds, from CIS (mostly in bonds), all become completely tax-free.

The saving for each type of taxpayer is therefore:

- Additional rate taxpayer saves 45%
- Higher rate taxpayer saves 40%
- Basic rate taxpayer saves 20%
- Lower rate taxpayer saves 10%
- Non-taxpayer does not save anything

Dividend income – a NISA cannot reclaim the 10% tax credit – but no further tax to pay

We know that when a company declares a dividend that the dividend is received net of a 10% tax credit. A NISA cannot reclaim this 10% tax. However, shares that are NISA wrapped do not have any extra income tax to pay.

This means that any investment directly in shares or indirectly via a CIS, that is NISA wrapped, is very tax efficient but not tax-free.

The saving for each taxpayer is therefore:

- Additional rate taxpayer saves 27.5%
- Higher rate taxpayer saves 22.5%
- Basic rate taxpayer, the lower rate taxpayer and the non-taxpayer do not save any more income tax because they only have 10% or 0% to pay in total

NISAs are also exempt from capital gains tax

Investments held in NISAs are also exempt from capital gains tax.

Other features of NISAs

Here is a summary of additional features of NISAs:

- NISAs can be transferred to other providers – this preserves the tax wrapper, but may incur transfer costs
- If the NISA investor moves abroad, the tax benefits remain, but they are no longer allowed to contribute to their NISA

Contributions to a NISA cannot exceed £15,000 for the tax year 2014/15. For example, if £15,000 is invested in May 2014 and later in November £1,000 is withdrawn, no more can be invested until the new tax year on 6 April 2015.

11.3. Junior ISAs

The government introduced Junior ISAs (JISAs) from 1 November 2011. These are available to children under the age of 18 who were either born after 2 January 2011 or who were not eligible for a Child Trust

Fund. Existing CTFs will continue to function for those eligible. For the purpose of the IMC exam, they have the same features as JISAs.

Overview

Here are the key features of JISAs:

- A JISA can be opened by anyone with parental responsibility for the child (or by children themselves from age 16)
- Maximum investment in a JISA is £4,000 per tax year which may be split between a cash JISA and a stocks and shares JISA
- One of each type of JISA can be opened per child
- Any income generated in an ISA that a parent has funded will not be taxable on that parent
- There is no access to the JISAs cash proceeds until the child's 18th birthday

11.4. Offshore funds

An offshore fund is essentially a unit trust, with the exception that it is domiciled overseas. As with a unit trust, investors' money is pooled and then invested in the shares of companies and/or other assets.

The fund itself also does not pay UK tax.

Offshore funds are classed as either reporting/distributor or non-reporting/non-distributor ('roll up funds').

Reporting funds

Distributor funds are those which have applied to HMRC for reporting status and report income. The distributions from such a fund are paid gross.

Distributor funds distribute at least 85% of their income.

Income is paid to investors gross and is treated as taxable income for UK residents. Any subsequent gains on the disposal of units are subject to capital gains tax.

Non-reporting funds ('roll up' funds)

Non-distributor funds distribute less than 85% of their income. They usually reinvest ('roll up') their income and do not pay dividends.

Gains on the disposal of units are subject to income tax, not capital gains tax.

11.5. Life Company Funds

Introduction

Life assurance companies do not just offer life protection, but also offer investments to their policyholders. These are often referred to as **life company bonds**, although these are not bonds like the debt instruments referred to earlier in the manual. Instead, these bonds are linked to a portfolio of assets and the income and gain on the bond is determined by the performance of the assets under managements.

These life company bonds can take the form of endowment policies, offering a basic sum assured on death of the policyholder or on maturity of the policy. Some offer a basic sum assured plus regular bonuses, referred to as with-profits bonds. Some simply offer the returns of a portfolio under management with no life assurance element, such as unit-linked bonds.

Since the introduction of ISAs (now NISAs), investments into life company funds have not been quite as popular. One of the reasons for this is that the taxation of an investment in a life company fund is not as attractive for investors as the taxation of a collective investment scheme held in an ISA.

Tax implications

An investment into a life company fund has 20% corporation tax deducted on income and gains made within the fund. This is different from investments in collective investment schemes that are exempt from tax on gains within the fund.

The 20% tax that has been deducted from a life fund cannot be reclaimed. There may also be additional tax to pay when an investor either cashes in their investment or dies – both of these events are termed 'chargeable events'.

It is termed a chargeable event because additional income tax may be chargeable for higher or additional rate taxpayers. Notice that this additional tax is actually income tax and not capital gains tax, therefore an individual cannot use their annual capital gains tax allowance to offset profits from Life Funds.

The Life Fund has already deducted 20% and, as some taxpayers are due to pay income tax at 40% or even 45%, they would be liable for an additional 20% or 25% income tax on gains made within their life fund. Lower and non-taxpayers cannot reclaim the 20% tax paid but would not have any more tax to pay.

Qualifying and single premium policies

There are two types of Life Company Policy: qualifying and single premium/non-qualifying policies.

Qualifying policies

Qualifying policies are investments into a life fund that meet the qualifying rules. If an investment meets these qualifying rules then there is **no further tax to be paid** on any pay out from the policy – even for higher and additional rate taxpayers.

To be a qualifying policy a policy must:

- Be a regular premium policy – at least annual premiums (normally monthly premiums)
- Have an initial term of ten years (must be kept for 3/4 of the term or ten years, whichever is the lower)

The most common kind of qualifying policy is an endowment policy. This is a regular premium into a life fund and meets all the qualifying rules. Endowment policies are used as savings plans, some of which aimed to build up enough of a value to repay a mortgage debt. However, investment returns are not guaranteed, and these policies can suffer shortfall risk.

Single premium/Non-qualifying policies

A single premium policy does not meet the qualifying rules. Any profits made from this policy will be taxable. An often quoted example is a simple premium life company bond. A portfolio-linked investment that tries to maximise returns over a medium to long period.

Remember that life funds have 20% tax deducted within the fund that cannot be reclaimed. Should an investor in a life fund cash in or die (both chargeable events) then higher rate taxpayers will have an extra 20% or 25% income tax to pay. Where qualifying policies have no more tax to pay, non-qualifying policies may incur this extra tax.

Examples of non-qualifying policies include lump sum investments into a life fund such as:

- Investment bonds/Insurance bonds
- Unit linked bonds and with profit bonds
- Distribution bonds

Withdrawals from Life Company Funds – the 5% rule

Introduction

When an investor makes a lump sum investment into, for example, a life company bond, there is a way to withdraw capital and defer tax liabilities on that withdrawal.

Withdrawals of up to 5% of the original capital invested can be made per year on a tax deferred basis. Tax deferred does not mean tax-free - instead these withdrawals are assessed for income tax when a chargeable event occurs, e.g. the investment is ultimately cashed in (or encashed) or the death of the policyholder.

Features

Here are the key features of this 5% withdrawal rule:

- It only applies to lump sum investments in life funds i.e. investment bonds, insurance bonds, with-profits bonds, unit linked bonds and distribution bonds
- Up to 5% of the original capital may be withdrawn each year on a cumulative basis and the income is tax deferred
- If more than 5% is withdrawn in any tax year, the withdrawal is classed as a chargeable event and higher rate tax payers are due an extra 20% and additional taxpayers a further 30% (remember a life fund has already deducted 20%)
- When the bond is ultimately encashed, the withdrawals and any gains are assessed together at this time and taxed as income

Tax advantage and risks

The idea behind this feature is that a higher or additional rate taxpayer (when they are of working age) who needs extra income could withdraw the 5% from their bond and not incur any income tax at this stage (tax deferred).

If in later years, once they have retired, their income drops and they become a basic rate taxpayer then when they encash their bond they may have no further income tax to pay because their tax rate has fallen.

If once the investor retires they are still a higher or additional rate taxpayer, then they would be liable to extra tax on any gains. Remember that gains on life funds are taxed as income tax.

Offshore life assurance bonds

Offshore life assurance bonds do not pay corporation tax on income and gains within the fund, although withholding tax on dividends is not reclaimable. This ‘gross roll-up’ of income and gains generally has the effect of causing the fund to grow more quickly than an onshore fund. Income withdrawals are achieved by selling units. Provided annual withdrawals do not exceed 5% of the initial investment, no liability to tax will arise until the bond is encashed in full. Withdrawals in excess of 5% per annum are liable to UK income tax at the taxpayer’s highest rate, as is the overall gain on final encashment. On final encashment, any ‘gain’ in the value of the investment bond (taking into account any previous withdrawals) is added on to the investor's income and is subject to tax in the normal way.

11.6. Venture Capital Trusts (VCTs)

Venture Capital Trusts (VCTs) are a type of Investment Trust that invests primarily in unquoted companies.

Venture capital is all about investing in small unproven companies with both great potential and high risk. As the government wants to encourage investments in such companies VCTs have a number of attractive tax benefits for investors.

There are significant tax benefits to investing in a Venture Capital Trust.

Income tax

- Maximum investment per tax year is £200,000
- Income tax relief is at 30% (if held for five years)
  - *Therefore the maximum income tax relief is the lower of an investor's total income tax liability and 30% of £200,000 i.e. £60,000*
- Dividends are tax free (no holding period requirement)

Capital gains tax

- No CGT is payable on disposals from a VCT (non holding period requirement)
- Losses are not allowable to use against gains

11.7. Enterprise Investment Schemes (EISs)

Enterprise Investment Schemes (EISs) also provide tax reliefs for investments in UK unquoted companies. EISs can only invest in companies with total assets no greater than £15m before the issue of shares.

This asset limit is called the Gross Assets Test and results in EIS investments only being allowed into fairly small companies. Note that Venture Capital Trusts typically invest in even smaller companies with even less of a track record.

Like VCTs investments in EISs have their own tax benefits.

Income tax

- Maximum investment per tax year is £1,000,000
- Minimum investment per tax year is £500
- Income tax relief is at 30% (if held for three years)
  - *Therefore the maximum income tax relief is the lower of an investor’s total income tax liability and 30% of £1,000,000 i.e. £300,000*
- Up to 100% of any investment into an EIS made each tax year may be ‘carried back’ to the previous tax year

Capital gains tax

- Investments in EIS schemes do not incur capital gains tax (if held for three years)

- Losses (after considering income tax relief) can be offset against income or other gains

Inheritance tax

- An EIS is exempt from inheritance tax

11.8. Seed Enterprise Investment Schemes

SEIS run alongside EIS. They are targeted specifically at start-up companies.

They offer:

- 50% income tax relief on up to £100,000 of investment per year
- Up to 50% of gains that are reinvested in a SEIS are exempt from CGT.

11.9. Pensions

Pensions have a very beneficial tax status in the UK. These tax benefits are as follows:

- Tax relief on each contribution at the investor's highest marginal tax rate. This means that for every £100 contribution to a pension a higher rate taxpayer pays £60 and a basic rate taxpayer pays £80
- Tax efficient funds, such as pension funds, pay no income tax or capital gains tax
- Up to 25% can be withdrawn as a **tax-free lump sum** on retirement. The rest of the pension fund must be taken as an income and is taxable as earned income

The main disadvantages of pensions are that your money is tied up and not accessible until later in life and that most of the pension fund must be taken as an income. This said, the tax benefits of pensions are very valuable in saving over the long-term for retirement.

The maximum contribution to a pension per tax year is the higher of:

- £3,600
- 100% of an investor's pre-tax earnings (up to a maximum of £40,000)

There is a maximum lifetime allowance of £1.25m. Any contributions above this will not benefit from the income tax relief.

12. Tax planning

12.1. The role of tax planning in financial advice

Financial advisors should take account of the client's personal tax position when considering the most suitable assets and tax wrappers to recommend.

We have seen the significant tax savings available by investing in tax wrappers such as NISAs, JISAs, CTFs and pensions to name a few. Other investments such as collective investment schemes allow the investor to use their annual capital gains tax allowances to carefully time when and how much of their investment to sell each tax year.

It is often said that 'the tax tail should not wag the investment dog', meaning that tax is only one of many factors involved in an investment decision. The client's objectives and their constraints should be as important as the tax treatment.

Clearly the advisor has a key role to play in the tax planning of investments. Moving on to the issue of inheritance tax, advisors have an equally important role to play in educating their clients in this largely unknown area of tax. With some advance planning significant sums of inheritance tax can be avoided and protected to pass on to future generations.

In real life, one issue is that not all advisors are trained and authorised in each financial planning area. Mortgage advisors concentrate on housing needs and investment advisors concentrate on investment needs. The result can be that some tax issues can be left unresolved and be ignored.

So to conclude, tax planning has a role to play in all aspects of financial advice.

12.2. Tax avoidance vs. tax evasion

It is important to understand the difference between tax avoidance and tax evasion:

- Tax avoidance – legally minimising tax liabilities
- Tax evasion – illegally hiding/not declaring the true nature of income and capital gains

Tax evasion incurs penalties and ultimately a prison sentence.

12.3. Ideas to minimise tax – tax avoidance

Here is a summary of some of the ideas we have looked at to help clients to legally minimise the tax that they pay:

- Use of the personal allowance £10,000 (2014/15), and ensuring non-taxpayers get to use their personal allowance each tax year by holding assets in their name
- Use spouse's personal allowance if not being used
- Use children's personal allowance if not being used. Note that if the gift comes from the parent of the child, the tax-free income is limited to £100 pa after which the income is taxed at the parents marginal rate. Income generated through gifts from other sources, grandparents, aunts and uncles, etc. benefit from the full allowance
- Choosing carefully who should own assets – thinking about their tax status

- Annual £15,000 NISA allowance – 'use it or lose it'
- Child Trust Funds and Junior ISAs – £4,000 per subscription year
- Pensions – employer schemes very valuable – if not available, use private pensions; perhaps a self-invested personal pension
- Annual CGT allowance can be used by investments in CISs e.g. Unit Trusts, OEICs and Investment Trusts
- Gains from direct share investments can also be realised if care is taken when reinvesting the gains
- EIS and VCT investments have many tax benefits
- Fixed income securities do not incur capital gains tax, only income tax on the coupons
- REITs and ETFs are also exempt from CGT within the fund
- Make a tax efficient will
- When the time is right consider gifting assets to family (potentially exempt transfers) either directly or via a trust to start the seven-year clock to legally avoid inheritance tax
- Use all available capital losses to offset against capital gains
- Remember the National Savings & Investments tax-free products such as index-linked savings certificates
- Important to have a financial review towards the end of each tax year/at the start of each tax year to understand how tax changes announced in the budget may impact on financial plans
- Married couples should consider gifting the nil-rate band to each other

12.4. Other tax planning issues

This chapter ends with an important section that is tested regularly. It is especially important that you are familiar with the international tax issues section that follows.

The two main tax issues covered in this section relate to the following:

- Parents giving money to children
- International tax issues

12.5. Transfer of Ownership

If one spouse is a higher rate taxpayer and the other spouse is having a career break, it makes sense to transfer ownership of investment capital, which generates taxable income into the name of the non-working spouse in order to make use of their personal allowance and their lower marginal rate of income tax.

The tax authorities are very cautious about parents that gift monies to children, as this may be used by parents as a way to evade tax themselves.

As a result if the monies given to children by their parents earn over £100 in income per tax year then the income is assessed as belonging to the parent. The implication of this is that parents cannot avoid tax by putting large sums of monies into their child's name.

Interestingly, gifts from grandparents or any other relative or person are fine. It is only gifts directly from parents that fall under this rule. It is also worth noting that children have their own personal allowance each tax year.

12.6. Strategies to mitigate Capital Gains Tax

- Spreading ownership of assets between family members to make use of the maximum number of annual exemptions. Transfers between partners are free from CGT
- Phasing encashments over several tax years if at all possible in order to access more than one annual exemption. For example, make two separate disposals in, say, late March 2014 (tax year 2013/14) and late April 2014 (tax year 2014/15), thus accessing two annual exemptions (rather than selling all of the investments in March 2014 and being entitled to only one annual exemption)
- Deliberately realising paper losses in order to reduce gains that would otherwise exceed the annual exemption and become taxable
- Deliberately realising gains within the annual exemption so that there is no actual taxable gain, then repurchasing a similar (but not identical) investment. This has the effect of increasing the base cost of the investment and thus reducing the risk of future gains exceeding future annual exemptions. Remember that any unused annual exemption cannot be carried forward. Purchasing back the same shares would be subject to the share matching rules and therefore taxable

12.7. International tax issues

Here is a quick recap of some of the key international tax issues that we have covered. These are regularly tested in the exam.

Residence

Definitions of residence – important for CGT and Income tax (see the start of the chapter for the definitions – it is important to know these).

A UK resident is liable to both income tax (on worldwide income) and capital gains tax (on worldwide gains).

A UK resident is entitled to a personal allowance for income tax, and an annual CGT exemption for CGT.

A non-UK resident is not entitled to these allowances.

Domicile

Domicile is important for IHT – your domicile is your permanent home.

A UK domiciled individual is liable for IHT on worldwide assets.

A non-UK domiciled individual is liable for IHT only on UK assets.

A non-domiciled spouse only receives £55,000 of the nil rate band of IHT.

Deemed domicile is gained after living in the UK for 17 of the last 20 years.

Other issues

The investor in a NISA cannot keep contributing to a NISA if they move abroad i.e. cease to be a UK resident. Their NISA does, however, still retain its tax benefits.

Investors in offshore funds with reporting status are taxed on gains as gains and income as income. Investors in offshore funds with non-reporting status are taxed on gains, and income as income.

13. Summary

13.1. Key concepts

Introduction to UK taxation for individuals

- 6.1.8 - The implications of residence and domicile in relation to liability to income, capital gains and inheritance tax
- 6.1.9 - The system of UK tax compliance including self assessment, Pay As You Earn (PAYE), tax returns, tax payments, tax evasion and avoidance issues

Income tax

- 6.1.1 - The principles of income tax applicable to earnings, savings and investment income in the UK
- 6.1.2 - In relation to income tax, the system of allowances, reliefs and priorities for taxing income
- 6.1.3 - The taxation of the income of trusts and beneficiaries

National Insurance

- 6.1.4 - The system of national insurance contributions (NICs)

Capital gains tax (CGT)

- 6.1.5 - The principles of capital gains tax (CGT) in the UK

Inheritance tax (IHT)

- 6.1.6 - The principles of inheritance tax (IHT)
- 6.1.7 - The limitations of lifetime gifts and transfers at death in mitigating IHT

Taxation of investment income

- 6.1.14 - The taxation of direct investments including cash and cash equivalents, fixed interest securities, equities and property
- 5.7.6 - The taxation of the various types of funds in the UK

Stamp duty

- 6.1.10 - The principles of stamp duty land tax (SDLT) as applied to property transactions buying, selling and leasing
- 6.1.11 - The principles of stamp duty reserve tax (SDRT)

Corporation tax

- 6.1.12 - How companies are taxed in the UK

Value added tax (VAT)

- 6.1.13 - In outline, the principles of Value Added Tax (VAT)

Tax wrappers

- 6.1.15 - The key features and taxation of indirect investments including pension arrangements, New Individual Savings Accounts (NISAs), Junior ISAs and Child Trust Funds, onshore and offshore life assurance policies, Real Estate Investment Trusts (REITs), Venture Capital Trusts (VCTs) and Enterprise Investment Schemes (EISs)

Tax planning

- 6.2.1 - The tax considerations shaping clients' needs and circumstances
- 6.2.2 - The key principles of income tax planning
- 6.2.3 - How the use of annual CGT exemptions, the realisation of losses, the timing of disposals, and sale and repurchase of similar assets can mitigate CGT
- 6.2.4 - The most common elements of income tax and NICs, CGT, and IHT, including the impact of lifetime transfers and transfers at death
- 6.2.5 - Elementary tax planning recommendations in the context of investments and pensions advice

Now you have finished this chapter you should attempt the chapter questions.