Chapter 2

The FSA's High Level Standards

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2.1 Introduction

The Financial Services and Markets Act 2000 ("FSMA 2000") gives the Financial Services Authority ("the FSA") responsibility for supervising the financial services industry. The rules and guidance that the FSA makes for this purpose are contained in the FSA Handbook of Rules and Guidance ("the Handbook"), organised into several "blocks", block 1 of which is entitled "High Level Standards". The rules and guidance in this block provide the foundation of the regulatory system, defining the fundamental organisational and ethical obligations of regulated businesses and the individuals who run them. They derive from concepts formulated under former regulatory regimes replaced by the FSA in 2001, as well as from European directive obligations and other accepted international standards.[1]

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The prominence and role of the high level standards has changed since the Handbook was first introduced. The FSA has embarked on a conscious move towards reliance on principles- and outcome-focused rules rather than on detailed rules prescribing how outcomes must be achieved, thus placing a heightened obligation on firms (and specifically on their senior management) to ensure that they can defend their actions in terms of the high level standards. In addition, the amount of guidance contained in this block of the Handbook has substantially increased, notably in the SYSC module, and has been supplemented by material outside the Handbook. The implementation of the Markets in Financial Instruments Directive ("MiFID") in

[1] In particular, the core principles for effective supervision adopted for their respective sectors by the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors and the International Organisation of Securities Commissions.

2007 has also had a significant impact on some modules of the high level standards, in particular PRIN and SYSC, and the discussion in this Chapter reflects the changes made.

Block 1 of the Handbook is subdivided into seven modules, entitled as follows (together with the acronyms by which they are generally known):

(a) Principles for Businesses ("PRIN");
(b) Senior Management Arrangements, Systems and Controls ("SYSC");
(c) Threshold Conditions ("COND");
(d) Statements of Principle and Code of Practice for Approved Persons ("APER");
(e) The Fit and Proper Test for Approved Persons ("FIT");
(f) General Provisions ("GEN"); and
(g) Fees ("FEES").

Some provisions of these modules (certain aspects of GEN and the whole of FEES) are essentially administrative in nature, and sit slightly oddly in this Handbook block. The general thrust of the block, however, is the provision of a framework of standards for firms and approved persons to observe.

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2.2 Principles-based regulation

The FSA is required, as part of its general statutory duties, to follow principles of good regulation,[2] including ensuring that the regulatory burden imposed on firms is proportionate to the benefit derived (measured in relation to the FSA's statutory objectives) and that the FSA uses its resources in the most efficient and economic way. These requirements have led the FSA to adopt a risk-based approach to supervision. For example, small firms will not generally be required to establish management structures and controls to the same degree as larger organisations, because although small firms may as a consequence be at greater individual risk of failure, the impact of such a failure on market stability and consumer confidence would be

[2] Section 2(3) FSMA 2000; *see* Chapter 1.

limited. A large firm poses a greater potential threat to the FSA's statutory objectives.

A proportionate approach also helps the FSA to reconcile potential conflicts in its objectives, in particular the conflict between its desire to protect consumers by limiting the failure of firms, and its duty to encourage competition and innovation in the financial sector.

The FSA believes also that sound management, individual competence and a culture of good business ethics as set out in the High Level Standards are the most effective means of delivering its regulatory objectives. In theory, if a firm can satisfy the FSA that it has effective systems and controls in place to identify, manage and monitor the risks associated with its business activities and that these are operating well in practice, the need for direct intervention should be limited because the FSA can be reasonably confident that issues will be addressed appropriately as they arise.

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Whilst this was the FSA's express intention, the growing size and scope of the FSA Handbook was historically telling a different story. The FSA acknowledged this as a problem and in 2005 announced[3] a project to review the policy content of the Handbook with a view to making changes where existing requirements were disproportionately restrictive, did not deliver benefits to justify their cost, or were not consistent with the FSA's focus on senior management responsibilities. This project has so far produced revision of material including that relating to money laundering, training and competence and the approved persons regime, followed by revision of conduct of business material. One consequence is that Block 1 and SYSC in particular are expanding, but more detailed prescriptive material elsewhere in the Handbook is being deleted.

The FSA has publicly adopted[4] a new focus on "principles-based regulation", which it believes will foster innovation and competition in the financial services industry. The flexibility afforded to firms should in the FSA's view provide more effective regulatory outcomes. The FSA warns that increasing reliance on principles-based regulation requires

[3] *See* FSA Press Release 2 February 2005.

[4] "Principles-based regulation: focusing on the outcomes that matter", April 2007 available at www.fsa.gov.uk/pubs/other/principles.pdf

a change in behaviour of both firms and the FSA, and expresses its own commitment to make the new approach work. This includes provision of additional guidance, including material outside the Handbook, improving the capabilities of its own people, and making information more readily available. The Business Plan for 2007/08 set aside a budget of £50 million to fund the transition element of these expenses.

Consistent with this approach, the FSA has expressed willingness to work with industry to develop market-based solutions to apparent market failures, without calling on its regulatory powers. Examples include the FSA's work on soft commissions and unbundling, and the development of market practices for contract certainty in general insurance. The FSA has also developed a policy framework for FSA confirmation of industry guidance, articulated in Policy Statement 07/16 issued in September 2007.

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The extent to which the FSA is able to apply principles-based regulation is limited by a number of factors.

(a) Firstly, much of the UK's corpus of prudential and conduct of business regulation for financial services stems from European directives establishing and maintaining the single European market in these services. For a variety of reasons, European directives are sometimes more prescriptive than the FSA would prefer, and the relatively new Lamfalussy model for financial services directives, providing for Europe-wide implementation measures made by delegated legislation on the basis of principles set out in a directive, seems unlikely to reduce the amount of prescriptive material. It may be that in some areas of financial services the FSA is confident of its ability to administer a principles-based regime where the relevant authorities in other EEA countries would not be. In a single market the ability of one country's regulators to adopt innovative approaches is constrained. The FSA's greater criticism of European initiatives, however, has been that they have not always been accompanied by adequate impact assessments.

(b) Secondly, the FSA needs to have regard to the operations of the Financial Ombudsman Service ("FOS")(*see* Chapter 10). The FOS is an independent scheme for resolving disputes between

consumers and firms. Whilst the resolution of many such disputes will turn on questions of fact or general business law rather than FSA regulation, some cases may have wider implications for the interpretation of high level standards.

(c) Similarly, other regulators and quasi-regulators have activities that overlap those of the FSA. Examples include the Banking Code Standards Board, the Pensions Regulator and the Office of Fair Trading. There may be occasions where the agenda of such other regulators means that the FSA must adjust its approach to avoid the impression of inconsistency between regulators.

(d) The FSA is also constrained by the perceived low level of financial capability of many consumers. The FSA has a longer-term strategy of tackling this deficiency through consumer education. At the present time, its perceived focus at least as far as principles-based regulation is concerned, is to encourage firms to be sensitive to their customers' needs and requirements. As the FSA acknowledges, one possible impact is that firms will feel obliged to adopt a very low risk tolerance in their approach to compliance, working counter to the broader objective of encouraging flexibility and focusing on outcomes.

(e) Lastly, the FSA has acknowledged the concern among some firms that principles-based regulation can lack predictability, creating an environment of greater uncertainty, particularly for smaller firms who lack the resources to develop their own internal frameworks. Some firms may fear regulation by hindsight, particularly if public or political opinion presses the regulator to identify culprits when something seems to have gone wrong, even if no rule appears to have been infringed. The FSA has undertaken to provide greater guidance and has confirmed that firms may rely on FSA materials. It has also sought to contain the risk of capricious regulatory action by revising aspects of its enforcement procedures that had come under criticism earlier in the decade.

Principles-based regulation enables the FSA to tailor its regulatory strategy for firms that fail to meet expectations. Whilst enforcement action is an option, the FSA has other tools, short of enforcement, to deal with apparent failure, including the imposition of a risk mitigation programme or a skilled person's report (*see* Chapter 9).

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2.3 Scope and application of the high level standards

The high level standards are for the most part defined in general terms, in line with the intention that each regulated firm apply the high level standards in a way that is appropriate to its circumstances.

Many of the provisions in the high level standards have the status of rules. The FSA has made it clear that a breach of these provisions, even if it does not involve a breach of any other more specific rule set out in the Handbook, can still be a basis for disciplinary action. In a fast-developing and complex financial environment, detailed rules can never cover all eventualities, and principles-based regulation attempts to respond to this fact of life. Where detailed regulation is still felt necessary to supplement the high level standards, it will inevitably lag behind market developments. High level standards ensure that there is not a complete hiatus. In the context of smaller firms, high-level judgment may also be essential for cost effectiveness.

To mitigate the risks inherent in the direct application of the Standards to discipline, the FSA has undertaken to provide informal, prompt and substantive guidance to firms and individuals on the application of the high level standards to specific circumstances, although before seeking guidance firms should analyse the issue for themselves, including obtaining advice where appropriate. It is therefore important for firms to demonstrate that they are aware of the requirements of the high level standards and that their activities are conducted with those requirements in mind. A decision that has properly reasoned regard to the high level standards (even if the regulator disagrees with an interpretation adopted by the firm) is less vulnerable to supervisory action than one which a firm only seeks to justify in Handbook terms after the event.

Although requirements in PRIN, SYSC and GEN are capable of being waived, it is perhaps not surprising given the fundamental importance of the high level standards to the FSA's overall regime that (as at September 2007), no published waivers had been granted in relation to PRIN, and those published for SYSC relate exclusively to a specific concession for non-UK firms in relation to liquidity risk rules.

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A number of waivers were issued in 2004–05 in respect of GEN, but this was a temporary expedient, stemming from practical consequences of the extension of the FSA's mandate to cover mortgages and general insurance intermediation. At September 2007 there was only one extant published waiver for the rules in GEN.

Finally, breach of some of the rules in the Handbook is by virtue of Section 150 of FSMA 2000 capable of forming the basis for an action for damages by a private person. However rules requiring a firm to hold financial resources are specifically excluded, and other rules are only included to the extent that the rule is identified as such in the Handbook. Schedule 5 to each module indicates whether and if so which rules in the module are included. No rule in PRIN or SYSC creates such a right, though rules (not evidential provisions) in GEN may. There are no rules in COND, APER or FIT (and FEES is not concerned with dealings with private persons) so the question does not arise in respect of those modules.

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2.4 The Principles for Businesses

There are 11 Principles for Businesses ("the Principles"). The text of these, established in 2001, remained unchanged at the time of writing, though the accompanying guidance has evolved in response to the extension of the FSA's mandate, to update Handbook cross-references and to take account of new European directive requirements, in particular the implementation of MiFID in November 2007.

The Principles assist the FSA by providing a conceptual basis for:

(a) making judgments of fitness and propriety;
(b) determining whether to exercise its powers of investigation and intervention;
(c) applications for an injunction;
(d) bringing disciplinary proceedings; and
(e) requiring restitution.

2.4.1 The Principles

The 11 Principles are as follows.

2.4.1.1 *Principle 1: integrity*

Principle 1 states that a firm must conduct its business with integrity. The FSA has described "integrity" as a moral concept. Few have difficulty in identifying fraud, deception, misrepresentation and breach of trust as failures of integrity, perhaps not only because they are failures of morality but also because they give rise to remedies under general law and are therefore well defined and understood. Integrity in other less traumatic situations is not so easily defined, but failure appears to require some deliberate misconduct or omission (rather than negligence, which would be caught by Principle 2).

Firms should be aware that breaches of Principle 1 are likely to give rise to disciplinary action so that, whatever the difficulties, the precise definition of integrity does matter. Standards are likely to vary according to context and market custom and, it is to be hoped, will not be unduly influenced by media attention. Firms should consider whether their internal policies and corporate culture pay sufficient regard to integrity in the wider context.

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2.4.1.2 *Principle 2: skill, care and diligence*

Principle 2 requires a firm to conduct its business with due skill, care and diligence. The concept of care is primarily directed to a firm's obligations to its customers. Neglect of shareholders' or employees' interests will not normally be regarded as a breach of this Principle (though in some cases, for example mutual companies, such interests may not in practice be severable from customer interests). The standard of diligence and skill required will depend on the business carried on by the firm and the reasonable expectations of its customers.

2.4.1.3 *Principle 3: management and control*

Principle 3 requires a firm to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems. This Principle introduces the FSA's high-level precepts for management arrangements and controls which represent a consistent theme running through the FSA Handbook. In particular the provisions of SYSC (discussed at 2.5 below), the Approved Persons regime, Training and Competence[5] and the Prudential Sourcebooks[6] all build on the requirements of Principle 3.

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[5] *See* Chapter 3.
[6] *See* Chapter 4.

2.4.1.4 Principle 4: financial prudence

Principle 4 requires firms to maintain adequate financial resources. The title of the Principle, "Financial prudence", implies foresight and circumspection but not risk aversion as such. The FSA has emphasised that it is not looking for a zero-failure regime so speculation is not prohibited. However, firms are not expected to take risks without first assessing the potential impact of those risks and making appropriate financial provision to ensure that consumers are protected and that market confidence is not adversely affected.

Detailed rules for quantitative assessment of financial resources and financial resource requirements are set out in the Prudential Sourcebooks[7] in the Handbook. In addition to these quantitative requirements, firms are also required to consider their economic capital requirements according to their individual risk profile, a process which requires a firm to determine its level of "risk appetite". Still, the relationship between current financial resources requirements and economic risks is not straightforward or obvious. So there must always be a risk of the regulator interpreting "prudence" with the benefit of hindsight when a firm experiences financial difficulty, particularly in high-profile cases where public and media perception may place pressure on the regulator.

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2.4.1.5 Principle 5: market conduct

Principle 5 requires firms to observe proper standards of market conduct. It is intended to support the FSA's statutory objective of maintaining market confidence. This Principle underpins the rules and Code of Market Conduct in the Market Conduct Sourcebook ("MAR") and its regime for inter-professional dealings. There is some complexity in the relationship between Principle 5 and the Takeover Code, which is endorsed by MAR. Issues may arise as to the detailed supervision of these overlapping rules and codes and how regulatory responsibilities will be apportioned.[8]

2.4.1.6 Principle 6: customers' interests

Principle 6 requires a firm to pay due regard to the interests of its customers (the Handbook definition of "customers" excludes "eligible

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[7] *See* Chapter 4.
[8] *See* Chapters 5 and 6.

counterparties", the term derived from MiFID that has replaced the previous designation of market counterparties) and treat them fairly. General law relating to agency or trusts may impose obligations on a firm in excess of the requirements of Principle 6 and the FSA does not attempt to reduce these.

Whilst the English tradition has focused on "buyer beware" rather than fairness, an obligation of fairness exists in a number of pieces of UK legislation and in European directives. The FSA has not provided a definition of fairness, and the concept will often depend upon context.

Treating customers fairly, or "TCF", has been a major focus of the FSA. Principle 6 is not construed narrowly; it goes beyond conduct of business requirements and is intended to govern all dealings with customers. To date, the FSA has taken this Principle further than any other in implementing its principles-based regulation agenda. According to the FSA, firms have historically paid insufficient attention to the ongoing interests of customers in various aspects of the customer relationship ranging from product design through to cessation of the customer relationship. These defects need not have been deliberate; failings in other aspects of management responsibilities such as systems and controls and training and competence can plausibly lead to failures to treat customers fairly. To encourage an integrated approach by firms to TCF, the FSA set a deadline for firms to implement the Principle in a substantial part of their business by the end of March 2007, with management information operative by March 2008 and completion of embedding by November 2008. During 2006 and 2007, the FSA extensively revised and where possible reduced the detail of the detailed conduct of business sourcebooks, though considerable quantities of prescriptive material do remain in those sourcebooks partly in response to European directive requirements. At the same time, the FSA has published extensive material that is external to the Handbook but is intended to provide guidance to firms on how they should apply the Principle and how the FSA will assess compliance. A section of the FSA website (www.fsa.gov.uk/tcf) provides a point of access for this material.

As principles-based regulation is outcomes based, the FSA has identified six outcomes which it expects firms' TCF frameworks to achieve. These are as follows:

(a) consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture;
(b) products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly;
(c) consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale;
(d) where consumers receive advice, the advice is suitable and takes account of their circumstances;
(e) 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;
(f) consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

These outcomes are also relevant to other Principles, in particular Principles 7 and 9 (*see* 2.4.1.7 and 2.4.1.9 below).

How firms achieve these outcomes is their responsibility. Recent FSA publications include guides on culture and on management information, providing illustrations of good and poor practice. These materials do not prescribe particular actions by firms, or set out a required minimum standard.

The FSA has paid particular attention to the fair handling of customers' complaints, for which there are detailed rules and guidance set out in the Dispute Resolution: Complaints Sourcebook ("DISP").[9]

The FSA also has another avenue for pursuing its TCF agenda, in that it is empowered under the Unfair Contract Terms in Consumer Contracts Regulations 1999 to challenge unfair standard terms in investment contracts. In 2007, the FSA published an Unfair Contract Terms Regulatory Guide, including Statements of Good Practice, to indicate how it would interpret those Regulations.

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[9] *See* Chapter 10.

Eligible counterparties are expected to be able to protect their own interests and therefore are excluded from Principle 6.

2.4.1.7 Principle 7: communications with customers

Principle 7 requires a firm to pay due regard to the information needs of its clients and to communicate information to them in a way that is clear, fair and not misleading. In assessing whether its communications meet this standard a firm needs to have regard to the level of understanding of its particular clients, hence the existence of different classifications of client in the rules on conduct of business.[10] The requirements of Principle 7 underpin a number of the FSA's specific rules, in particular the financial promotion regime and disclosure rules (which also reflect European directive requirements)[11] but also apply more widely to all client communications. The emphasis on clear communication is designed to support the FSA's statutory objective to promote public understanding of financial products, which the FSA has continually identified as an area of weakness in its annual financial sector risk assessments.

This Principle has limited application to communications directed at eligible counterparties, requiring only that such communications are not misleading.

2.4.1.8 Principle 8: conflicts of interest

Principle 8 requires a firm to manage conflicts of interest fairly, both between itself and its customers and between a customer and another client. The FSA chooses its words carefully; eligible counterparties are "clients" but are excluded from the definition of "customer", so firms are expected to pay particular attention to the interests of private customers. No guidance is given under Principle 8 on how conflicts should be managed, but specific rules relating to disclosure, confidentiality and Chinese walls can be found in the conduct of business sourcebooks and MAR.[12]

As well as complying with the FSA's specific rules, a firm should consider implementing internal governance policies designed to

[10] *See* Chapter 5.
[11] *See* Chapter 5.
[12] *See* Chapters 5 and 6.

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identify and manage conflicts of interest likely to arise within its business. Examples of areas firms might wish to consider are disclosure of personal interests, guidelines on gifts, hospitality and other inducements, rules covering personal share dealings, express confidentiality provisions, declining to act and so on.

Principle 8 does not apply to eligible counterparties. Where it does apply, however, it applies in the "prudential context" to activities of a firm wherever they are carried on, and is not limited to activities carried on by a firm from an establishment in the UK. The prudential context means the context in which a firm's activities might or might seem to affect negatively either confidence in the financial system or the ability of the firm to meet regulatory provisions relating either to fitness or propriety or financial resources.

This disapplication of Principle 8 is qualified, however, since as a consequence of MiFID some conflict of interest provisions set out in SYSC 10 do apply to eligible counterparty business, so the disapplication of Principle 8 does not benefit a firm subject to that chapter of SYSC.

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2.4.1.9 Principle 9: customers: relationships of trust

Principle 9 requires a firm to take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely on its judgment. It is not limited to situations where a fiduciary relationship exists. Where advice is given to customers or discretion exercised on their behalf, firms must take reasonable care to ensure that advice given (including any advice given by an appointed representative) or discretionary decisions made, are suitable having regard to the customers' needs and situation. Again, the use of the term "customer" excludes eligible counterparties from the operation of this Principle. Detailed rules on suitability derive from this Principle and can be found in the conduct of business sourcebooks.[13]

2.4.1.10 Principle 10: clients' assets

Principle 10 requires a firm to make adequate arrangements for the protection of its clients' assets when it is responsible for them.

[13] *See* Chapter 5.

Detailed rules relating to client money and custody of client assets may be found in the Client Assets Sourcebook ("CASS"). Eligible counterparties which have entrusted client assets to another for safe custody are entitled to the same degree of protection as other clients.

2.4.1.11 Principle 11: relations with regulators

Principle 11 requires a firm to deal with its regulators in an open and cooperative way. The use of the plural here is intentional and includes overseas regulators as well as other UK regulators with jurisdiction over regulated activities, for example the Office of Fair Trading in relation to competition matters. Under Principle 11 firms are expected to advise the appropriate regulator of relevant matters even if these arise in unregulated parts of the business or unregulated group companies. However, this does not create a new obligation over and above that which already exists between the regulator and the firm. Further guidance is contained in the Supervision Manual ("SUP").

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This Principle applies generally throughout the routine processes of authorisation, supervision and enforcement. If tribunal processes are resorted to, where issues of natural justice may be relevant, the nature and extent of the obligation to communicate with the regulator will be determined by the tribunal.

Firms should have procedures in place to ensure that matters that the regulator would expect to be made aware of are brought to the regulator's attention at an early stage. Internal accountability for reporting such matters (and for deciding what will be reported) must be clearly defined.

2.4.2 The application of the Principles

A casual reader might expect "Principles for Businesses" to be self-evident and universal in their application but, in practice, the Principles are subject to a range of limitations (some of them already mentioned above).

2.4.2.1 General rules on application

The Principles apply to all firms with the following exceptions:

(a) The Principles do not apply to an incoming electronic commerce activity provider acting as such (detailed rules covering such firms may be found in the Electronic Commerce Directive Sourcebook ("ECO") in Block 5 Specialist Sourcebooks).
(b) In the case of incoming EEA or Treaty firms (that is, EEA firms "passporting" into the UK under the single market directives, and certain analogous situations) the Principles do not apply in respect of matters reserved to the firm's home state regulator (guidance on this matter is provided at Appendix 1 to SYSC).
(c) In the case of certain credit institutions that are incoming EEA firms, Principle 4 still applies to the liquidity of the branch in question (this reflects a provision of the Banking Consolidation Directive).
(d) For incoming EEA firms that are only providing cross-border services into the UK (i.e. they do not have a branch) the Principles do not apply at all.
(e) UCITS qualifiers are subject only to Principles 1, 2, 3, 7 and 8, and only in respect of communication and approval of financial promotions.
(f) A firm is not subject to a Principle to the extent that it would be contrary to the UK's obligations under a Single Market Directive. This proviso was introduced as a practical response to the somewhat complicated effect of the implementation of MiFID.

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The Principles generally apply only to regulated and, if a firm is authorised to carry on designated investment business, ancillary, activities. The Handbook defines an ancillary activity as any activity which is not itself regulated but which is carried on in connection with, or held out as being for the purposes of, a regulated activity. This suggests that a direct link to the regulated activity is required, so initial concerns that all unregulated activities might be deemed to be ancillary activities have not been realised.

The Principles do not therefore generally apply to the unregulated business of firms. Neither do they generally apply to group companies which are not themselves authorised. However, Principles 3 and 4 are exceptions to this general rule on the grounds that management, control and adequacy of resources can only be judged effectively by taking into account the operation of the firm as a whole, and that of

groups of which it is a member, including operations outside the UK. In the case of Principle 4, consideration of capital adequacy at group level is a European directive requirement for insurers, banks and investment firms.

The conduct of business and care of customers principles (primarily Principles 6 to 9) only apply in the UK and, in theory, do not apply in relation to business such as deposits and issuing electronic money where detailed conduct of business rules do not apply. However, there is no evidence of the FSA regarding these principles as inapplicable in such areas (e.g. TCF seems to be as relevant to banks' customers who have current accounts as to those with investment accounts).

All except the conduct of business and customer care principles (i.e. 6, 8 and 9 and most of 7) apply to inter-professional dealings but are "conditioned" by the conventions of those markets. Given that the Principles embody the FSA's fundamental standards, firms need to have regard to them even in areas where, on the face of it, they do not apply. The Principles also encapsulate the "suitability" test which is a prerequisite (Threshold Condition 5) for obtaining and maintaining authorised status, and serious violations have resulted in authorisation being withdrawn.

2.4.2.2 Applying the Principles to MiFID business

The implementation of MiFID during 2007 created particular practical difficulties for the FSA in terms of the application of the Principles. Former FSA managing director John Tiner described the Directive's "wealth of detailed provisions" as "hard to characterise as fully principles-based",[14] though MiFID does contain its own high level standards that are broadly consistent with PRIN. The differences lie in their application to different types of business, and transactions on regulated markets or in a multilateral trading facility. The FSA felt that to amend the rules in PRIN to accommodate these differences would undermine the status of PRIN as a clear, high-level set of principles that relate to outcomes and do not set out specific measures or means.

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[14] Speech on "Principles-based regulation: the EU context", 13 October 2006.

The FSA's response to this difficulty has been to introduce the high-level qualification to the Principles mentioned above, that a firm will not be subject to a Principle to the extent that it would be contrary to the UK's obligations under a Single Market Directive (PRIN 3.1.6R, applicable from 1 November 2007). This is then supplemented by a new Chapter 4 of PRIN, consisting entirely of guidance and cross-referring to rules in other modules which provide more specific information on the differential application of the Principles.

The territorial application of all the Principles except Principles 4, 5 and 11 is modified for MiFID investment firms. For a UK MiFID investment firm, their application is extended to equate to that of any applicable rule relevant to the activity in question. Thus, if a prescriptive rule covers an activity outside the normal territorial scope of a Principle, the Principle will apply notwithstanding. Similarly, where the normal territorial scope of a Principle would include a matter pertaining to an EEA MiFID investment firm, but MiFID reserves responsibility for the matter in question to the home state regulator, the Principle will not apply to that matter.

Under MiFID, conduct of business requirements are less stringent for eligible counterparty business and for transactions carried out on a regulated market or a multilateral trading facility. Where this is the case, Principles 1, 2, 6 and 9 do not apply for that business or those transactions. Further information about these limitations is contained in Appendix 1 of the new Conduct of Business Sourcebook.

Finally, as mentioned above, a firm may be subject to the provisions of Chapter 10 of the SYSC module, in which case it must observe conflict of interest provisions in respect of eligible counterparty business, notwithstanding that Principle 8 does not apply.

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2.5 Senior Management Arrangements, Systems and Controls

Principle 3 requires a firm to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems. The SYSC module of the Handbook contains important rules and guidance derived from this underlying principle.

SYSC has expanded considerably from its original form. During 2006, the FSA introduced high-level material on anti-money laundering, taking the place of the Money Laundering Sourcebook (now deleted), and in 2007 material on systems and controls sourced from MiFID and the Capital Requirements Directive ("CRD") was brought into SYSC together with other material formerly contained in the core prudential modules of the Handbook.

Having originally had four chapters, SYSC now has a total of eighteen, as follows:

- Chapter 1 – Application and purpose;
- Chapter 2 – Senior management arrangements;
- Chapter 3 – Systems and controls requirements;
- Chapter 4 – General organisational requirements;
- Chapter 5 – Employees, agents and other relevant persons;
- Chapter 6 – Compliance, internal audit and financial crime;
- Chapter 7 – Risk control;
- Chapter 8 – Outsourcing;
- Chapter 9 – Record-keeping;
- Chapter 10 – Conflicts of interest;
- Chapter 11 – Liquidity risk systems and controls;
- Chapter 12 – Group risk systems and controls;
- Chapter 13 – Operational risk: systems and controls;
- Chapter 14 – Prudential risk management and associated systems and controls;
- Chapter 15 – Credit risk management systems and controls;
- Chapter 16 – Market risk management systems and controls;
- Chapter 17 – Insurance risk systems and controls;
- Chapter 18 – Guidance on Public Disclosure Act: Whistle-blowing.

Appendix 1 to SYSC provides guidance on which matters are reserved to a home state regulator.

2.5.1 The application and purpose of SYSC

The application of different chapters of SYSC to a firm depends on whether the firm is a "common platform" firm. The common platform approach derives from the fact that both the CRD and MiFID contain high-level requirements relating to the organisation and

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governance of a firm that falls within their ambit. The requirements are differently formulated but they are broadly comparable. The FSA's approach to implementation of these aspects of the Directives was to create a unified set of reasonably high-level risk management and systems and controls requirements, applying to firms subject to both Directives, differentiated as necessary. These are described as the common platform requirements and are set out in Chapters 4 to 10 of SYSC. SYSC 4 to SYSC 9 are referred to as the common platform organisational requirements.

The application of Chapter 2 (senior management arrangements) of SYSC broadly follows that of the underlying Principles, that is, with exceptions for certain firms where a home state regulator has responsibility for prudential supervision under one of the Single Market Directives and (other than in a prudential context) unregulated activities. The provisions apply to activities carried on by firms in the UK, and in a prudential context for activities carried out worldwide by a firm to which the provisions apply, and taking into account the activities of other members of groups of which a firm is a member.

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Chapter 3 (systems and controls) does not apply to a common platform firm as the provisions of Chapter 3 are superseded for those firms by the common platform requirements with effect from 1 November 2007. However for other firms the application is the same as for SYSC 2.

Some specific provisions of SYSC 3 in relation to financial crime and money laundering are disapplied for certain activities and relate to the historical exemption of those activities from the scope of detailed anti-money laundering requirements. Those provisions are also disapplied for activities not carried on from an establishment in the UK and for unregulated activities. However, the high-level requirement to maintain effective systems and controls for this area still applies to a firm even if the detail does not apply by virtue of these disapplications.

Chapters 4 to 10, the common platform requirements, apply to a common platform firm, except that as with SYSC 2 and SYSC 3, they will not apply to an incoming EEA firm, with the proviso that UK branches of EEA MiFID investment firms must still comply with the

requirements of SYSC 9 on record keeping. Like SYSC 2 and SYSC 3, the common platform requirements apply to activities carried on outside the UK, and to unregulated activities, only in the prudential context and in that context will also take into account the activities of other group members.

As with firms not subject to the common platform, detailed requirements in respect of money laundering and financial crime (SYSC 6.3) do not apply to certain activities and in certain circumstances.

For SYSC 2, SYSC 3 and SYSC 9, the territorial scope of their application may be overridden if and to the extent that a relevant rule has a wider territorial scope.

SYSC 11 on liquidity risk applies to insurers (other than EEA-deposit insurers and Swiss general insurers), to BIPRU firms (BIPRU is the Prudential Sourcebook for Banking and Investment Firms, new in 2007) and to non-UK banks with branches in the UK. The Chapter is derived from material previously in PRU (now repealed).

SYSC 12 on group risk systems and controls applies to most credit institutions, investment firms and regulated insurance entities, but not to incoming EEA firms, incoming Treaty firms, UCITS qualifiers or Investment Companies with Variable Capital ("ICVCs"). The application varies according to the type of group that is under consideration.

SYSC 13 to SYSC 17 apply only to insurers, excluding incoming EEA firms. For EEA-deposit insurers and Swiss general insurers, these provisions apply only with respect to their operations in the UK; for other insurers the application is worldwide. This material was formerly located in SYSC 3A and in PRU. SYSC 18 relates to the Public Interest Disclosure Act 1998 ("PIDA 1998") and applies to firms to the extent that Act applies to them.

As is the case with PRIN, incoming electronic commerce activity providers acting as such are not subject to SYSC. Rules and guidance for such firms are contained in ECO in Block 6 Specialist Sourcebooks.

The purpose of rules and guidance in SYSC is set out in SYSC 1.2.1G as follows:

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(a) to encourage firms'directors and senior managers to take appropriate practical responsibility for their firms' arrangements on matters likely to be of interest to the FSA because they impinge on the FSA's functions under the Act;
(b) to increase certainty by amplifying Principle 3, under which a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems;
(c) to encourage firms to vest responsibility for effective and responsible organisation in specific directors and senior managers;
(d) to create a common platform of organisational and systems and controls requirements for firms subject to the CRD and/or MiFID; and
(e) to set out high-level organisational and systems and controls requirements for insurers.

SYSC also has the purpose (in Chapter 18) of reminding affected firms of the requirements of PIDA 1998 (protecting employees against reprisals for whistle-blowing) and encouraging the establishment of systems for communication with employees in respect of their concerns.

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2.5.2 Apportionment of responsibilities

SYSC 2.1.1R requires a firm (other, obviously, than a sole trader with no employees) to take reasonable care to maintain clear and appropriate apportionment of significant responsibilities among its directors and senior management team so that:

(a) it is clear who is responsible for what; and
(b) the business of the firm can be controlled by directors, relevant senior managers and the governing body of the firm.

The implications of these requirements are quite wide ranging. Firstly, responsibilities for all areas of business have to be allocated to specific directors or senior management. This will require great care where responsibilities meet and overlap or where responsibilities are shared. Secondly, all areas of responsibility have to be assigned, which implies that there must be, underlying the apportionment of

responsibilities to individuals, an assessment of all areas of risk affecting the business. There is no requirement that this risk assessment should be formalised (it could be left to the judgment of the chief executive), but it may be easier to demonstrate that reasonable care has been taken in accordance with Principle 3 if a formal and objective risk assessment process is adopted.

2.5.2.1 Responsibility for apportionment – the role of the chief executive

Clearly, the responsibility for apportioning responsibilities must itself be given to someone. SYSC 2.1.3R requires a firm to allocate to one or more individuals the responsibility to:

(a) apportion responsibilities to other directors and senior managers as required by SYSC 2.1.1R; and
(b) oversee the establishment of effective systems and controls within the firm.

These, known together as the "apportionment and oversight" function, are a key aspect of the senior management of a firm and constitute a controlled function, meaning that they must be performed by an approved person. Normally, the FSA expects that this will be the firm's chief executive. However, this expectation is not a hard and fast rule and the table in SYSC 2.1.4R sets out a number of permissible variations, depending on the type of firm and the persons by whom and to whom allocation may be made.

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A chief executive need not allocate all responsibilities to other directors or senior managers. He may reserve some of these responsibilities for himself. The chief executive need not be involved in the discharge of all responsibilities. He has a responsibility to oversee the execution of these responsibilities, which he could do by direct monitoring or with the assistance of internal audit or the risk management department. He need play no part at all in those areas of corporate governance such as the audit committee where it would be contrary to good practice for him to be involved.

If the firm is managed by a management committee the apportionment and oversight function can be assigned to the committee so that each member of the committee is jointly responsible. If the firm has a chief executive who is not a member of the management committee, joint responsibility must also be assigned to that person.

2.5.2.2 Branches of non-UK firms

The position in respect of non-UK firms operating in the UK varies depending on whether they are EEA firms.

Non-EEA firms must apportion responsibilities for systems and controls applicable to the activities carried on in the UK establishment. These firms must allocate responsibility to the chief executive. "Chief executive" means, in the case of an overseas firm, the person responsible for the firm's business in the UK. That is a question of fact in any given case – it might be the manager of the UK establishment, or it could be the chief executive of the firm as a whole if he has that responsibility.

EEA firms with a branch in the UK are not required to allocate the apportionment function. They must still assign the oversight role, but not necessarily to the chief executive and only in respect of oversight of those systems and controls, the supervision of which is the responsibility of the FSA as host state supervisor. Annex 1G to Chapter 13 of SUP contains a summary of the Handbook elements that apply to incoming EEA firms; this relates primarily to the systems and controls over the conduct of business carried on from the UK branch.

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2.5.3 Recording the apportionment

A firm must make a suitable record of its arrangements:

(a) to apportion responsibility for particular risks to individual directors and senior managers under SYSC 2.1.1R; and
(b) to allocate the responsibility for that apportionment and the responsibility to exercise oversight over systems and controls under SYSC 2.1.3R.

Such records must be kept for at least six years after they have been superseded by new records. Material changes need to be reflected as soon as is practicable. Firms should have established procedures to review the records on a regular basis so that they can demonstrate reasonable care in keeping them up to date.

These records need not be prepared specially for the purpose, and indeed using records that are kept for other purposes would be

consistent with the FSA's preference of embedding high level standards in a firm's day-to-day operations. The types of record envisaged are:

(a) organisation charts;
(b) project management documents;
(c) job descriptions; and
(d) committee terms of reference.

Senior management relationships and responsibilities are usually subtle and complex, reflecting individual personalities, competences and rivalries, and can change quite rapidly in response to the pressures of the business. Chief executives may need to realign the responsibilities of their team to reinforce areas of weakness or to remove responsibility from an officer who has failed to perform a particular task, and it may be difficult to reflect these important realities in the records. There is a natural risk that individual responsibilities at top management level will be poorly defined or not defined at all, as a result of chief executive officers or boards being unwilling or unable to address management issues in a proper manner. The requirement for clear and recorded apportionment aims to contain this risk.

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2.5.4 *Systems and controls*

Apart from the rules relating to the allocation and apportionment of senior management responsibilities, SYSC 3.1.1R requires firms to take reasonable care to establish, maintain and monitor systems and controls over other aspects of their business. The required systems and controls must be commensurate with:

(a) the nature, scale and complexity of the business;
(b) the diversity of the operations;
(c) the volume and size of transactions; and
(d) the degree of risk associated with the operations.

The high-level guidance on systems and controls provided relates to typical organisational structures but this guidance is neither exclusive nor exhaustive. Different classes of firm will require different approaches to systems and controls. Where a firm is subject to the Combined Code prepared by the Committee on Corporate

Governance, the FSA will grant credit for compliance with the provisions of the Code.

Firms need to be aware that provisions elsewhere in the Handbook set out detailed requirements regarding systems and controls relevant to particular business areas or particular types of firm, though from 2007 a number of requirements have been brought together in the expanded SYSC. Compliance with SYSC will not necessarily ensure that a firm is compliant with provisions elsewhere in the Handbook.

The FSA will expect the firm to have in place procedures to ensure that its systems and controls are kept under regular review. This review should be designed to ensure that systems and controls have kept pace with developments in the marketplace and within the business. The firm should also obtain regular confirmation that systems and controls are being operated effectively. This assurance can be gained by:

(a) departmental self-assessment;
(b) internal and external audit;
(c) compliance review; and
(d) risk-management processes.

Key exceptions identified by means of these processes should be reported to senior management and remedial actions monitored to see that they are implemented effectively.

Section 3.2 of SYSC identifies specific areas that the FSA would normally expect a firm to address in its policies on systems and controls. Much of this section consists of high-level rules supported by extensive guidance (requirements for systems and controls in relation to compliance, financial crime and money laundering have a greater emphasis on rules). For those aspects of the section relying on guidance, the guidance does not require systems and controls to be in writing, or to be communicated or reviewed in any specific way, but its nature implies for many firms that there should be substantial formality surrounding these matters:

(a) *Organisation* – reporting lines and responsibilities should be clearly defined and communicated within the firm. Where

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responsibility is delegated to employees or appointed representatives the firm should assess whether the recipient is suitable to carry out the delegated responsibility. Limits to delegated authority should be set. There should be procedures in place to supervise and monitor the delegation of responsibility and follow-up action should take place where there is a cause for concern.

Similar processes should apply to delegation to an outsource supplier. The FSA has paid particular attention to outsourcing, regarding this as a potential area of weakness in firms' risk management. A firm cannot contract out of its regulatory obligations so it needs to ensure that it properly assesses the impact of outsourcing on its systems and controls, and that it properly supervises the discharge of functions outsourced to a contractor.

Where appropriate, delegated responsibilities should be properly segregated. For instance, no one individual should be responsible for initiating, processing and controlling a transaction.

For overseas banks, at least two individuals must effectively direct the branch's business. This rule (SYSC 3.2.5A) has been transferred from the Interim Prudential Sourcebook for Banks and is now resident in SYSC 3 because overseas banks are not captured by the common platform.

(b) *Compliance, financial crime and money laundering* – it is a rule (SYSC 3.2.6R) that the firm must monitor procedures to ensure compliance with regulatory requirements and to ensure that the facilities of the firm are not used to facilitate financial crime.

"Financial crime" is referenced back to Section 6 of FSMA 2000 and includes not only money laundering and handling the proceeds of crime, but also any offence involving fraud or dishonesty and market abuse.

Specific material (SYSC 3.2.6AR–6JG) sets out senior management responsibilities in respect of money laundering, including a requirement to designate a director or senior manager as responsible for the establishment and maintenance of effective anti-money laundering systems and controls (SYSC 3.2.6.HR), and to appoint a Money Laundering Reporting Officer ("MLRO") with suitable authority, independence and resources

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(SYSC 3.2.6IR). The MLRO is a controlled function under Chapter 10 of SUP. These two functions may be carried out by the same individual, but this is not a requirement. Firms also have anti-money laundering obligations beyond the Handbook, under the Money Laundering Regulations, the Terrorism Act 2000 and the Proceeds of Crime Act 2002. *See* Chapter 7 for further information on the Handbook's requirements in respect of anti-money laundering.

A firm which carries out designated investment business with or for customers (i.e. clients other than eligible counterparties) must allocate to a director or senior manager the duty of overseeing the firm's compliance procedures (SYSC 3.2.8R). This person must report directly to the firm's governing body. In respect of this rule, "compliance" means at a minimum the rules in the Conduct of Business, Collective Investment Schemes, New Collective Investment Schemes and Client Assets Sourcebooks. This is the "compliance oversight function" referred to in Chapter 10 of SUP.

It may be appropriate for any firm to have a separate compliance department, but this is not required in every case. If a firm does have a compliance function its organisation and responsibilities should be documented, it should be staffed by a sufficient number of competent individuals, it should be independent and it should have access to relevant records and ultimate recourse to the firm's governing body.

(c) *Risk assessment* – where appropriate a firm should have a risk assessment function. The decision as to whether it is appropriate to designate a separate function will have regard to the nature, scale and complexity of the firm's operations. The organisation and responsibilities of this function should be documented, adequately resourced and independent of operational areas.

(d) *Management information* – firms should have arrangements in place to ensure that the firm's governing body, and those others whom the firm considers necessary, receive on a relevant, reliable and timely basis the information that they need for the purposes of identifying, assessing and managing risks of regulatory concern. "Regulatory concern" here relates to the FSA's statutory objectives,

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that is, fair treatment of customers, protection of consumer confidence in the financial system and the fight against financial crime.

(e) *Employees and agents* – firms should have in place personnel procedures to ensure as far as is practicable that employees and agents are competent and honest. Honesty should be assessed at the commencement of employment; competence at the outset and subsequently. Those individuals carrying out controlled functions are also required to meet suitability criteria as Approved Persons (the Training and Competence Sourcebook and Approved Persons regime are discussed in Chapter 3 below).

(f) *Audit committee* – it is for the firm to decide whether to have an audit committee, though for larger businesses the establishment of an audit committee would be expected. It should have clear terms of reference and an appropriate non-executive element.

(g) *Internal audit* – depending on the nature, scale and complexity of its operations, it may be appropriate for a firm to have an internal audit function, which may play an important role in monitoring the appropriateness and effectiveness of its systems and controls. An internal audit function should have clear responsibilities, adequate powers and an appropriate reporting line.

(h) *Business strategy* – all firms are required to plan their business effectively. Planning means the process of identifying, measuring and controlling risks. For larger firms these plans should be documented and updated regularly.

(i) *Remuneration policies* – it is possible for these to create a tension between personal gain and compliance with the regulatory systems, and such tensions should be appropriately managed. For example, strong controls should be in place to supervise traders or salesmen who are highly incentivised. The FSA's material on TCF is relevant to this aspect of systems and controls.

(j) *Business continuity* – a firm should have plans in place to enable it to continue to function and to meet its regulatory obligations in the event of disruption to normal service. These plans should be reviewed and tested regularly. As is also the case with some other aspects of SYSC 3, a firm may wish to refer to guidance given by the FSA in the common platform chapters of SYSC; SYSC 4.1.8G provides an indication of what the FSA expects a business continuity policy to cover.

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(k) *Records* – every firm is subject to a general requirement (SYSC 3.2.20R) to make and retain adequate records of matters and dealings that are the subject of requirements and standards under the regulatory system. The Handbook contains a wide variety of specific record-keeping requirements; time limits vary and are set out in the relevant modules of the Handbook. By convention, Schedule 1 to each module provides a non-authoritative summary of that module's record-keeping requirements. At the high level the FSA requires these records to be:

(i) kept in English, unless they relate to business carried on overseas;
(ii) accessible;
(iii) retained for an appropriate period of time; and
(iv) held securely.

2.5.5 Rules for common platform firms

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As mentioned above, Chapters 4 to 10 of SYSC implement the high-level organisational and systems and controls requirements of the CRD and MiFID for firms subject to these Directives. The FSA's approach to these Directives has been to "copy out" the requirements from the English-language version of the Directives and implementing measures, with minimal amendment to language to make the material appropriate for insertion into the Handbook, each rule being annotated with its source in the Directive in question. The FSA has added limited additional guidance. Its attitude remains that it is for a firm's management to decide how best to meet high-level requirements.

The contents of the common platform chapters are broadly similar to the analogous provisions of SYSC 3 for non-common platform firms. The material is organised as follows:

(a) *General organisational requirements* – SYSC 4.1 requires a firm to have robust governance arrangements, with clear reporting lines and responsibilities and systems and controls appropriate to the nature, scale and complexity of the firm's business. These systems and controls should be adequate to permit monitoring of compliance with internal and external requirements, and their continuing adequacy should also be monitored.

This section also requires a business continuity policy, to ensure that the firm's regulated activities will continue in the event of disruption.

There is a specific requirement for appropriate accounting policies and procedures to be adopted, to enable reporting to the FSA on a true and fair basis.

Finally this section deals with the possiblility of establishing an audit committee. The FSA has retained for common platform firms its guidance in SYSC 3 on this matter.

(b) *Senior management* – SYSC 4.2 and 4.3 set out requirements for the senior personnel of a common platform firm. SYSC 4.2 requires senior personnel to be of good repute, a requirement broadly similar to the Threshold Condition requirements and Approved Persons requirements (*see* below). This section also requires a common platform firm (other than a sole trader or a body corporate controlled by a single person) to be managed at the top level by at least two persons, a requirement analogous to that applied to overseas banks by SYSC 3.2.5A and mentioned above.

SYSC 4.3, which applies to MiFID investment firms, establishes the responsibility of senior management for ensuring compliance, and sets out requirements for formal reporting on risk and compliance matters to enable the discharge of this responsibility.

(c) *Employees, agents and other relevant persons* – SYSC 5 requires common platform firms to ensure that personnel have the appropriate skills, knowledge and expertise, that appropriate segregation of duties is applied including between internal audit (where outsourced) and external audit, and that relevant persons are aware of the procedures to which they are subject for the proper discharge of their responsibilities.

This chapter also requires systems, internal controls and arrangements relevant to this area to be appropriate to the nature, scale and complexity of the firm's business, and to be monitored and regularly re-evaluated for adequacy and effectiveness.

(d) *Compliance* – Chapter 6 of SYSC establishes rules on compliance. Under rules in SYSC 6.1, analogous to SYSC 3.2.6R, the firm must establish and maintain procedures appropriate to the nature, scale and complexity of the firm, to ensure compliance

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with regulatory requirements and to ensure that the facilities of the firm are not used to facilitate financial crime.

This chapter also requires a common platform firm to establish an appropriately resourced compliance function and internal audit function, with appropriate responsibilities and reporting lines. SYSC 6.1.4R lays down specific requirements, including a requirement to appoint a compliance officer, independence of the compliance function from the activities on which they report, and a requirement that the manner in which the remuneration of persons involved in compliance is determined does not compromise their objectivity and is not likely to do so. The final two of these requirements, relating to independence and remuneration, may be disregarded (SYSC 6.1.5R) where a firm can demonstrate that they are not proportionate given the nature, scale and complexity of its business and the nature and range of its investment activities. However a compliance officer must still be appointed, and the firm must be able to demonstrate that its compliance function remains effective.

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Financial crime is dealt with in SYSC 6.3. These requirements do not copy out MiFID or CRD requirements but reflect the requirements for non-common platform firms in SYSC 3.

(e) *Risk control* – SYSC 7 expands on the high-level requirements of SYSC 4 in respect of identification and management of risks. It imposes on senior personnel a requirement to approve and periodically to review the firm's processes in this area, including those relating to risks posed by the macroeconomic environment.

Specific requirements are imposed in respect of the management of credit risk, market risk and operational risk. Residual risk, the risk that a credit risk mitigation technique will not be as effective as expected, is also specifically covered.

(f) *Outsourcing* – Section 8.1 sets out requirements in respect of outsourcing generally. These include specific conditions that a common platform firm must observe when entering into an outsourcing arrangement. MiFID investment firms are also subject to additional requirements (SYSC 8.2 and 8.3) when outsourcing portfolio management for retail clients to a non-EEA state. Such arrangements require prior notification to the FSA, and the FSA may object to the proposed arrangement

within one month. The firm should have already completed its due diligence and concluded that the proposed arrangement is suitable, before it sends the formal notice to the FSA. For a significant outsourcing arrangement, the firm might well already be in correspondence with the FSA concerning its intentions, in the spirit of Principle 11.

(g) *Record keeping* – MiFID established minimum record-keeping requirements for MiFID business, which are broadly similar to those referred to above for non-common platform firms. They are dealt with in SYSC 9. A principles-based approach is applied to non-MiFID business of common platform firms.

The Committee of European Securities Regulators ("CESR") has issued recommendations on minimum records to comply with the MiFID requirements, and these are available on the CESR website.

(h) *Conflicts of interest* – MiFID imposes conflict of interest requirements which go beyond the requirements of Principle 8, as mentioned above. These provisions are contained in SYSC 10. They apply to all regulated activities or ancillary activities or provision of ancillary services constituting MiFID business, that are carried on by a common platform firm. This applies regardless of the status of the client.

A firm must identify, record and manage conflicts of a type that fall within this chapter of SYSC, and where its arrangements do not provide adequate confidence that risk of damage to clients will be prevented, the rules require pre-disclosure of the conflicts.

To facilitate compliance with these requirements, the firm must establish and maintain a policy on conflicts of interest, and SYSC 10.1.11R sets out the minimum requirements for that policy. Additional guidance as to policy content is provided for the case of securities offerings by common platform firms.

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2.5.6 Liquidity risk management

SYSC 11 deals with liquidity risk systems and controls, a matter of particular prominence at the time of writing due to events in the inter-bank liquidity markets in the second half of 2007 and the impact

of the consequent shortage of inter-bank liquidity on individual institutions. Public perception of a shortage of liquidity can be very damaging to a firm, even if its solvency is not in question. Firms will doubtless be examining the events of 2007 in a bid to determine whether their liquidity risk systems and controls are adequate in such scenarios.

SYSC 11 applies broadly to insurers, credit institutions and investment firms. It takes the first six paragraphs of the chapter to set out the detail of the application and it is not feasible to repeat or summarise these here.

Although SYSC 11.1.3R provides that this chapter does not apply where the relevant matter is reserved to a home state supervisor under a Single Market Directive, the general position of those Directives is that liquidity management in a branch is a matter for the host state supervisor. Accordingly, incoming EEA firms with branches in the UK are subject to the requirement. However, where an incoming firm can satisfy the FSA that its home state supervisor provides adequate supervision of this aspect of risk management, it may apply for a waiver of the relevant application rule (SYSC 11.1.1(3) for incoming EEA firms and SYSC 11.1.1(4) for third country BIPRU firms). A number of such waivers have been given.

Apart from two rules applicable to BIPRU firms, which copy out provisions of the Banking Consolidation Directive and require subject firms to maintain liquidity policies and contingency funding plans, the chapter consists mainly of guidance dealing with different aspects of liquidity risk, including liquidity risk policy and management. Liquidity risk can affect both sides of the balance sheet and this section refers to liability liquidity risk as well as asset liquidity risk. The guidance is supported by evidential provisions relating to scenario analysis and stress testing, to limit testing and to contingency funding plans. In each of these cases failure by a firm to comply with the standards set out may be relied upon to establish contravention of the higher-level risk management rules in GENPRU.

Prior to 1 January 2007, this material was dealt with in the Integrated Prudential Sourcebook ("PRU") at Chapter 5. Its transposition to SYSC was part of a general move of systems and controls material

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from PRU which occurred when that module was replaced by GENPRU, INSPRU, MIPRU and UPRU (*see* Chapter 4).

2.5.7 Group risk management

SYSC 12 provides rules and guidance in relation to systems and controls in the context of a group. "Group" does not only include financial services undertakings, and the scope of these systems and controls provisions may therefore differ from the scope of quantitative financial group capital adequacy provisions. The material was previously located at PRU 8.1.

SYSC 12 does not apply to incoming EEA or Treaty firms, UCITS qualifiers or ICVCs. With those exceptions, the rules apply to:

(a) all regulated entities (credit institutions, insurance undertakings and investment firms, whether or not headquartered in the EEA);
(b) electronic money institutions;
(c) insurers;
(d) BIPRU firms;
(e) non-BIPRU firms that are parent financial holding companies in an EEA state and also members of UK consolidation groups;
(f) any firm subject to the consolidated supervision provisions of Interim Prudential Sourcebook for Investment firms;
(g) UCITS firms that are members of groups containing one of the other types of firms in the list; and
(h) the Society of Lloyd's.

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A firm is required to have adequate processes and controls for assessing and managing its exposure to group risk, as well as for providing the necessary data for doing so and for making any required reports of group capital adequacy.

Firms that are members of certain groups must also ensure that the group of which they are a member also has adequate risk management processes and controls, and is able to monitor funding in the group. This additional requirement applies where the group's interest in the firm is more than a participation and the group falls into one of the following categories:

(a) an FSA-regulated EEA conglomerate; or
(b) a banking, investment or insurance group headed in the EEA where the FSA has not agreed that another supervisor is responsible for the supervision of the group.

One effect of these limitations is that the additional requirement does not apply in the case of "third-country groups", that is, where the ultimate financial parent undertaking is outside the EEA. However, such a group may well contain an EEA sub-group to which the requirements will apply.

The rules draw a distinction between a financial group and a mixed-activity group (one that is not predominantly a financial group). Where a financial group is a sub-group of a mixed-activity group, however, the risk management processes and internal control mechanisms of a firm that is a member of that group should be adequate to monitor transactions between the members of the financial group and the wider group. In the case of banking or investment groups or conglomerates, the application of this requirement is limited to the two classes of group identified above. However, insurance firms are subject to this requirement whether or not the group meets those criteria.

The remaining guidance in this chapter indicates that in some groups, systems and controls may be organised on a group basis. The FSA clarifies that it does not expect firms in such groups to duplicate their processes. However, it does note that a firm retains responsibility for ensuring that its processes, systems and controls are adequate.

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2.5.8 Rules specific to insurers

SYSC 13 to SYSC 17 represent the material on operational risk, prudential risk management, credit risk management, market risk management, and insurance risk systems and controls that were previously contained in SYSC 3A and PRU 6.1, and in PRU sections 1.4, 3.1, 4.1 and 7.1 respectively. These chapters apply only to insurers, other than non-directive friendly societies and incoming EEA and Treaty firms. As far as concerns EEA-deposit firms and Swiss general insurers, they apply only to activities carried on from a UK branch (which means that other types of third-country insurer should

comply on a global basis). Chapter 13 on operational risk also applies to insurance special purpose vehicles ("ISPVs").

2.5.8.1 Operational risk – SYSC 13

This chapter consists only of guidance. It is intended to guide insurers in applying other provisions of SYSC in the context of operational risk, for which the FSA quotes the Basel Committee definition of operational risk as "the risk of loss, resulting from inadequate or failed internal processes, people and systems, or from external events". It also aims to draw together references to other Handbook provisions relevant to that context, such as the obligation to notify the regulator (Principle 11). It includes generic and specific examples of possible operational risk exposures for firms to consider, and commentary on other Handbook requirements, under the following specific heads:

(a) *People* – operational risks can arise from employees, including employees of a supplier to which functions have been outsourced. Examples of such risks that could result in operational loss include: variations in operational risk culture across an organisation; the impact of remuneration policies on operational risk awareness; inadequate or inappropriate training; potential non-compliance with employment law and regulations; inadequate plans in the event of employee unavailability or loss; and the impact on operations of matters such as overtime, sickness and employee turnover.

    Firms need to ensure that employees have appropriate skills and awareness for their operational risk-management responsibilities. In assessing this matter, firms need to consider whether their systems and controls are adequate to provide for appropriate segregation of duties, supervision of employees, clarity of requirements and properly enforced disciplinary measures. These points are particularly important in the case of those who represent an enhanced operational risk potential, such as approved persons, those in positions of great personal trust and those in positions requiring significant technical competence such as derivatives trading or reinsurance underwriting.

(b) *Processes and systems* – a firm should have appropriate systems and controls to manage its operational risk exposure to inadequacies or failures in its processes or systems, and those of its agents, suppliers and other third parties if appropriate.

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In assessing its exposure a firm needs to have regard to the importance and complexity of its systems, the controls that enable it to prevent or detect and promptly rectify system and process failures, the suitability of its systems and processes for ensuring compliance with regulatory and other requirements, its arrangements for business continuity in the event of failure of a key process or system, and the extent to which it monitors metrics that could indicate system or process risk (e.g. reconciliation exceptions, compensation payments and documentation errors).

A firm's considerations in respect of this aspect of its operational risk management should cover the adequacy of internal documentation, the reliability of external documentation (and the adequacy of its scrutiny of that documentation), the appropriateness of its systems and controls for managing IT system risks, the security of its information and the operational impact of any differences in processes and systems in different locations.

(c) *External events and other changes* – a firm's systems and controls should be adequate to cope with heightened operational risk arising from events external to the firm (for example, a takeover or merger, or a crisis) and other major changes to the operating environment (for example, a major re-engineering of business processes). The systems and controls should be adequate to manage the response to the event and (in the case of foreseeable changes) to manage the change itself and its consequences.

Specific guidance is provided on the matter of business continuity management. The FSA expects firms to identify their exposures to events that could threaten the continuity of business and to develop, document and keep under review a business continuity plan. Firms should aim to control both the likelihood of an event interrupting business continuity, and its impact.

(d) *Outsourcing* – the FSA views outsourcing as a potential source of operational risk because of the reduced control that it implies over the people, processes and systems involved in the operations of the firm. Firms should therefore consider the appropriateness of outsourcing, and exercise diligence in supervising the discharge of outsourced activities.

The FSA provides guidance on the approach that it expects a firm to adopt towards material outsourcing arrangements. These include that a firm should:

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(i) notify the FSA before entering into the arrangement;
(ii) analyse the expected impact of the arrangement on its operations (including its structure, business processes, risk profile, and risk monitoring and management);
(iii) conduct suitable due diligence on the outsource provider (even if it is a regulated undertaking);
(iv) ensure that the arrangement provides for all necessary rights and responsibilities to enable the firm to discharge its regulatory responsibilities; and
(v) ensure that the arrangement provides for performance monitoring, contingency plans and other features to enable the firm to manage its exposure to the outsource provider.

A firm cannot outsource its regulatory responsibilities, including its responsibilities under PRIN and SYSC, and it therefore remains responsible to the FSA for the activities of the outsource provider that touch upon regulation under FSMA 2000.

(e) *Insurance* – a firm may use insurance to manage its operational risks, but should be alert to the limitations of insurance, including exclusions and policy limits, exposure to the insurer, potential delays in settlement, and the fact that insurance is of limited benefit in managing reputational risk.

2.5.8.2 Prudential risk management and associated systems and controls – SYSC 14

The purpose of SYSC 14, which consists mostly of guidance, is to set out provisions relating to the establishment and maintenance of systems and controls for the management of those risks of an insurer that could threaten the adequacy of its financial resources and thereby the stability of the financial system or the interests of consumers. The chapter covers a number of issues, including:

(a) the delegation of responsibilities;
(b) prudential risk management within a group;
(c) the need for business planning;
(d) the organisation of risk management;
(e) the role of internal audit;
(f) management information; and
(g) the need for records.

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While most material is guidance (though still of importance as an indication of the FSA's expectations) there are some specific rules, including a requirement to establish and maintain a documented business plan. The business plan must include a description of the firm's policies for market, credit, liquidity, operational, insurance and group risk, as well as documenting the systems and controls, financial accounting policies and a description and justification of the methods and assumptions used in financial projections and in stress testing and scenario analysis. These rules (SYSC 14.1.18R–19R) provide a reference point on which much of the guidance in the following chapters and some of the foregoing ones is based.

The rules in this chapter also include a requirement to establish and maintain adequate internal controls, and a requirement to make and retain in the UK accounting and other records that will enable the firm to demonstrate to the FSA that it is financially sound and compliant with the rules in PRU. Where activity is carried on outside the UK, the records may be maintained in the country where the activity is carried on, but must be periodically summarised and the summary sent to the UK.

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2.5.8.3 Credit risk management and systems and controls – SYSC 15

SYSC 15 contains guidance on credit risk management systems and controls. The guidance expands on the more general requirements of SYSC 14, discussing particular aspects of credit risk and actions that an insurer can take, including counterparty assessment, risk measurement, risk monitoring, identifying and dealing with problem exposures, provision and risk mitigation.

2.5.8.4 Market risk management and systems and controls – SYSC 16

Similarly to SYSC 15 for credit risk, SYSC 16 contains guidance on market risk management to supplement the high-level requirements of SYSC 14. It too consists entirely of guidance.

2.5.8.5 Insurance risk management and systems and controls – SYSC 17

SYSC 17 also consists entirely of guidance. Insurance risk means the risk of fluctuations in the timing, frequency and severity of insured events relative to the expectations of the firm at the time of underwriting, as well as fluctuations in the amount and timing of claim settlements. The chapter deals with issues such as establishing risk

appetite, reacting to events, monitoring and controlling risk (including the examination of policy wordings, the setting and maintenance of underwriting limits, and the use of reinsurance and other forms of risk transfer) and record keeping. An insurer may need to retain records for a very long period if they are needed to inform pricing or provisioning decisions.

2.5.9 Public Interest Disclosure Act 1998

Chapter 18 of SYSC reminds firms of their obligations under PIDA 1998, under which workers are protected against action arising from the making by them of protected disclosures. The FSA encourages firms to put in place appropriate procedures to encourage workers to "blow the whistle" internally on matters that are of relevance to the FSA. The FSA suggests some procedures that could be appropriate for larger and for smaller firms. Firms should also consider telling workers that they can blow the whistle directly to the FSA.

The FSA also reminds firms that any action to the detriment of a person making a protected disclosure in an area relevant to the FSA is viewed very seriously and could call into question the fitness and propriety of the person taking that detrimental action and the continued suitability of the firm under the threshold conditions.

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2.6 The threshold conditions

To carry on a regulated activity, a firm must (if it is not an exempt person) become an authorised person by obtaining permission from the FSA under Part IV of FSMA 2000. The authorisation process is dealt with in Chapter 8 of this Guide. This section deals only with the "threshold conditions" set out in Schedule 6 to the Act, which, under Section 41, an applicant must satisfy before it may be granted a Part IV permission.

COND provides high-level guidance on the application of the threshold conditions to the granting of permission, the varying of permission and the withdrawal of permission. Greater detail on the practical application of the threshold conditions is available in SUP. Other guidance relevant to this topic, formerly located in the now repealed

Authorisation and Enforcement Manuals, is now found in the Perimeter Guidance Manual ("PERG") and Enforcement Guide ("EG") – not technically Handbook text but still having the status of official guidance issued under Section 157 of FSMA 2000.

2.6.1 The threshold conditions

As noted above, the threshold conditions are set out in Schedule 6 to FSMA 2000 but they are reproduced in Chapter 2 of COND. The "additional conditions" are not specified in Schedule 6 but are prescribed by the Treasury under the authority of that Schedule. The full list of conditions is as follows:

(a) 1: legal status;
(b) 2: location of offices;
(c) 2A: appointment of claims representatives;
(d) 3: close links;
(e) 4: adequate resources;
(f) 5: suitability;
(g) additional conditions.

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The applicability of the threshold conditions is limited in some cases: conditions 2 and 2A do not apply to incoming EEA firms or Treaty firms, and the other conditions only apply to such firms in respect of "top-up" permissions (i.e. permissions to carry on regulated activities other than those permitted under passporting or treaty rights). Conditions 3, 4 and 5 do not apply to Swiss general insurers. Condition 2A applies only to motor liability insurers, and the additional conditions only apply to non-EEA applicants seeking to carry on insurance activity in the UK.

"Firm" in this context includes applicants for Part IV permission (that is, persons who will become firms if the permission is granted).

The threshold conditions include both questions of fact and questions of judgment. In the latter case it is necessary to look for guidance as to how the FSA will interpret the requirements. In addition to the guidance in COND, in the Regulatory Processes block and in PERG, there is now a corpus of precedents to consult, as when the FSA refuses or withdraws permission it publishes the reasons for its decision in a Notice.

2.6.1.1 Legal status
If an applicant seeks permission to carry out insurance business then the applicant must be a body corporate (but not a limited liability partnership), a registered friendly society or a member of Lloyd's. In practice, active members of Lloyd's are not individually authorised, and the FSA exercises supervision at syndicate and at market level.

If an applicant seeks permission to carry on deposit-taking business or issuing electronic money, then the applicant must be a body corporate or a partnership.

These restrictions are required to comply with European directives. Apart from these restrictions Section 40 FSMA 2000 provides that an application to the FSA for permissions may be made by:

(a) an individual;
(b) a body corporate;
(c) a partnership; or
(d) an unincorporated association.

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2.6.1.2 Location of offices
If the applicant is incorporated in the UK, its head office and its registered office (if any) must be in the UK. A slightly different provision applies to those seeking to undertake insurance intermediation activity; in that case it is possible for an applicant to be incorporated and have its registered office in the UK but its head office elsewhere. However, if it has a registered office that office must be in the UK, and if it does not then its head office must be in the UK.

If the applicant is a person but not a body corporate and its head office is in the UK, it must carry on business in the UK.

These provisions implement the requirements of the so-called "Post-BCCI Directive" and are designed to prevent, for example, the establishment of an authorised entity in the UK to carry on business exclusively offshore. In the case of insurance mediation, the underlying Directive requirements are different, hence the difference in the provisions for such firms.

The major practical difficulty with these requirements is how to determine the nature of activities constituting a head office and the location

at which these activities are carried out – this is not defined in either the Directives or the Act. In the case of a natural person applying to carry out insurance mediation, the question is determined by reference to the person's residence. Otherwise, the FSA approaches this question on a case-by-case basis. The "head office" of a firm is not necessarily its place of incorporation or even where its business is mainly carried on. The FSA looks more to the location of the firm's central decision-makers and its central administrative functions.

2.6.1.3 Appointment of claims representatives

Threshold condition 2A arises from the obligations of the UK under European motor insurance directives. If an applicant for permission proposes to carry on motor liability insurance business, it must have a claims representative in every other EEA state. Further rules and guidance are contained in ICOB, the Insurance Conduct of Business Sourcebook.

2.6.1.4 Close links

If an applicant has close links with another person, then the FSA must be satisfied that these links are not likely to prevent it exercising effective supervision. In addition, if it appears to the FSA that the closely linked person is subject to foreign laws and regulations, the FSA must be satisfied that these laws and regulations will not prevent the FSA exercising effective supervision.

Closely linked entities include parent organisations, subsidiaries, fellow subsidiaries or relationships with a 20 per cent shareholding or any other form of relationship through which control is exercised.

The FSA takes a proportionate approach to this threshold condition as to others. Where a firm discloses a situation that is relevant, the FSA takes it into consideration only as far as it is significant (though significance is assessed in context – for example, many identified matters may be individually insignificant but significant when taken together).

2.6.1.5 Adequate resources

An applicant must have resources which, in the opinion of the FSA, are adequate in relation to the regulated activities to be carried on. In forming this opinion FSMA 2000 permits the FSA to have regard to

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the effect that membership of a group may have and to take into account the level of provisions made and the procedures in place to manage the risk.

The FSA's high-level guidance on this requirement cross refers to the various Prudential Sourcebooks which set out a range of detailed provisions. Resources are not limited to financial resources but include information systems, risk-management procedures, human-resource management procedures and the high-level systems and controls requirements set out in SYSC.

In assessing the impact of group activities on the resources of the applicant, the FSA requires detailed financial information on group capital adequacy and large exposures and qualitative information on the activities and managements of material group companies.

The FSA considers whether the applicant's resources are not merely sufficient to meet present requirements but also sufficient to meet the future requirements identified in the firm's strategic plans (including possible stress and scenario tests) and to continue to comply with prudential standards as the business grows.

If an applicant or anyone close to it has been adjudged bankrupt or has gone into liquidation (voluntary or involuntary) the FSA will consider whether this is relevant to the question of resources. While some might regard this as an issue relating to a particular officer's suitability rather than to the resources of the firm, non-suitability of individual principals can in practice represent inadequacy of resources and the FSA has refused authorisations on this ground.

In assessing the adequacy of resources, the FSA examines the extent to which the applicant has identified the risks inherent in its business plan and designed risk-management procedures to control these risks. The FSA seeks to establish that the applicant has identified the interests of consumers in its business case, has tested the business plan, and that the firm's financial and other resources are commensurate with the risks.

The FSA expects the applicant to have researched its market to ensure that, as far as is reasonably possible, its business will be viable and

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competitive. The FSA considers viability and competitiveness only to the extent that they are required to protect consumers (one of its statutory objectives) and to promote competition under the principles of good regulation.

2.6.1.6 Suitability

The final general threshold condition requires the applicant to satisfy the FSA that:

> "he is a fit and proper person having regard to all the circumstances, including –
>
> (a) his connection with any person;
> (b) the nature of any regulated activity that he carries on or seeks to carry on; and
> (c) the need to ensure that his affairs are conducted soundly and prudently".

The suitability condition applies primarily to the applicant firm. The suitability of directors and senior employees who are applying to be approved persons will be assessed separately using the fit and proper test (*see* 2.8 below), and as noted above that test may result in the adequacy of the applicant's resources being called into question. Even where individual managers would satisfy the fit and proper test for approved persons it is still possible for the collective suitability of the management team and consequently the suitability of the applicant to be challenged.

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Suitability of the firm is judged against various standards which broadly mirror the Principles for Businesses. The FSA will want to be satisfied that the business will be conducted with integrity in compliance with proper standards. Specific matters that the FSA will consider include:

(a) Any previous convictions for fraud, dishonesty or tax offences applicable to the firm or relevant individuals. Particular emphasis will be placed on offences in relation to financial services, banking, company law, insurance services and consumer protection.
(b) Any involvement by the applicant or persons closely connected with it in any previous regulatory investigations or disciplinary

proceedings even if these did not give rise to adverse findings. The requirement extends to proceedings of overseas regulators, as well as clearing houses, exchanges, professional bodies and other government agencies.

(c) Whether the applicant or any person closely connected to it has breached any of the FSA's regulatory requirements or any of the rules, guidance, codes of practice and statements of principle of other regulators, clearing houses, exchanges, professional bodies and government bodies. The FSA applies a materiality standard in assessing the importance of such breaches but will seek a high level of disclosure from applicants so that the FSA remains the judge of what is material. The FSA also adopts a qualitative approach to materiality, considering the nature of the contravention as well as its quantum.

(d) Whether the applicant or anyone closely connected to it has been refused registration, authorisation, membership or licence to carry out a trade, business or profession or had such permission terminated.

(e) Whether the applicant has put in place adequate procedures to ensure as far as is reasonably possible that all staff are aware of regulatory requirements applicable to their duties and there are adequate procedures to monitor ongoing compliance. This requirement applies particularly to the training and monitoring of approved persons sponsored by the applicant.

(f) Whether the applicant or person connected to it has become insolvent.

(g) Whether an applicant or person connected to it has been dismissed from an employment or other position of trust, or has been disqualified as a director.

(h) Whether the applicant or a person connected with it has been truthful and candid with the regulator in past dealings and has demonstrated willingness to comply with regulatory requirements.

In assessing suitability, the FSA also has regard to the procedures the applicant has established to ensure competent and prudent management. The following are particularly relevant considerations:

(a) that the Board of Directors or governing body has an appropriate range of skills and experience, including an appropriate level

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of non-executive participation if that is appropriate to the circumstances of the business;

(b) that the Board is organised in such a way to allow it to control the activities of the business and supervise the activities of senior personnel;

(c) that there are procedures to ensure compliance with the FSA training and competence regime;

(d) whether those persons that the applicant proposes to carry out controlled functions are or will be capable of meeting the requirements of the FSA's approved persons regime;

(e) whether personnel policies are in place to enable the applicant to demonstrate that honesty and integrity has been assessed;

(f) whether sound financial and risk-management policies, including robust information and reporting systems have been properly developed, tested and installed;

(g) that anti-money laundering procedures (training, verification of identity, record keeping and reporting) are properly established;

(h) that suitably qualified auditors have been appointed; and

(i) that all other factors are satisfactory including:

   (i) assurances by overseas regulators;
   (ii) position in the group; and
   (iii) the firm's plans to seek variations or extension to its permission.

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The FSA also takes into consideration factors specific to the sector that the applicant proposes to operate in, for example whether an application proposing to carry on insurance business will comply with relevant requirements relating to actuarial functions, and whether an insurance intermediary meets the requirements for knowledge and ability and for good repute contained in MIPRU in the Prudential Standards Block.

In assessing suitability of an applicant for permission that has regulated operations in other EEA states, the Financial Groups Directive provides that the FSA should consult its equivalent competent authorities in those other states. This consultation would include consideration of the suitability of the shareholders, and the reputation and experience of proposed directors and officers who are also involved in the management of other group entities.

2.6.1.7 Additional conditions

Non-EEA applicants seeking to carry on insurance activity in the UK are also subject to "additional conditions" including a requirement to maintain an authorised representative in the UK. These additional conditions, dealt with in COND 2.6, mainly implement EU directive requirements (there are some exemptions for Swiss general direct insurers due to a treaty on the matter between the EU and Switzerland).

2.7 Statements of Principle and Code of Practice for approved persons

Under FSMA 2000, functions within a firm that are designated as "controlled functions" may only be undertaken by persons who have received prior approval from the FSA. This requirement stems from the perceived need not only to encourage firms to align their policies and procedures with good practice and regulatory requirements, but also to impose obligations at the individual level on rogue traders or underwriters and commission-hungry salesmen or, indeed, careless senior managers.

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For a detailed review of the approved persons regime, including a full description of the Statements of Principle and the Code of Practice, *see* Chapter 3. We give only a brief, high-level description here.

The Statements of Principle in Chapter 2 of APER set out the high level standards which approved persons are expected to meet. Interpretation of the Statements of Principle is supported by a Code of Practice in Chapters 3 and 4 of APER which sets out examples of behaviour tending either to indicate failure to comply with a Statement of Principle or (in one case supporting Statement of Principle 3) to indicate compliance. The examples in the Code of Practice have the status of evidentiary provisions in the FSA Handbook.

2.7.1 Application and scope

The FSA's powers to establish Statements of Principle for approved persons are set out in Section 64(1) FSMA 2000. When the FSA uses

this power, under Section 64(2) it must also publish a Code of Practice. The intention of this requirement is undoubtedly to help approved persons to fulfil their obligations by making the FSA's requirements as explicit as possible.

Section 64(11) FSMA 2000 allows the FSA to apply different provisions according to circumstances, for example in relation to a person's conduct. The primary example of this is the application of Statements of Principle 1–4 to all approved persons and Statements of Principle 5, 6 and 7 only to those who perform "significant influence" functions.

The Statements of Principle only apply to an approved person when he is carrying on a controlled function in relation to a regulated activity. Where a person's functions extend to activities which are not controlled, then the Statements of Principle are not applied to those activities.

2.7.2 The Statements of Principle for approved persons

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There are seven Statements of Principle. Statements of Principle 1 to 4 apply to all approved persons.

(a) Statement of Principle 1 – an approved person must act with integrity in carrying out his controlled function.
(b) Statement of Principle 2 – an approved person must act with due skill, care and diligence in carrying out his controlled function.
(c) Statement of Principle 3 – an approved person must observe proper standards of market conduct in carrying out his controlled function.
(d) Statement of Principle 4 – an approved person must deal with the FSA and other regulators in an open and cooperative way and must disclose appropriately any information of which the FSA would reasonably expect notice.
(e) Statement of Principle 5 – an approved person performing a significant influence function must take reasonable steps to ensure that the business of the firm for which he is responsible is organised so that it can be controlled effectively.
(f) Statement of Principle 6 – an approved person performing a significant influence function must exercise due skill, care and diligence in managing the business of the firm for which he is responsible in his controlled function.

(g) Statement of Principle 7 – an approved person performing a significant influence function must take reasonable steps to ensure that the business of the firm for which he is responsible in his controlled function complies with regulatory requirements imposed on that business.

See Chapter 3 below for more details on approved persons.

2.8 The fit and proper test for approved persons

The FIT module consists entirely of guidance. It sets out the criteria that the FSA uses in assessing an application from a person seeking approval to carry out a controlled function. As applications for approval are submitted by the firm rather than the prospective approved person, the provisions apply to both the firm and the candidate seeking approval. They also apply to approved persons, as a means of assessing ongoing suitability of the person to hold that status.

"Fit and proper" is a term that is widely used and generally understood but difficult to define. In broad terms, fitness may be regarded as representing a person's ability to perform a task, in terms of matters such as qualifications and experience. Propriety is looked on more as a moral term relating to honesty and integrity.

In assessing fitness and propriety the FSA will need to be satisfied that the candidate is suitable to perform the controlled function in question. The FSA can take account of any information that comes to its attention and determine what relevance to attach to it. Given that each case is considered on its merits it would be impossible for the FSA to provide a definitive list of factors that it will take into account, but the assessment criteria generally fall within the following categories:

(a) *Honesty, integrity and reputation*. Matters taken into account under this heading are broadly the same as those applied under the suitability test for firms (*see* 2.6.1.6 above), although clearly they are assessed in relation to the individual rather than the firm.
(b) *Competence and capability*. The FSA considers whether the individual satisfies the requirements of the Training and

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Competence Sourcebook and can demonstrate by experience or training the requisite competence to perform the function. The need to satisfy the FSA as to competence in a particular function should not be underestimated. It is possible for an individual to be approved to carry out one controlled function but rejected for another, and past approval is no guarantee of approval in future. Previous convictions or dismissals for incapability, for example due to alcohol or drug abuse, are only taken into account for the purposes of assessing a candidate's or an approved person's continuing ability to perform the function in question.

(c) *Financial soundness*. The FSA will want to know of any circumstances, for example judgment debts or bankruptcy, which might indicate that the individual is unsuitable to carry out the controlled function in question. It is financial soundness rather than the ability to demonstrate financial means that is important here. The FSA will not usually require a statement of means.

The process for applying for approval is explained further in Chapter 3 of this Guide.

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2.9 General provisions

The General module of the high level standards block contains miscellaneous provisions.

2.9.1 FSA approval and emergencies

GEN 1 includes provisions that apply to all persons subject to the FSA's rules (with a limited exemption for UCITS qualifiers), including:

(a) a restriction on claims, express or implied, that the FSA has approved any aspect of a firm's business or affairs. This does not preclude either statements of fact that are fair, clear and not misleading, e.g. that a firm is authorised, that a person is an approved person, or that the FSA has given written approval on a specific matter, or statements that are required (e.g. disclosure of a firm's authorised status);

(b) *force majeure* provisions allowing firms temporary relief from FSA rules (subject to certain conditions including notification to

the FSA) where it is impracticable for firms to comply in an emergency, including a firm-specific emergency.

2.9.2 Interpreting the Handbook

The second chapter of GEN explains how to interpret the FSA Handbook. Fundamentally, every provision of the Handbook must be interpreted in the light of its purpose. While this may provide some licence where provisions are ambiguous or contradictory, "interpretation" has limits and this licence is unlikely to extend to the ability to ignore a rule altogether, even if a firm believes that the provision is counter-intuitive. Firms have the right under FSMA 2000 to seek individual guidance from the FSA, and this would seem a safer course of action in such circumstances than relying unilaterally on the interpretation provision.

This Chapter also provides some material on the status of each type of Handbook provision (a fuller description may be found in Chapter 6 of the Reader's Guide published by the FSA, and that description is drawn on in the following comments). The most common provisions are:

(a) Rules (marked R) which are binding; failure to comply with rules will amount to a breach and could lead to enforcement action. In some cases, a breach of a rule may also lead to a claim for damages.
(b) Guidance (marked G) which clarifies the FSA's requirements in certain areas or provides examples of how particular rules might operate. Guidance is not binding and failure to follow it will not in itself indicate a breach of a rule.
(c) Evidential Provisions (marked E) specify behaviour which tends to show compliance with, or contravention of, another rule. As such, evidential provisions are not capable of standing alone and will always relate back to a binding rule.

Other less frequently used provisions are:

(a) Directions (marked D) which indicate directions and requirements stemming from the FSMA 2000 and relevant statutory instruments, and are binding on the persons to whom they are

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addressed. This designation is also used for quotations from statute that form part of guidance – for example the threshold conditions reproduced in Chapter 2 of COND.

(b) Statements of Principle (marked P) which are binding on approved persons and appear in APER.

(c) Code (marked C), used only in MAR, to describe behaviour which the FSA is satisfied will not amount to market abuse.

The FSA has recently introduced two new types of Handbook provision, which are literally "flagged" as directly applicable, non-FSA legislative material. The FSA Handbook cannot be relied upon as a definitive or comprehensive statement of obligations under non-FSA law. The two categories are:

(a) UK legislative provisions (marked with a Union Flag icon, and described in cross-reference with the prefix UK), which represent non-FSA UK statutory material, copied out with potentially some textual changes to accommodate, for example, the need to cross-refer to defined terms in the Handbook Glossary.

(b) EU legislative provisions (marked with a European Union Flag icon, and described in cross-reference with the prefix EU), which represent EU statutory material, again copied out with minimal textual changes. The introduction of this category reflects the EU's intention to provide implementation measures for financial services directives, that will be either directly applicable or suitable for incorporation unchanged into Member States' legislation.

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In addition to these matters, Chapter 2 of GEN clarifies how defined terms are to be interpreted (in accordance with the Glossary if italicised, in accordance with their normal sense if not), and the FSA's approach to continuity of unincorporated associations and partnerships on change of membership.

2.9.3 Statutory status disclosure

Chapter 4 of GEN (there is no longer any Chapter 3) sets out the circumstances under which the authorised status of a firm must be disclosed to clients, and those under which it is not required. The rules deal with the various possible permutations of the location of the firm, the customer and the activity in question. Specific provisions

apply to the activities of third-party processors. These were introduced following the FSA's assumption of responsibility for mortgage and general insurance intermediation.

2.9.4 The FSA logo and the keyfacts logo

Chapter 5 deals with the circumstances under which the FSA logo and the "keyfacts" logo may (or must) be reproduced on communications produced by firms and their appointed representatives. Firms have a general licence to reproduce the FSA logo in particular circumstances and subject to certain conditions. Outside those circumstances, a firm may apply for a special licence. The keyfacts logo may not be used outside the circumstances in which it is required by the rules.

2.9.5 Insurance against financial penalties

The final chapter of GEN bars firms and Lloyd's members from entering into, arranging, claiming on or making payment under insurance contracts indemnifying any person for the costs of financial penalties imposed by the FSA. This prohibition does not extend to insurance covering the cost of defending an action or covering an award of costs made against the defendant.

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2.10 The Fees Manual

In 2005, the FSA took a decision to consolidate Handbook provisions relating to fees into a single module, and gave effect to this decision by creating FEES. FEES is located in the High Level Standards block. To some extent, this appears to be an odd location for the provisions since fee provisions are hardly high level standards; the Regulatory Processes block might have been a better home.

FEES has six chapters.

2.10.1 Application and purpose

The first chapter deals with application and purpose of the module. FEES applies to all persons required under a provision of the

Handbook to pay a fee or levy. This definition therefore encompasses not only fees and levies payable to the FSA, but also those payable to the Financial Ombudsman Service ("FOS") and the Financial Services Compensation Scheme ("FSCS"), and the chapter specifies who is subject to each of these provisions.

2.10.2 General provisions

The second chapter of FEES provides general rules and guidance on fees and in particular sets out the basis of penalties for late payment of fees. The guidance in the chapter cross-refers to provisions in statute that give the FSA its powers in respect of recovery of fees.

The FSA and FOS have powers to reduce or remit fees or levies due to them where it would be inequitable not to do so. This provision does not extend to FSCS levies.

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2.10.3 Application, notification and vetting fees

FEES 3 covers a number of "one-off" fees. These include fees payable by applicants for Part IV permission, applicants for other forms of recognised status, and fees payable by already authorised persons for changes to scope of permission or on specified occurrences.

2.10.4 Periodic fees

Chapter 4 deals with periodic fees and transaction reporting fees. The provisions include rules dealing with short periods, and adjustments to amounts payable based on the payment method. The amounts of fees are calculated, for each firm, based on the firm's activity and formulae set out in the Annexes to FEES 4.

2.10.5 Financial Ombudsman Service funding

Although FOS is separate from the FSA, the FSA collects the annual general levy and supplementary levy on firms on behalf of FOS. FOS itself levies case fees. Since some persons within the jurisdiction of FOS are not authorised persons, it is not only firms that pay fees. This chapter of FEES sets out the basis of calculation and collection of levies and case fees.

2.10.6 Financial Services Compensation Scheme funding

The FSCS is independent of the FSA, but the FSA has responsibility for making rules to enable the FSCS to impose levies in order to meet its expenses. Levies are of two types: a management expenses levy to provide for the running costs of the FSCS, and a compensation costs levy to fund amounts that have been paid out as a consequence of an event resulting in invocation of the FSCS. The rules and guidance in this chapter provide a basis for identifying the "sub-schemes" within FSCS to which a particular firm belongs, and for calculating the amounts payable.

2.11 Key points

The FSA's high level standards are set out in Block 1 of the FSA Handbook. These provisions include standards to be met by firms and standards to be met by individuals involved in the running of authorised firms. Increasingly, the FSA is seeking to rely, where practicable, upon high level standards rather than detailed prescriptive rules. The high level standards are contained in seven separate Handbook modules, summaries of which appear below.

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2.11.1 Principles for Businesses ("PRIN")

The PRIN module sets out 11 fundamental standards that firms authorised by the FSA must abide by. These reflect the FSA's statutory objectives and all other rules and guidance contained in the FSA Handbook derive from these Principles.

Although widely drawn, the Principles are rules in their own right and disciplinary action can be and has been taken against firms that contravene them.

2.11.2 Senior Management Arrangements, Systems and Controls ("SYSC")

The SYSC module contains rules and guidance designed to assist firms in meeting Principle 3 which provides that "a firm must take reasonable care to organise and control its affairs responsibly and effectively with adequate risk-management systems".

Both the firm and individuals have an important part to play in achieving a well-run organisation and SYSC imposes regulatory obligations on both. Particular emphasis is placed on senior management responsibilities.

The two main requirements of SYSC are that firms must:

(a) apportion clear responsibilities between directors and senior managers so that the firm's business can be adequately monitored and controlled; and
(b) establish and maintain appropriate systems and controls.

The FSA increasingly uses SYSC to provide high-level requirements and guidance in matters relating to systems and controls for which it is not practicable to provide detailed rules. A number of requirements of MiFID have been implemented by including additional material in SYSC.

2.11.3 *Statements of Principle and Code of Practice for approved persons ("APER")*

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The Statements of Principle in APER set out the general principles that the FSA expects all approved persons to adhere to.

The Code of Practice contains guidance for approved persons on the standards of conduct which are likely to indicate a breach of the principles and which may lead to disciplinary action.

Examples of unacceptable behaviour are given in the form of evidential provisions.

2.11.4 *Fit and proper test ("FIT")*

This sets out the fitness and propriety criteria that must be satisfied by individuals applying to be approved persons. The main criteria are:

(a) honesty, integrity and reputation;
(b) competence and capability; and
(c) financial soundness.

The conditions must be met on a continuing basis. Approval can be withdrawn if the FSA considers that a person is no longer fit and proper to carry out a controlled function.

2.11.5 Threshold conditions ("COND")

Firms are required to satisfy the threshold conditions for all regulated activities they undertake both at authorisation stage and on an ongoing basis.

The statutory threshold conditions are:

(a) legal status;
(b) location of offices;
(c) appointment of claims representatives;
(d) close links;
(e) adequate resources; and
(f) suitability.

"Additional conditions" prescribed by the Treasury apply to non-EEA insurance firms.

2.11.6 General provisions ("GEN")

This module brings together some basic provisions that apply across all sections of the FSA Handbook. It covers matters such as use by firms of the FSA's name, logo and other key marks, emergency provisions, interpretation of the Handbook, disclosure of authorised status, and insurance against financial penalties imposed by the FSA.

2.11.7 Fees ("FEES")

This module collects together rules and guidance on fees and levies. It includes provisions in respect of the funding of the Financial Ombudsman Service and the Financial Services Compensation Scheme, as well as FSA fees payable.

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