Chapter 1

The Principal Provisions

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1.1 Introduction

This Guide outlines the regulatory structure established by the Financial Services and Markets Act 2000 ("FSMA 2000") as it affects firms carrying on "regulated activity". Broadly, this Guide covers all of those areas which constituted "investment business" under the Financial Services Act 1986 ("FS Act 1986"). It does not examine in detail the FSMA 2000 regime as it relates to deposit taking, insurance business, mortgage lending and administration, or Lloyd's, nor is it particularly concerned with corporate finance activities. Similarly, there is not space here for a detailed examination of the regime for financial promotion, although the outlines are traced in this Chapter and Chapter 6 of this Guide. These matters are covered by other Guides in this series.

The FSMA 2000 came fully into force on 30 November 2001. It is a substantial piece of legislation but it is nevertheless supplemented by a very large amount of delegated legislation and by the Financial Services Authority's ("FSA's") Handbook.

With effect from 1 November 2007 the Handbook was amended in order to implement the Markets in Financial Instruments Directive ("MiFID"). This Guide reflects those amendments.

1.2 FSMA Part II – Regulated and prohibited activities

1.2.1 Section 19 – The general prohibition

This lies at the heart of the regulatory regime and much of the material in the FSMA 2000, the delegated legislation, and the Handbook flows from it, directly or indirectly.

> "No person may carry on regulated activity in the United Kingdom, or purport to do so, unless he is – (a) an authorised person; or (b) an exempt person."

The approach is, of course, to ensure that any person carrying on activities that relate to investments should be under an obligation to do so in accordance with the detailed rules and regulations which make up the bulk of the new regime. It is those detailed rules which together are designed to achieve the FSA's statutory regulatory objectives of market confidence, public awareness, the protection of consumers, and the reduction of financial crime.

An "authorised person" is a person who is authorised for the purposes of the FSMA 2000 (Section 31(2)). In the vast majority of cases authorisation is embodied in a permission granted to the person in question under Part IV of the FSMA 2000. The obtaining of a "Part IV permission" is discussed below.

An "exempt person" is entitled to carry on regulated activity without a Part IV permission. The main place to look for exemptions is in the Financial Services and Markets Act 2000 (Exemption) Order 2001 (SI 2001/1201) (the "Exemption Order") made under Section 38. Contravention of the general prohibition is a criminal offence punishable with imprisonment for up to two years, or a fine, or both (Section 23). Falsely claiming to be authorised or exempt is also a criminal offence (Section 24).

1.2.2 Section 20 – Requirement for permission

Clearly, not all firms will carry on the same kind of regulated activity and it is not the policy of the FSMA 2000 to give blanket authorisation to all firms to carry on all activities. Instead the firm may only carry on the activities specified in its Part IV permission. This circumscribes what a firm can do and also triggers the application of the relevant parts of the Conduct of Business Sourcebook ("COBS") which will then govern the day-to-day activities in the firm.

A firm which carries on regulated activity outside its Part IV permission does not commit a criminal offence but may incur regulatory sanctions and/or civil liability.

1.2.3 Section 22 – Regulated activities

The terms of Sections 19 and 20 obviously beg the question, what is "regulated activity"? Section 22 addresses this although the detail lies elsewhere. Note that activity is not "regulated activity" unless it is "carried on by way of business". That test is sufficiently important that an Order has been made under Section 419 FSMA 2000 setting out circumstances in which a person is or is not to be regarded as carrying on a regulated activity by way of business. This is examined in Chapter 4 of this Guide.

Section 22(2) gives effect to Schedule 2 to the FSMA 2000 which outlines the sort of activities which may constitute regulated activity but it is illustrative only because the definitive statement of what constitutes regulated activity lies in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) made under Section 22. This is examined in greater detail in Chapters 2 and 3 of this Guide.

1.2.4 Section 21 – Financial promotion

With a view to protecting consumers from securities fraud, the law has for many years imposed controls on how investments may be offered to the public. The principal source of rules on this subject is now Section 21 FSMA 2000 and the regime for "Financial Promotion".

The full picture is provided by Section 21 itself and by Section 397 which deals with misleading statements and practices, plus the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (SI 2005/1529) (the "Financial Promotion Order") made under Section 21 and Chapter 4 of the COBS.

Section 21 is in essence a prohibition on promotional activity:

> "A person must not, in the course of business, communicate an invitation or inducement to engage in investment activity."

The term "communicate" is deliberately wide as it was a policy objective to make the FSMA 2000 "media neutral".

Subsection 21(8) defines "engaging in investment activity" as entering or offering to enter into an agreement the making or performance of which by either party constitutes a controlled activity or exercising any rights conferred by controlled investment to acquire, dispose of, underwrite or convert a controlled investment. Subsections (9) and (10) expand on "controlled activity" and "controlled investment".

Note that a communication that originates outside the UK will be caught by the regime if it is capable of having an effect in the UK.

Contravention of Section 21 is a criminal offence and agreements entered into as a result of a breach of the Section are unenforceable. A third party will be entitled to recover any money or property transferred, as well as compensation for any loss suffered.

The most important exemption is in Section 21(2) which disapplies the prohibition if the person communicating the financial promotion is an authorised person or if the content of the communication is approved by an authorised person. It follows that it is a defence for a person facing a charge under Section 21 to show that he believed on reasonable grounds that the content of the communication was prepared or approved by an authorised person, or that the accused person took all reasonable precautions and exercised all due diligence to avoid committing the offence.

The FSMA 2000 regime abolishes the distinction between investment advertising and cold calling, but it brings in a new distinction between "real time" communication and "non-real time" communication. This is set out in the Financial Promotion Order (*see* 1.2.5 below), but in brief:

(a) a real time communication means one made in the course of a personal visit, telephone conversation or other interactive dialogue;
(b) a non-real time communication means everything else and so includes letters, e-mails and communications in any form of publication, including on a website.

Within real time communications, the new regime also distinguishes "solicited" and "unsolicited".

A solicited communication is one which is initiated by the recipient or takes place in response to an express request from the recipient. Everything else is unsolicited. The importance of the distinction is that not all of the exemptions set out in the Financial Promotion Order apply to all kinds of communications.

The new regime also introduces the concept of "indications". These are "health warnings" and certain exemptions will not be available unless the person communicating the financial promotion includes the prescribed indications.

1.2.5 The Financial Promotion Order

The Financial Promotion Order sets out exemptions from the basic prohibition on financial promotions which appears in Section 21. Importantly, the exemptions are available to both authorised and unauthorised persons.

Significantly, in the normal course an authorised person must comply with the requirements of Chapter 4 of COBS when communicating a financial promotion. These include contents requirements and record-keeping obligations. Where an authorised person communicates a financial promotion which is exempt within the Financial Promotion Order, however, the requirements of COBS are largely disapplied apart from general principles such as the requirement that communications must be clear, fair and not misleading.

In addition, "indications" must be given with an adequate "degree of prominence" which means that they must be portrayed in a way that can be easily understood and in a manner which is best calculated to bring the matter in question to the attention of the recipient. This implies an end to the common practice of putting risk warnings etc. in the small print at the foot of an advertisement.

The Financial Promotion Order provides a number of exemptions available in relation to all controlled activities, then further exemptions which are available only to specific kinds of activity. The generally available exemptions apply to:

(a) certain communications to overseas recipients;
(b) communications from customers and potential customers;

(c) certain activities by way of follow up to solicited real time communications;
(d) certain introductions;
(e) communications by exempt persons;
(f) generic promotions which do not identify the party offering the investment or the service;
(g) communications caused to be made or directed by unauthorised persons;
(h) communications by parties which act as "mere conduits" where the content of the communications is devised by another person, and the communicator has no material input, including electronic commerce communications;
(i) communications to investment professionals (authorised persons, exempt persons and other persons whose ordinary activities involve them carrying on controlled activities to which the communication relates); and
(j) communications by journalists.

Part VI of the Order then provides a host of further exemptions in relation to certain controlled activities. These include:

- one-off communications fulfilling certain conditions;
- a number of exemptions for overseas communicators;
- communications by governments and central banks;
- communications by industrial and provident societies;
- communications by nationals of European Economic Area ("EEA") states;
- communications by certain financial markets;
- certain communications among participants in a joint enterprise;
- certain communications among participants in recognised collective investment schemes;
- certain communications in relation to bearer instruments;
- certain communications to and among members and creditors of bodies corporate and open-ended investment companies;
- communications among bodies corporate in the same group;
- certain offers of credit to companies;
- communications by persons whose business it is to place promotional material or to disseminate information;
- certain communications to certified high net worth individuals, high net worth companies or other bodies;

- sophisticated investors or associations of high net worth or sophisticated investors;
- communications to a "common interest group" of a company;
- communications among settlors, trustees and personal representatives or between beneficiaries under a trust, will or intestacy;
- certain communications by members of professions;
- communications in relation to certain employee share schemes;
- communications made for the purposes of or in connection with a sale of goods or a supply of services; or
- in relation to transactions under which 50 per cent or more of the voting capital of the body corporate will change hands;
- various communications in relation to the takeover of certain unlisted companies; and
- certain communications relating to the listing of shares on stock markets.

The exemptions are detailed and many of them have very precise conditions attaching to them.

1.2.6 Conduct of Business Sourcebook

Chapter 4 of the COBS imposes further obligations on regulated firms when issuing financial promotions. The main purpose is to drive home the general obligation to treat customers fairly and to communicate in a way which is fair, clear and not misleading. COBS not only applies to communications directed into the UK, but also in a number of cases to communications made by UK authorised persons to persons outside the UK (the EEA territorial scope rule).

Significantly, Chapter 4 is disapplied in relation to financial promotions only to eligible counterparties.

Where Chapter 4 does apply it imposes obligations on firms to ensure that a financial promotion is clearly identifiable as such and that a firm communicating or approving a financial promotion has systems and controls in place to comply with the rules in Chapter 4. This systems and controls requirement is set out in Chapters 3 and 4 of the Senior Management Arrangements, Systems and Controls Sourcebook ("SYSC").

COBS Chapter 4 goes on to set down the record-keeping requirements and rules on the form and content of promotions.

1.3 FSMA 2000 Part IV – Permission to carry on regulated activities

1.3.1 Applications under Part IV

Section 40 FSMA 2000 states that an application to carry on one or more regulated activities may be made to the FSA by:

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

A permission granted by the FSA to an application made under Section 40 is referred to as a "Part IV permission".

In certain circumstances, an application for permission under Section 40 is not appropriate. For example, a firm which has already obtained a Part IV permission would not make a further application under Section 40 if it wished to conduct an additional regulated activity but would need to vary its existing permission in accordance with Section 44 FSMA 2000.

In addition, an EEA firm which is able to use its passporting rights under MiFID or the Second Banking Coordination Directive would not make an application for permission under Section 40 in order to establish a branch in the UK or provide services in the UK but would need to follow the procedures applicable under those Directives.

1.3.2 The application procedure

The formal procedures for applying for Part IV permission are described in the FSA's Guidance on its website under the heading "Doing Business with the FSA". Applicants are able to "build their own" application pack appropriate for their type of firm. The application pack will generally contain the following documents:

(a) Checklist and declaration: this contains a declaration checklist referring to the contents of the entire application pack. Before signing, the applicant must have completed the checklist for the application pack and read the declaration;
(b) Core Details: this form identifies core information about the applicant such as the date of incorporation, legal status and group structure. The form also identifies the proposed regulated activities, specified investments and the category of client;
(c) Form A: details of all persons performing a controlled function (such as directors, investment managers or advisers).

After receiving the application pack, the FSA will begin its formal process of consideration. At an early stage, the FSA will determine whether an application is complex or non-complex. If the application is complex, the FSA is likely to request additional information and meet the applicant's management team and visit its premises before determining the application. If the application is non-complex, it is possible that a visit to the premises will not be necessary. The FSA stresses that the application process is "interactive" and that applicants are encouraged to discuss an application with the FSA's corporate authorisation department about their plans and applications. Where an application is complex, applicants are encouraged to meet with the FSA prior to submitting an application.

1.3.3 The Threshold Conditions

Section 41(2) states that, in giving or varying permission, or imposing or varying any requirement, the FSA must ensure that the person concerned will "satisfy, and continue to satisfy, the Threshold Conditions in relation to all of the regulated activities for which he has or will have permission".

The Threshold Conditions are set out in Schedule 6 to the FSMA 2000. In addition, the FSA has set out guidance on the Threshold Conditions in the Threshold Conditions Sourcebook contained in the High Level Standards section of the FSA Handbook. When assessing an application for authorisation, the FSA will assess that application against the Threshold Conditions.

The following paragraphs set out the various Threshold Conditions.

1.3.3.1 Legal status

(a) If the regulated activity concerned is the effecting or carrying out of contracts of insurance, the authorised person must be a body corporate, a registered friendly society or a member of Lloyd's.

(b) If the person concerned appears to the FSA to be seeking to carry on, or to be carrying on, a regulated activity constituting accepting deposits, it must be:

    (i) a body corporate; or
    (ii) a partnership.

This Threshold Condition further restricts the requirements on legal status set out in Section 40(1) in relation to effecting and carrying out contracts of insurance and accepting deposits. These restrictions are as a result of the provisions of the Banking Consolidation Directive and the First Non-Life Directive.

1.3.3.2 Location of offices

(a) If the person concerned is a body corporate constituted under the law of any part of the UK:

    (i) its head office; and
    (ii) if it has a registered office, that office,

    must be in the UK.

(b) If the person concerned has its head office in the UK but is not a body corporate, it must carry on business in the UK.

This condition implements the requirements of Article 6 of the Post BCCI Directive and extends this condition to firms which are outside the scope of the Single Market Directive and the UCITS Directive.

"Head office" is not defined, although the FSA has stated that the key issue in identifying the head office of a firm is the location of its central management and control, that is, the location of the directors and other senior management, who make decisions relating to the firm's central direction, and the material management decisions of the firm on a day-to-day basis and the location of the central administrative functions of the firm.

1.3.3.3 Close links

(a) If the person concerned ("A") has close links with another person ("CL") the FSA must be satisfied:

  (i) that those links are not likely to prevent the FSA's effective supervision of A; and
  (ii) if it appears to the FSA that CL is subject to the laws, regulations or administrative provisions of a territory which is not an EEA state ("the foreign provisions"), that neither the foreign provisions, nor any deficiency in their enforcement, would prevent the Authority's effective supervision of A.

(b) A has close links with CL if:

  (i) CL is a parent undertaking of A;
  (ii) CL is a subsidiary undertaking of A;
  (iii) CL is a parent undertaking of a subsidiary undertaking of A;
  (iv) CL is a subsidiary undertaking of a parent undertaking of A;
  (v) CL owns or controls 20 per cent or more of the voting rights or capital of A; or
  (vi) A owns or controls 20 per cent or more of the voting rights or capital of CL.

(c) "Subsidiary undertaking" includes all of the instances mentioned in Article 1(1) and (2) of the Seventh Company Law Directive in which an entity may be a subsidiary of an undertaking.

In summary, Threshold Condition 3 requires that the FSA is satisfied that the close links that a firm has will not prevent effective supervision. The factors which the FSA will take into account include, among other things, the following:

(a) it is likely that the FSA will receive adequate information from the firm, and those persons with whom the firm has close links, to enable it to determine whether the firm is complying with the requirements and standards under the regulatory system; this will include confirmation of whether the firm is ready, willing and organised to comply with FSA Principle 11 which relates to dealing with the regulator in an open and cooperative way;

(b) the structure and geographical spread of the firm, the group to which it belongs and other persons with whom the firm has close links, might hinder the provision of adequate and reliable flows of information to the FSA; factors which may hinder these flows include the fact that there may be branches or connected companies in territories which supervise companies to a different standard or territories with laws which restrict the free flow of information, although the FSA will consider the "totality of information available from all sources";
(c) the firm and the group to which it belongs are, or will be, subject to supervision on a consolidated basis (consolidated supervision) (e.g., if a financial resources requirement is determined for the group as a whole); and
(d) it is possible to assess with confidence the overall financial position of the group at any particular time; factors which may make this difficult include lack of audited consolidated accounts for a group, if companies in the same group as the firm have different financial years and accounting dates and if they do not share common auditors.

1.3.3.4 Adequate resources

The resources of the person concerned must, in the opinion of the FSA, be adequate in relation to the regulated activities that he seeks to carry on, or carries on.

In reaching that opinion, the Authority may:

(a) Take into account the person's membership of a group and any effect which that membership may have.
(b) Have regard to:
    (i) the provision he makes and, if he is a member of a group, which other members of the group make in respect of liabilities (including contingent and future liabilities); and
    (ii) the means by which he manages and, if he is a member of a group, which other members of the group manage the incidence of risk in connection with his business.

Threshold Condition 4 requires the FSA to ensure that a firm has adequate resources in relation to the specific regulated activity or

activities which it seeks to carry on. The FSA interprets the term "adequate" as meaning "sufficient in terms of quantity, quality and availability" and "resources" as including "all financial resources, non-financial resources and means of managing its resources" such as capital, provisions against liabilities, holdings of or access to cash and other liquid assets, human resources and effective means by which to manage risks.

The FSA has set out its requirements with regard to systems and controls in the High Level section of the Handbook in the Senior Management Arrangements, Systems and Controls Sourcebook ("SYSC"). Detailed financial resources and systems requirements are set out in the relevant section of the General Prudential Sourcebook or Prudential Sourcebook for Banks, Building Societies and Investment Firms.

1.3.3.5 Suitability

The person concerned must 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.

Threshold Condition 5 requires the firm to satisfy the FSA that it is "fit and proper" to have Part IV permission having regard to all the circumstances, including its connections with other persons, the range and nature of its proposed regulated activities and the overall need to be satisfied that its affairs are and will be conducted soundly and prudently.

The particular factors which the FSA will take into account include, but are not limited to, whether a firm:

(a) conducts, or will conduct, its business with integrity and in compliance with proper standards;
(b) has, or will have, a competent and prudent management; and
(c) can demonstrate that it conducts, or will conduct, its affairs with the exercise of due skill, care and diligence.

1.3.4 Limitations and requirements

Section 42 FSMA 2000 states that the Authority may give permission for the applicant to carry on the regulated activity or activities to which this application relates. The FSA may incorporate in the description of a regulated activity which a firm is permitted to conduct such limitations (e.g., as to circumstances in which the activity may, or may not, be carried on) as it considers appropriate. A limitation is specific to a particular regulated activity (either to the specified activity, the specified investment or both). A limitation may be applied for by the applicant or, alternatively, imposed by the FSA. Examples of limitations include the following:

(a) a limit on the types of client that a firm may deal with; or
(b) a limit on the number of clients with whom a firm may carry on a particular regulated activity during, for example, an initial period of operation (perhaps because a firm's system is not yet adequate to be able to process a high volume of transactions); or
(c) a limit on the types of specified investments that a firm can deal in; or
(d) a limit on the type of insurance business which a firm may carry on in connection with certain categories of specified investments; or
(e) in relation to the carrying on of designated investment business, carrying on such business in respect of certain customer classifications (e.g., only carrying on designated investment business in respect of intermediate customers and market counterparties but not private customers).

Section 43 states that a Part IV permission may include such "requirements" as the FSA considers appropriate. The requirements may be imposed on a firm to:

(a) take a particular action; or
(b) refrain from taking a particular action.

The FSA states that a requirement will either be unrelated to the performance of regulated activities (e.g., a requirement that relates to reporting) or will relate to all, or a number of, the regulated activities

which an applicant wishes to carry on. This can be contrasted with a limitation, which is specific to one particular regulated activity.

Perhaps the most common requirement is one stating that the firm is not to hold or control client money. A requirement is also used by the FSA to define the scope of a number of regulated activities carried on by a firm so that a particular differentiated regulatory regime applies. For example, a different regulatory regime applies for locals, venture capital firms, corporate finance advisory firms and service companies. Consequently, an applicant may wish to apply for Part IV permission which includes a requirement defining the scope of each regulated activity so that it is able to benefit from this differentiated regime.

Examples of requirements which the FSA may impose in particular circumstances include the following:

(a) a requirement that a firm given Part IV permission obtains the approval of the FSA before payment of a dividend (in accordance with powers contained in section 48 FSMA 2000); or
(b) a requirement to submit financial returns more often than normal, for example, during the firm's first months or years of business; or
(c) a requirement to submit audited financial accounts of a parent company; or
(d) a requirement, on the permission of an insurer, to carry on only reinsurance business; or
(e) a requirement to submit periodic independent compliance reviews, performed by an appropriate person, during the first months or years of business.