Consultation Paper

06/9***

Financial Services Authority

Organisational systems and controls

Common platform for firms

May 2006

FSA®

Contents

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 19 August 2006.

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1 Overview

Introduction

1.1. Confidence in the UK's financial markets depends on firms organising and controlling their affairs responsibly and effectively. This calls for effective management oversight, systems and controls, including risk management and organisational requirements. This Consultation Paper (CP) proposes revised regulatory standards to be expected of firms and of their senior management in this area.

1.2. Our existing rules and guidance on high level systems and controls are set out in Chapter 3 of Senior Management Arrangements, Systems and Controls (SYSC), within the High Level Standards section (Block 1) of our Handbook. These requirements amplify Principle 3[1] and apply to all firms. Two new important European Directives applicable to investment firms and credit institutions, the Markets in Financial Instruments Directive (MiFID) and the Capital Requirements Directive (CRD)[2], each contain requirements intended to secure effective management and internal systems and controls. We must implement the CRD by 1 January 2007 and MiFID by 1 November 2007, and to do so we will have to change our existing regulatory framework. Existing Handbook provisions, although broadly similar in scope to the requirements of the Directives, are not sufficient to implement them.

1.3. This CP proposes rules and guidance to implement the organisational and systems and controls requirements contained in these two Directives in the UK for those firms subject to either or both of these Directives (common platform

1 Principle 3 ('A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems') is in our Principles for Businesses (PRIN), which is also in Block 1 of the Handbook.

2 Directive 2004/39/EC of 21 April 2004. MiFID has been amended by Directive 2006/31/EC of 5 April 2006, which postpones the deadlines for the transposition and application of MiFID and makes a number of consequential amendments. MiFID will replace the Investment Services Directive (ISD) (Directive 93/22/EEC).

firms). Our proposals are based on the CRD, MiFID and the draft MiFID implementing measures (the Draft Implementing Measures). In due course, we will review the final implementing measures against the Draft Implementing Measures and consider how to deal with any significant changes.

1.4. The rules and guidance that we are proposing will be located in SYSC. From 1 November 2007, we will replace, for common platform firms, the existing SYSC Chapter 3 with seven new chapters, which we refer to as the 'common platform'. Each new chapter covers a particular subject[5]. As further discussed below, common platform firms may choose to comply with the common platform instead of SYSC Chapter 3 (which will include, for CRD firms, the CRD organisational requirements that we have to implement by 1 January 2007) at any time in the 10 months prior to 1 November 2007 if they wish. SYSC Chapter 3 will be disapplied to all common platform firms on 1 November 2007 and replaced by the common platform; SYSC Chapter 3 will remain in force for firms not subject to either Directive.

Our general approach to implementation

1.5. We outlined our approach to implementation of European Directives in our *Better Regulation Action Plan*, published in December 2005, and in the *Joint Implementation Plan* for MiFID, published with HM Treasury in May 2006. We made clear we would be guided by the following principles:

- that implementation would be pragmatic and proportionate: meeting the requirements of Directives in a way that makes sense for UK markets, consistent with the statutory objectives and principles of good regulation;
- that we will add national measures that go beyond Directive requirements only when they are justified in their own right (including through use of appropriate market failure analysis (MFA) and cost-benefit analysis (CBA)) and where consistent with Directive provisions;
- that 'copy-out' will be the basis for implementing EU financial services Directives (that is, our rules will generally be based on copied-out Directive text), to avoid our placing any unintended additional obligations on firms; and

3 The CRD consists of the recast Capital Adequacy Directive (recast CAD) and the recast Banking Consolidation Directive (recast BCD). Respectively, these recast the Capital Adequacy Directive (Directive 93/6 EEC) and the Banking Consolidation Directive (Directive 2000/12 EC). We have consulted on the main requirements of the CRD in CP 05/3 '*Strengthening Capital Standards*' (published in January 2005) and CP 06/3 '*Strengthening Capital Standards 2*' (published in February 2006). The text of the recast CAD and recast BCD have been politically agreed (Council of the European document reference 12890/05, dated 18 and 24 October 2005) but has not yet been published in final form in the Official Journal of the European Union. There may be some drafting amendments to the final text of these Directives, which may need to be reflected in the final version of our rules.

4 Draft Commission Directive implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms, and defined terms for the purposes of that Directive, published on 6 February 2006.

5 For further details, see Chapter 2.

- that we will use the implementation of MiFID as an opportunity to review existing Handbook material, removing measures that are no longer effective or proportionate.

1.6. As part of its efforts to promote better regulation in respect of European legislation the European Commission has included a draft provision in the Draft Implementing Measures, Article 4, which seeks to limit Member States' freedom to add additional obligations at the national level to those contained in that Directive. We will take responsibilities in relation to Article 4 seriously. We will carefully consider the common platform requirements against the tests set out in that provision once the Draft Implementing Measures are finalised.

1.7. We have applied these principles in formulating the proposals in this paper. However both CRD and MiFID have management oversight, internal governance and systems and controls requirements. Though their approaches and the wording of their requirements are not identical, the Directives cover broadly the same ground. We therefore think that the right way to proceed is by creating a unified set of requirements applying to all common platform firms based on the Directives' requirements. This approach is consistent with the purpose underlying these Directives. The unified requirements would cover areas where we think, in practice, the standards implied by the wordings of both Directives are very similar in effect, even if their wording is not identical. This approach would also avoid our Handbook being increased significantly by a plethora of parallel provisions – that is, one set for each Directive.

1.8. In general, we believe that firms would prefer one set of requirements rather than two parallel sets. Most of the firms subject to the CRD are also subject to MiFID; we doubt that these firms would find it attractive to have two similar, but different, regulatory requirements applying to the same or substantially overlapping business functions, and often there will be net benefit in having a single standard. For example, both MiFID and the CRD contain requirements on internal governance/management oversight. A unified set of requirements will be simpler and more cohesive. It is also consistent with our present requirements which apply a unified standard for all firms for these oversight and control responsibilities.

1.9. This approach, creating a 'common platform' of organisational requirements, is designed to make clear to common platform firms what is expected of them and of their senior management. It does this by having management oversight and systems and controls in areas such as risk management, governance, internal audit, compliance, employees and agents, conflicts of interest and record keeping.

1.10. A unified set of organisational requirements may, in some cases, go beyond the strict Directive minimum requirements. MiFID organisational

requirements themselves, in many cases, require firms' systems and controls to cover business operations and activities beyond MiFID investment services and activities (for example, risk management, accounting, and internal audit). However, to apply the one standard to business operations and activities beyond those inherent in the MiFID requirements, will involve super-equivalence. The nature and extent of this super-equivalence will depend on the nature and scope of any relevant CRD requirement – as CRD requirements apply to the whole of a firm's business. For example, we propose that the unified standard for outsourcing will apply to common platform firms' outsourcing of critical or important functions related to a firm's MiFID business, non-MiFID regulated activities, listed activities under the BCD, and ancillary services under MiFID. This goes beyond the MiFID minimum which is limited to regulating outsourcing of critical or important operational functions related to a firm's MiFID business but is only super-equivalent to the extent that it goes beyond CRD requirements.

1.11. We are conscious that where a single standard implies material levelling-up of the requirements of one of the Directives, then we should be confident that that makes sense in CBA terms. The benefits of tidiness can always be secured by any firm choosing for itself to adopt the higher standard. Consequently this CP has two CBAs. The first is in respect of our Financial Services and Markets Act (FSMA) obligations and mainly focuses on the impact of our proposals against our existing rules and guidance. For this work we have used information on impact obtained from firms through a survey conducted on our behalf by Capgemini and backed up by interviews with firms. In addition, where our proposals go beyond Directive minima, for example, applying MiFID material to firms subject only to the CRD or applying MiFID requirements to business activities other than those contemplated by the particular requirement, we have undertaken a second CBA against a baseline of the minimum for a Directive.

1.12. In most cases, firms surveyed in our CBA studies predicted that the impact of our proposals for a unified standard would be small, and we concluded that benefits outweighed costs. Where this was not the case, we have modified our thinking. For some aspects of our proposals, however, the CBA is not clear-cut so in this CP we have included specific questions about the impact of the common platform in certain cases.

1.13. We do not intend to carry forward for common platform firms, as part of the common platform, existing material that is redundant, superfluous or obsolete. In developing the common platform for each subject, we have considered material in certain Prudential Sourcebook (PRU) Chapters and SYSC Chapter 3A (mainly only in force currently for insurers) and the

relevant parts of the various Interim Prudential Sourcebooks (IPRUs) currently in force for banks, building societies and investment firms[6].

1.14. This CP does not contain proposals in relation to outsourcing to non-EEA providers of portfolio management services to retail clients, because the relevant provisions in the Draft Implementing Measures remain under active discussion at a European level. Similarly, we currently plan to consult on proposals for certain subjects (e.g. record keeping), which MiFID deals with alongside systems and controls, in the *Reforming COB Regulation* CP in the fourth quarter of 2006.

The restructuring of SYSC

1.15. Our existing systems and controls requirements, which apply to all firms, are mostly set out in SYSC. We previously consulted on planned revisions of our systems and controls requirements in CP97 (*Integrated Prudential Sourcebook*) and CP142 (*Operational risk systems and controls*). In 2004 we put on hold (other than for insurers) the CP142 proposals for a unified framework. This was pending the finalisation of CRD and MiFID.

1.16. For common platform firms, from 1 November 2007 (or earlier in 2007 if they choose to comply with the common platform before 1 November 2007), SYSC Chapter 3 will be disapplied and replaced by the proposed seven new SYSC common platform chapters. As part of our Handbook rationalisation, from 1 January 2007, we will also be moving certain PRU Chapters into SYSC as Chapters 12 and 14-17[7]. All except PRU Chapter 8.1 apply only to insurers and their application will remain the same when they are moved into SYSC. In addition we will move SYSC Chapter 3A to create the new SYSC Chapter 13. The high-level SYSC requirements in PRU Chapter 5.1 (Liquidity risk systems and controls) will become SYSC Chapter 11; we are currently reviewing the material in that chapter and will consult on it later this year[8]. For full details, see Chapter 2.

Commencement

1.17. We are consulting on our proposed rules and guidance now for two reasons. First, so that we meet the implementation deadline of 1 January 2007 in

6 CP06/03 ('*Strengthening Capital Standards 2*') published in February 2006 consults on the GENPRU and BIPRU modules of the FSA Handbook that will replace these IPRUs; for more information on the proposed structure, see the September 2005 edition of the Handbook Development Newsletter (HDN 67).

7 The chapters are PRU 1.4 (Risk management and associated systems and controls); PRU 3.1 (Credit risk); PRU 4.1 (Market risk); PRU 6.1 (Operational risk); PRU 7.1 (Insurance risk); PRU 8.1 (Group risk).

8 SYSC Chapter 7 (Risk control) contains CRD liquidity risk requirements to ensure that we have adequately consulted on them before the CRD implementation date of 1 January 2007. These requirements will move to SYSC Chapter 11 in due course. However, the risk management provisions in PRU 5.1 – for insurers only – will move to INSPRU (this will be consulted on in our '*Strengthening Capital Standards – Restructuring the Handbook*' CP planned for May 2006

relation to the systems and controls requirements of the CRD (a firm subject to the CRD must comply with these requirements from that date); and secondly, so that the rules and guidance comprising the whole of the common platform (which contains MiFID as well as CRD requirements) can be made and are available to common platform firms by 1 January 2007. A CRD firm will need to comply with the CRD from that date[9]. But firms have until 1 November 2007 to come into compliance with MiFID and it would be super-equivalent to require common platform firms to comply with MiFID-derived requirements before that date. Hence we are proposing to provide common platform firms with the option of complying with the common platform (including MiFID-derived requirements) before that date by way of a transitional regime that will operate between 1 January 2007 and 1 November 2007.

1.18. All common platform firms will remain subject to SYSC Chapter 3 until 1 November 2007 when it will be disapplied for those firms and replaced with SYSC Chapters 4 to 10. To ensure we implement the requirements of the CRD by 1 January 2007, we are copying the relevant CRD requirements into SYSC Chapter 3 with effect from 1 January 2007. These requirements will also form part of the common platform and will be reflected in SYSC Chapters 4 to 10. Any common platform firm will be able to transition to the common platform between 1 January and 1 November 2007 should it so wish. We understand that some firms will wish to make only one set of changes to their internal systems and controls. But early adoption will be their choice – there will be no regulatory obligation for them to do so.

1.19. We plan to develop proposals for the application of the common platform to firms (except for insurers) outside the scope of MiFID and/or CRD over the next year. These requirements will be phased-in when our policy development and appropriate CBA have been completed and after further consultation. We will review our SYSC/organisational requirements for insurers as part of our work on the Solvency 2 Directive.

Which firms are subject to CRD and/or MiFID?

1.20. We drew attention to the broad coverage and impact of MiFID in our *Planning for MiFID* paper published in November 2005. The Treasury's December 2005 consultation document *UK Implementation of the Markets in Financial Instruments Directive* drew on this in setting out that MiFID will affect a wide diversity of firms, including:

- retail banks;
- investment banks;

9 A CRD firm will also need to continue to comply with SYSC 3.

- venture capital firms;
- stockbrokers;
- investment managers;
- proprietary trading firms;
- corporate finance firms;
- wholesale market brokers; and
- providers of custody services.

1.21. The CRD contains prudential requirements for the majority of firms performing investment activities set out in Annex 1 of MiFID (via the recast CAD) and credit institutions (via the recast BCD). These prudential requirements will be implemented through the new GENPRU and BIPRU modules of the Handbook. The CRD also contains systems and controls requirements which are the subject of this CP.

1.22. As the prudential requirements of CAD are determined by reference to MiFID services and activities, firms need to be clear as to whether they are carrying out 'MiFID' activities. At present, firms' prudential requirements are established by reference to their permissions which are set under FSMA by reference to the Regulated Activities Order[10]. To assist firms in making the transition to CRD terminology, we have developed guidance which helps firms determine whether they are carrying out MiFID services and activities and to help them determine their CRD prudential category. This guidance, the draft Perimeter Guidance, is described in Chapter 10 and set out in Annex 5.

Who should read this CP?

1.23. This CP is primarily of interest to firms that are subject to either CRD or MiFID, or both. Firms that are unsure whether MiFID or the CRD applies to them should read the draft Perimeter Guidance.

1.24. Firms that are outside the scope of both Directives may still wish to read some or all of the CP; we plan to consider the extension of the common platform over the next year (see under Next steps below). The CP contains the following chapters:

- Chapter 2 explains our rationale for the common platform, the areas it covers and the restructuring of SYSC, including the addition of certain PRU Chapters.
- Chapters 3-9 cover our proposals on a specific area:

10 The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544).

- General organisational requirements (Chapter 3);
- Employees and agents (Chapter 4);
- Compliance (including internal audit) (Chapter 5);
- Risk control (Chapter 6);
- Outsourcing (Chapter 7);
- Record keeping (Chapter 8); and
- Conflicts of interest (Chapter 9);

- Chapter 10 describes the CAD/MiFID perimeter guidance.

The CP also has five Annexes:

- Annex 1: Compatibility with our objectives and the principles of good regulation;
- Annex 2: Cost benefit analysis;
- Annex 3: List of questions in this Consultation Paper;
- Annex 4: Draft Handbook text; and
- Annex 5: CAD/MiFID draft perimeter guidance.

Next steps

1.25. The consultation on this CP will close on August 19 2006 (3 months from the date of publication of this CP). In due course, we will review the final implementing Directive against the Draft Implementing Measures and consider how to deal with any significant changes. We will publish a feedback statement in the fourth quarter of 2006.

1.26. A further Annex to this CP, covering consequential amendments required to other parts of the Handbook as a result of the creation of the common platform, will be published on our website in due course.

1.27. This CP is the first in our formal programme of four consultation papers setting out the changes to our rules and guidance necessary to implement MiFID. The *Implementing MiFID for firms and markets* CP, planned for July, will cover MiFID provisions on market transparency, transaction reporting, authorisation and permissions, passporting and enforcement and cooperation. The *Reforming COB Regulation* CP, referred to earlier, will cover:

- implementation of the MiFID conduct of business requirements;
- implications for business that falls outside MiFID scope in retail markets; and

- organisational requirements not included in this CP (that is, provisions on conflicts of interest in investment research and on outsourcing retail portfolio management services to non-EEA service providers).

1.28. The CP on *Marketing Communications*, also planned for fourth quarter of 2006, will cover the implementation of relevant MiFID requirements in the context of wider changes flowing from our ongoing review of financial promotions.

Consumers

The common platform proposals implementing the organisational requirements in MiFID and the CRD in the UK primarily concern the internal affairs of firms – management oversight and systems and controls. As such, there are limited direct implications for consumers. The proposals relating to conflicts of interest will be relevant to consumers in that firms will disclose appropriate information to clients to enable them to take an informed discussion with respect to the services provided by the firm. Compliance by banks, building societies and investment firms with these measures should ensure that their governance arrangements and systems and controls are robust and therefore make it less likely that they will fail to allow conflicts of interest to inappropriately affect the conduct of their business; fail to comply with their regulatory obligations; or fail to protect the confidentiality of their clients. This will help us to meet our statutory objective of maintaining market confidence and provide some benefits of consumer protection.

2 The common platform

CRD and MiFID overview

2.1. CRD, which is required to be transposed and applied by 1 January 2007, is primarily concerned with the introduction of a modern, risk-sensitive prudential framework for credit institutions. However, it also contains some high-level requirements concerning firms' management oversight and systems and controls. In particular, the CRD recasts Article 22 of the BCD, which requires firms to have robust governance arrangements, including a clear organisational structure with well-defined, transparent and consistent lines of responsibility. These arrangements must be comprehensive and proportionate. Firms are also to take into account specific requirements in areas such as credit, market, liquidity and operational risk. In implementing the CRD, we have to apply these requirements at group and sub-group level to firms within its scope.

2.2. MiFID has to be transposed by 31 January 2007 and applied from 1 November 2007. MiFID is concerned with markets in financial services and the provision of investment services and activities and it provides a regulatory framework for authorisation of, and operating conditions for, investment firms. MiFID was adopted by the European Parliament (EP) and Council. It represents 'Level 1' under the four level Lamfalussy structure for European financial services measures. In the area of systems and controls, it generally only sets out framework principles. These principles will be developed and elaborated by detailed technical implementing measures ('Level 2' measures) adopted by the European Commission (subject to the approval of the European Securities Committee and oversight by the EP).

2.3. Article 13 of MiFID sets out organisational requirements for investment firms, most of which require firms to have and maintain operational and administrative arrangements – that is, systems and controls around the firms operations. They include having proper administrative and accounting procedures; establishing internal control mechanisms and effective risk management procedures; providing for the appropriate treatment of conflicts

of interest; ensuring business continuity; and maintaining rigorous arrangements for outsourcing. The requirements of Article 13 of MiFID are expanded upon in the Draft Implementing Measures. The Draft Implementing Measures make senior management particularly responsible for three functions in the organisation of an investment firm - compliance, risk management and internal audit. The MiFID requirements are intended to be proportionate in their application to firms, allowing for variations in the nature, scale and complexity of firms' business.

2.4. Our proposals for implementing the systems and controls requirements of both CRD and MiFID are covered in this CP. Other requirements in Article 13 of MiFID are concerned with matters we treat as conduct of business issues, such as the safeguarding of client assets, personal transactions and record keeping. We have record-keeping requirements in SYSC and client asset protections are not dealt with in COB. Our proposals for implementing the first of these issues will be covered in our '*Implementing MiFID for firms and markets*' CP, while the rest will be contained in our planned '*Reforming COB Regulation*' CP. One other issue, the requirements which relate to the outsourcing of retail portfolio management services to non-EU providers, will also be covered in the '*Reforming COB Regulation*' CP, because the Draft Implementing Measures may change as a result of continuing discussions at a European level, which are expected to run into June 2006.

The rationale for the common platform

2.5. Although both MiFID and CRD have independently set requirements for management oversight, internal governance and systems and controls, they share a common approach and their requirements are broadly compatible, even if they are formulated differently. In CP 05/03 we said that our initial analysis of the Directives' requirements indicated that there is a large degree of commonality between the high level standards for risk management and the systems and controls required. We therefore think the right approach to implementation is to create a unified set of reasonably high-level, risk management and systems and controls requirements, applying to firms subject to both Directives, although differentiated as necessary; that is, a 'common platform'.

2.6. For common platform firms, there is a legal driver for a common platform: the principal CRD systems and controls provisions apply to many firms subject to MiFID and the principal MiFID oversight and systems and controls provisions apply to many institutions subject to CRD[1]. The alternative to a common

1 CAD Article 34 applies BCD Article 22 (which imposes a general 'robust governance' requirement) and BCD Article 123 (which mandates sound processes for assessing the capital required for the risks the firm takes on) to every investment firm that is not an "exempt CAD firm" (see the draft perimeter guidance in Annex 5). In addition, Article 1 of MiFID applies Article 13 to credit institutions which provide one or more investment service and/or perform investment activities. As a result, many firms will be subject to both MiFID and CRD organisational requirements.

platform would be two sets of requirements, each implementing one of the Directives, with many firms subject to both sets of requirements.

2.7. There are other, more practical, reasons for a common platform. There is a substantial degree of overlap of the territory which the CRD and MiFID requirements apply to (i.e. a firm's business operations). For example, both Directives cover outsourcing. The different requirements of each may well apply to the same back office functions which a firm may want to outsource.

2.8. Both Directives also require firms to manage risks, but the risks are likely to be the same and arise from the same or overlapping business activities. And both Directives expect a firm to look to risks from activities and products outside the specific scope of the Directive. For example, risks to a MiFID/CRD firm, arising from the sale of insurance-based products, would need to be managed under CRD risk management provisions as well as MiFID. The MIFID requirements on internal audit (to establish and maintain an audit function to evaluate the firm's systems and controls) would be likely to require a firm's internal audit function to be able to review the whole of a firm's business, not just those activities traceable to MiFID business. As CRD requirements for internal control also look to the whole of a firm's business, there is strong potential for regulatory overlap.

2.9. Two sets of systems and controls rules may also run counter to the way firms organise themselves (e.g. where firms outsource IT and helpdesks, which are not necessarily organised along the lines of Directive-specific activities). There could be additional costs and difficulties for firms from complying with two sets of requirements, with different rules for different parts of their business, and some areas subject to both sets of rules.

2.10. Against that background, in considering our approach to implementation, simple copy-out of both Directives did not appear sensible. Firms would have two sets of requirements - one CRD, one MiFID - which would be similar in some respects, but not all, and apply in an overlapping way to the same business operations.

2.11. Our proposed unified approach is also consistent with a principles-based approach to regulation which emphasises senior management responsibility. Setting our systems and controls requirements at a high level is in line with our objective that a firm's senior management takes responsibility to comply effectively with financial services regulation. A key element of that is determining what processes and internal organisation are appropriate for their business.

2.12. Well-managed firms with robust systems and controls can secure a regulatory dividend. Under CRD Pillar 2, we are required to review firms' systems and controls as an input to discussions on whether improvements and/or additional capital are needed. Our unified approach complements our aim to

concentrate our resources in the most appropriate areas to meet our statutory objectives and makes us easier to do business with.

Our approach to the common platform

2.13. Our proposal to establish a unified approach to systems and controls requirements for firms subject to CRD and/or MiFID will involve some degree of 'super-equivalence' for some firms, because setting a single unified standard can involve a substantive levelling-up of standards beyond what a particular Directive may require. The nature and extent of such super-equivalence and its impact on firms is not a simple matter to determine. By their nature, systems and controls requirements operate at the organisational level and whether, in their application to particular firms, they cause a firm to do more than may be strictly required by one of the Directives, may depend on the nature of a firm's business and how it is organised. And because firms organise their internal affairs differently, it is very difficult for us to assess the impact of the common platform more generally. However, we foresee that it could well be different as between three populations of firms:

- those subject to MiFID only – referred to in this CP as MiFID-only firms (such as 'exempt CAD firms' – firms only authorised to provide investment advice and/or receive and transmit orders from investors without permission to hold client money or securities);
- those subject to CRD only – referred to in this CP as CRD-only firms (such as banks who do not perform any investment services and activities within the scope of MiFID); and
- those firms subject to both CRD and MiFID (such as the majority of banks and investment firms).

Further information about the scope of the CRD and MiFID is set out in Chapter 10 and Annex 5.

2.14. We propose to extend the common platform to cover more of a firm's ancillary activities (as defined in our Handbook glossary) than SYSC Chapter 3 currently covers, where this is consistent with the scope of application of the CRD and MiFID. This requirement to be consistent with the CRD and MiFID may require some parts of the common platform to have a slightly different scope to the rest.

2.15. Paragraph 2.8 explains that many of the Directives' organisational requirements go well beyond their specific product focus. In relation to outsourcing, we propose to apply the one (MiFID) standard to all of a common platform firm's outsourcing of critical or important operational functions related to its MiFID business, to other non-MiFID regulated

activities, listed activities under the BCD, and ancillary services under MiFID. So, applying this standard to the outsourcing by a firm of business which is not MiFID or MiFID-related, or other business not directly covered by the MiFID provisions (i.e. outsourcing related to MiFID ancillary services), will (to the extent that they go beyond the CRD minimum requirements) be super-equivalent. But many firms organise outsourcing to support business functions not strictly separated into MiFID-related business or CRD-related business. And commonly, firms apply similar controls to all their outsourcing, not differentiating between the CRD, MiFID and other business. So the impact of two standards, although Directive minima, may be more than one unified standard.

2.16. To comply with the CRD standard for risk management, a firm would need to look to risks from all its business operations, whether CRD, MiFID or non-MiFID/CRD. In this case, a unified standard based on CRD provision but applying to all of a firm's activities, will not be super-equivalent.

2.17. We have analysed each of the common platform proposals and carefully considered the costs and benefits of each proposal. We have used information on the impact of our proposals obtained from firms, through a survey conducted on our behalf by Capgemini, backed up by interviews with firms. Details are set out in Annex 2. Overall, the nature and extent of super-equivalence appears modest and the impact on firms small. We have also identified possible areas of super-equivalence and the costs and benefits of these, although our data on them is limited.

2.18. In some cases, where our CBA did not appear to support a unified standard, we have proposed MiFID requirements apply only to MiFID firms and are not extended to CRD firms and vice versa. We explain this further in the relevant chapters. Because of the difficulty in predicting cost and other impacts for firms, we have included relevant consultation questions. Where the information from our CBA work is not clear cut, for example, conflicts of interest (Chapter 9), we explain the particular issue and ask specific questions on it. This approach would not affect the application of more general principles, that may be relevant depending on the circumstances. It remains, of course, open to firms, where there are two parallel sets of rules or where we propose, for example, not to apply a CRD requirement to a MiFID-only firm or not to apply a MiFID requirement to the whole of a firm's business, for a firm to level up if it chooses. However, any consequent material costs would not arise from our imposing the requirement through the Handbook but from the firm's own decision.

The re-structuring of SYSC with effect from 1 January 2007

2.19. We have identified seven broad areas of management oversight and control, including risk management, which the common platform will cover: general organisational requirements; employees, agents and other relevant persons; compliance and internal audit; risk control; outsourcing; record-keeping and conflicts of interest. The majority of our high-level systems and controls requirements are contained in existing SYSC Chapter 3 (Systems and Controls). For presentational and navigational reasons, we do not propose to extend SYSC Chapter 3 to include all of the CRD/MiFID related systems and controls material. So we propose that SYSC Chapter 3 should be disapplied for common platform firms and be replaced by seven new SYSC chapters, which we refer to as the common platform:

- Chapter 4: General organisational requirements (including business continuity);
- Chapter 5: Employees, agents and other relevant persons (including senior management requirements);
- Chapter 6: Compliance (including internal audit);
- Chapter 7: Risk controls (including certain CRD risk-specific material);
- Chapter 8: Outsourcing;
- Chapter 9: Record keeping; and
- Chapter 10: Conflicts of interest.

2.20. We propose that the detailed draft MiFID record-keeping requirements, which are mainly in the nature of conduct of business requirements, will be located in the Conduct of Business Sourcebook. Therefore, implementing proposals for these will be covered in the '*Reforming COB Regulation*' CP. That CP will also contain proposals for high-level record-keeping requirements, which will form SYSC Chapter 9. These proposals will take into account the Draft Implementing Measures and our existing SYSC record-keeping requirements. Firms that do not adopt the common platform before 1 November 2007 will remain subject to the high-level record-keeping requirements in SYSC Chapter 3.

2.21. SYSC Chapter 3 will remain in force for firms not subject to MiFID or CRD until we have completed our work on the extent to which the common platform might be applied to them. It will also remain in force for common platform firms until 1 November 2007 unless they move to the common platform earlier.

2.22. In devising the common platform, we have also considered all relevant existing Handbook material, which includes the systems and controls policy

material covered by CP142 (SYSC 3A and the risk-specific systems and controls chapters in PRU, most of which are only in force for insurers)[2]; relevant material in SYSC; and the current Interim Prudential Sourcebooks (IPRUs) for banks, building societies and investment firms.

2.23. On 1 January 2007, we will also move certain PRU chapters into SYSC as part of the Handbook recreation to become SYSC Chapters 11, 12, 14-17. This is because they contain high-level systems and controls material, even if, for the most part, they only apply to insurers. SYSC Chapters 13-17 will only apply to insurers. They will remain in SYSC in this form for the foreseeable future. Their contents and long-term future will be reviewed as part of our Solvency 2 Directive policy development work.

2.24. We intend to re-order the PRU chapters slightly to create an insurance-only part of SYSC. So PRU Chapters 5.1 (Liquidity risk) and 8.1 (Group risk) will become SYSC Chapters 11 and 12 respectively, as they apply more widely than to insurers alone. We are currently reviewing our policy on liquidity risk and we will consult on it later in the year. Our proposals for group risk are in Chapter 6 of this CP.

2.25. SYSC 3A (Operational risk systems and controls) will become SYSC Chapter 13, to be followed, with one exception, by the remaining PRU chapters listed in footnote 3 in order (PRU Chapter 1.4 will become SYSC Chapter 14, ending with PRU Chapter 7.1 becoming SYSC Chapter 17).

2.26. The exception is PRU Chapter 6.1 (Operational risk). Virtually all of the contents are being moved to INSPRU; the rest will become part of SYSC Chapter 14. We will consult on this in our '*Strengthening Capital Standards – Restructuring the Handbook*' CP to be issued shortly (though we include the relevant draft Handbook in this CP for respondents' information).

2.27. Finally, the current SYSC Chapter 4 (Whistle-blowing (the Public Interest Disclosure Act)) will become SYSC Chapter 18 but will otherwise be unchanged and continue to apply to all firms.

2.28. We propose to incorporate into the common platform existing Handbook material only where this is justified. To the extent that the material is not specifically covered by MiFID/CRD requirements, we have considered whether the material is sufficiently essential to justify retaining it in the common platform for its subject. In fact, most of the material is guidance which now appears superfluous or obsolete and little is carried forward. There are some specific requirements which we propose to carry forward (e.g. on compliance); these are explained in the relevant CP chapter.

2 The chapters are PRU 1.4 (Risk management and associated systems and controls); PRU 3.1 (Credit risk); PRU 4.1 (Market risk); PRU 6.1 (Operational risk); PRU 7.1 (Insurance risk); and PRU 8.1 (Group risk). All except PRU 8.1 apply only to insurers. SYSC 11 will incorporate parts of PRU 5.1 (Liquidity risk, which also applies more widely than to insurers alone), but we shall consult on liquidity risk later this year.

Commencement

2.29. The CRD must be transposed and applied by 1 January 2007 and MiFID must be transposed by 31 January 2007 and applied to firms from 1 November 2007. We are consulting now so that we meet both the CRD implementation deadline and the MiFID transposition deadline.

2.30. Because we believe the common platform will contain those standards on systems and controls which are appropriate for FSA-style regulation, our preferred approach is to ensure that, before 1 January 2007, the rules and guidance comprising the common platform, are set out in our Handbook. This will permit a common platform firm to comply with the common platform requirements on and from that date, should it so wish. We have drafted a transitional provision to provide the mechanism by which a firm can move to the common platform from 1 January 2007. The transitional provisions will come into force on 1 January 2007 and cease to have effect on 1 November 2007.

2.31. From 1 January 2007, a firm that is subject to the CRD must comply with the systems and controls requirements contained in the CRD. In order to ensure that we implement these requirements by 1 January 2007, we have copied them out into SYSC Chapter 3 where they will remain for the 10 months to 1 November 2007. Until 1 November 2007, a firm subject to the CRD must comply with SYSC Chapter 3 (including the new CRD related provisions) unless it opts to comply with the common platform requirements in full early, in which case SYSC Chapters 4 to 10 will apply to it and SYSC Chapter 3 will cease to apply to it.

2.32. During the ten month period between 1 January and 1 November 2007, a firm subject only to MiFID will also remain subject to SYSC Chapter 3 (although it will not have to comply with the new CRD related provisions) unless it opts to comply with the common platform requirements before 1 November 2007, in which case SYSC 3 will cease to apply to it and it will be subject to SYSC Chapters 4 to 10 instead.

2.33. As explained above, a firm subject to CRD and/or MiFID may opt into the common platform at any time during the 10 month period between 1 January 2007 and 1 November 2007. In order to do so, the firm must make a record of the date that it decides to comply with the common platform requirements. From that date, SYSC Chapters 4 to 10 will apply to it and SYSC Chapter 3 will be disapplied. It should be noted that a common platform may only opt into the whole of the common platform early; a selective approach to adoption by firms will not be permissible.

2.34. The common platform will apply to all common platform firms (including those who have not opted to comply with it earlier) from 1 November 2007,

when SYSC Chapter 3 will be disapplied for those firms and the CRD copy-out provisions deleted from the chapter.

2.35. SYSC Chapters 11 to 18 will apply from 1 January 2007 to all firms falling within the application scope of those chapters. SYSC Chapter 2 will continue to apply to all firms. We will consult on SYSC 2 in the context of senior management responsibility and the approved persons regime later this year.

2.36. Other possible options that we considered for transitioning firms to compliance with the systems and controls requirements of both CRD and MiFID would involve applying the MiFID requirements early. While the approach we have proposed will change the systems and controls requirements applying to CRD firms twice in ten months, the ability to opt-in to the common platform from 1 January 2007 will give these firms the option to transition from the old to the new regimes in a single stage.

Q1: Will your firm transition to the common platform before 1 November 2007?

3 General organisational requirements

Introduction

3.1. SYSC Chapter 4 contains the proposed rules and guidance on the general organisation of a firm and covers:

- a firm's governance, internal controls and organisation;
- a firm's accounting procedures;
- a firm's audit committee;
- business continuity;
- the persons controlling a firm (the 'four eyes requirement'); and
- senior management responsibility.

Governance, internal controls and organisation

3.2. The MiFID and CRD requirements on governance, internal controls and organisation are relatively similar. They require, broadly, that a firm has:

- robust governance arrangements;
- sound administrative and decision-making procedures;
- an organisational structure which clearly, consistently and in a documented manner specifies reporting lines and allocates functions and responsibilities;
- adequate internal control mechanisms;
- effective internal reporting and communication of information; and
- adequate safeguards for the security, integrity and confidentiality of information and for the firm's information processing.

The common platform proposals reflect these requirements and are in line with existing Handbook provisions. They extend to all common platform firms. As stated in Chapter 1, to provide clarity about the standards we expect of firms in these areas of governance and internal controls, the common platform proposals are for a unified set of requirements (with the exceptions detailed in paragraph 3.5 and 3.10 – 3.21 below). We did not think that firms would find it useful to have parallel requirements on these topics. Therefore, we propose SYSC 4.1.1 as a unified standard, transposing both MiFID Article 13(5) paragraph two and BCD Article 22. This includes applying the proportionality requirement in BCD Article 22(2), which is implicit in the MiFID level 1 text and explicit in a number of provisions in the Draft Implementing Measures, to the unified standard.

We also propose extending the qualification in the Draft Implementing Measures – that a firm's systems and controls should take into account the nature, scale and complexity of its business - to common platform firms not subject to MiFID (CRD-only firms).

3.3. Although the common platform proposals are broadly in line with existing Handbook provisions, a unified approach goes beyond the Directive minimum requirements in certain respects, and so we have carefully considered the costs and benefits in each case.

3.4. Our CBA indicates that the incremental economic benefits of applying to CRD-only firms the Draft Implementing Measures requirements concerning:

- an organisational structure which clearly, consistently and in a documented manner specifies reporting lines and allocates functions and responsibilities;
- adequate internal control mechanisms; and
- effective internal reporting and communication of information.

look very limited, but the incremental costs also look correspondingly small. Hence, the common platform proposals include these requirements, rather than creating a separate standard for CRD-only firms.

Q2: Do you agree with our proposal to create a unified standard by extending the Draft Implementing Measures requirements on governance, internal controls and organisation to CRD-only firms?

3.5. Our CBA indicates that the costs to CRD-only firms of applying the MiFID requirements concerning the security, integrity and confidentiality of information might exceed the benefits. Hence, we have proposed two standards in this area (the MiFID requirement for firms subject to MiFID, but

no such specific requirement for CRD-only firms) and do not propose to include this specific requirement in the common platform.

Q3: Do you agree that we should create two, parallel, standards in relation to the integrity of information (i.e. a separate standard for CRD-only firms)?

Accounting

3.6. Both MiFID and the CRD require a firm to have sound accounting procedures. MiFID also specifies that a firm must be able to produce to us, on request, financial statements which give a true and fair view of its financial position and comply with all applicable accounting standards and rules. We are proposing to extend this MiFID-derived element to CRD-only firms, because we believe the ready availability of proper financial statements supports effective systems and controls within a firm.

Q4: Do you agree with our proposal to create a unified standard for accounting systems and controls?

On-going monitoring

3.7. MiFID requires a firm to monitor, and regularly evaluate, the adequacy of its systems, internal control mechanisms and arrangements established to comply with the above MiFID requirements (and the business continuity requirements discussed below), and to take appropriate measures to address any deficiencies. We do not believe this adds materially to our existing requirements as we believe this obligation is implicit in SYSC 3.1.1 R. Our CBA analysis concludes that if there is benefit to the substantive requirements, it follows that there is benefit in requiring firms to monitor and evaluate regularly the effectiveness of any systems, internal control mechanisms and arrangements established in compliance with those requirements, and to remedy any deficiencies. Hence, the common platform proposals include this, rather than creating a separate standard for CRD-only firms.

Q5: Do you agree with our proposal to create a unified standard for on-going monitoring?

Verification of compliance

3.8. CAD requires a firm to ensure that its internal control mechanisms and administrative and accounting procedures permit the verification of its compliance with CAD at all times. We shall consider expanding this

requirement to refer to compliance with the 'regulatory system' (see chapter 5 for the rationale for expanding our compliance obligation to cover the regulatory system) and to apply it to common platform firms not subject to the CRD (MiFID-only firms) when we develop our policy concerning record-keeping during this year.

Q6: Would you like us to create a unified standard by extending the requirement concerning verification of compliance to MiFID-only firms and to cover the 'regulatory system'?

Audit committee

3.9. Our existing guidance in SYSC 3.2.15G provides that it may be appropriate for a firm to have an audit committee if this is proportionate to the nature, scale and complexity of the firm's business, and gives guidance on its role and composition. MiFID does not deal with the question of whether a firm should maintain an audit committee. We believe this guidance is prudent, high-level, flexible and succinct, and that it is appreciated by firms. The common platform proposals retain this guidance.

Q7: Do you agree with our proposal to retain this guidance concerning audit committees in the common platform?

Business continuity

3.10. Both MiFID and CRD set out requirements on business continuity.

3.11. CRD requires a firm to have contingency and business continuity plans in place to ensure its ability to operate on an ongoing basis and to limit losses in the event of severe business disruption.

3.12. The Draft Implementing Measures require an investment firm to establish, implement and maintain an adequate business continuity policy aimed at ensuring that its essential data and functions are preserved, and its investment services and activities maintained in the case of an interruption to its systems and procedures. Where that is not possible, a firm will need to enable the timely recovery or resumption of such data, functions, services and activities. These measures underpin the requirement in Article 13(4) of MiFID that a firm shall take reasonable steps to ensure continuity and regularity in the performance of services and activities, i.e. employ appropriate and proportionate systems, resources and procedures.

3.13. Given the broadly similar nature of the two Directive requirements, we have explored the possibility of unified business continuity requirements that

would require a firm to: establish, implement and maintain an adequate business continuity policy aimed at ensuring that its essential data and functions are preserved, losses are limited, and its regulated activities maintained in the case of an interruption to its systems and procedures. Where that is not possible, a firm would need to enable the timely recovery or resumption of such data, functions, and activities.

3.14. This proposal would involve two instances of super-equivalence:

- the CRD requires business continuity plans to be in place to cover the event of severe business disruption, whereas MiFID requires the plan to cover the wider case of an interruption to its systems and procedures. Our proposal would go beyond CRD minima and would mean all common platform firms meeting the broader standard, i.e. having plans in place to cover any interruption; and
- the CRD requirement applies to the whole of a firm's business whereas the MiFID requirement applies only to investment services and activities. A unified approach would go beyond MiFID's minimum requirements by requiring firms' business continuity plans to cover all regulated activities, not just MiFID activities.

3.15. Our CBA of the common platform proposals compared with current regulation indicates that there would be minimal impact from changing the current guidance (SYSC 3.2 19G) to the requirements suggested in paragraph 3.13.

3.16. However, the CBA assessment compared with the Directive's minimum requirements indicates that firms consider there to be a significant difference between 'severe business disruption' and 'interruption'. Where firms stated there would be an incremental cost in meeting the 'interruption' requirement, in most cases they expected this to be material, particularly where they had to extend their plans to cover their non-MiFID activities. While there may be some social benefit in requiring all common platform firms to have in place business continuity plans to cover 'interruptions', there are also commercial imperatives for firms to do this of their own accord. So the incremental costs of imposing the higher standard for business continuity do not obviously exceed the economic benefits.

3.17. On this basis, we propose intelligent copy-out of the MiFID and CRD requirements for business continuity, i.e. a parallel set of rules. Compliance will be straightforward for CRD-only firms who will have to meet the CRD-based rule, and for MiFID-only firms who will have to meet the MiFID-based rules.

3.18. We recognise that most common platform firms are subject to both Directives, and that complying with overlapping rules may be confusing. To minimise confusion we will 'intelligently copy-out' the Directive requirements so that firms can more easily identify where the requirements differ and where they

are the same. For example, MiFID requires a firm to have a business continuity policy while the CRD requirement is to have contingency and business continuity plans. In practice there is little difference in the terms so we are intelligently copying-out the rules so that both refer to a contingency and business continuity policy.

3.19. In practice, we understand that firms organise their business continuity arrangements on a firm-wide basis so they may choose to adopt a single standard. Indeed firms might choose to apply the higher standard, i.e. to have a business continuity policy that addresses an interruption across the whole of a firm's business. This outcome would look like a common platform for business continuity.

3.20. To assist firms in interpreting the parallel set of rules, we propose to add a rule making clear that a firm within the scope of both MiFID and CRD should comply with the MiFID rules on business continuity for its investment services and activities (i.e. its MiFID business), and the CRD rule for all of its other business.

Q8: Do you think the costs of the business continuity common platform approach outweigh the benefits?

Q9: Would you prefer the common platform approach to a parallel set of rules?

3.21. We also propose to include guidance which suggests that a firm's business continuity policy should include matters such as resource requirements, recovery priorities, communication arrangements, and regular testing where appropriate and proportionate. By pointing out the potential remit of a business continuity plan, this guidance explains how firms might implement the new rules on business continuity.

Q10: Do you agree that this guidance on what the business continuity policy might cover is sufficiently useful to have?

Persons controlling a firm (the 'four eyes' requirement)

3.22. MiFID and the CRD require that the management of a firm be undertaken by at least two persons of sufficient good repute and experience as to ensure the sound and prudent management of the firm. MiFID also allows us to authorise investment firms that are sole traders provided that alternative arrangements are in place to ensure sound and prudent management of the firm. These requirements are substantially the same as our existing Handbook and practice. We are moving some associated material from IPRU(BANK) to this part of SYSC 4 as part of the re-organisation of our Handbook[1].

Senior management

3.23. Broadly, MiFID requires that 'senior management'[2] be responsible for their firm's compliance with MiFID. We are reviewing separately how our Handbook (including SYSC 2) expresses our policy on senior management responsibility. We expect to consult on policy proposals arising from this review later in 2006. In the interim, we propose to copy out the specific MiFID requirements in Chapter 4 of SYSC and apply them only to MiFID firms[3].

1 As part of our Handbook rationalisation, the IPRU(BANK) 'four eyes' requirement for overseas banks will be moved to SYSC Chapter 3 (overseas banks are outside the scope of the common platform as they are not subject to MiFID or CRD).

2 We use the term 'senior personnel' (as opposed to 'senior management') in the draft Handbook provisions, because (i) BIPRU already introduces the defined term senior management, which is restricted to the firm's governing body and those of the firm's senior managers and other senior management (undefined) who have responsibilities relating to the measurement and control of risks which the firm's VaR model is designed to measure or whose responsibilities require them to take into account these risks; (ii) throughout the chapters of SYSC that are copied over from PRU there is reference to senior management (undefined); (iii) the Glossary already contains a definition for senior manager, which expressly excludes directors but does include a person given responsibility for management and supervision and who reports directly to the governing body/chief executive.

3 The CRD contains no express requirements on this subject.

4 Employees and agents

Introduction

4.1. Our proposals for the employees and agents of a firm are in SYSC Chapter 5. They cover:

- awareness of procedures;
- segregation of duties;
- employees' competence, skills, knowledge and expertise; and
- ongoing monitoring.

4.2. These requirements make clear that firms have a responsibility to ensure that the staff they employ (and agents) do their jobs properly, follow internal procedures, are competent to perform the tasks they are given, and are not given multiple duties which might compromise their ability to act properly. In addition, as was the case for many of the general organisational requirements discussed in the last chapter (see paragraph 3.7) a firm must monitor, and regularly evaluate, the adequacy of its systems, internal control mechanisms and arrangements established to comply with the requirements concerning staff, and take appropriate measures to address any deficiencies.

4.3. These requirements set standards which consumers would expect to find in organisations providing financial services and products, to which their financial affairs and savings are entrusted. Both MiFID and the CRD cover this area. We did not consider that firms would prefer two separate standards on these matters so our common platform proposal comprises a unified standard (with the exception detailed in paragraph 4.5 below). A unified standard involves some super-equivalence, which we identify below and invite comments on the costs and benefits (see Annex 2).

Awareness of procedures and segregation of duties

4.4. The common platform proposals require, broadly, that a firm must ensure that its 'relevant persons'[1] are aware of the procedures to be followed to do their jobs properly. In broad terms, a firm must also make arrangements concerning segregating the duties of staff, which ensure that that the performance of multiple functions by a 'relevant person' does not prevent them from discharging any particular function soundly, honestly, and professionally. It must also make arrangements covering the prevention of conflicts of interest facing, for example, individual members of staff. This is supplemented by some existing guidance concerning the segregation of staff duties. As was the case with several general organisational requirements (see Chapter 3) we propose extending to CRD-only firms the MiFID qualification - that these systems and controls concerning employees (and those concerning employee competence discussed in paragraph 4.5) should take into account the nature, scale and complexity of a firm's business. This is consistent with the general approach in the second paragraph of Article 22 of the recast BCD.

4.5. The common platform proposals are generally the same as our current requirements. Applying the MiFID requirement that firms' relevant persons are aware of the procedures to be followed to do their jobs properly to CRD-only firms is super-equivalent. Our CBA indicates that the costs to CRD-only firms might exceed the benefits to those firms. Hence, we have proposed two standards in this area (the MiFID requirement for firms subject to MiFID, but no such requirement for CRD-only firms) and do not propose to include this specific requirement in the common platform.

> Q11: Do you agree that we should create two parallel standards in relation to employees' awareness of procedures (i.e. a separate standard for CRD-only firms)?

4.6. The common platform proposal is for a unified standard on the segregation of the duties of staff. It comprises the CRD requirement (that a firm make arrangements regarding segregation of duties) with the MiFID requirement that a firm ensure that the performance of multiple functions by a relevant person does not prevent that person from discharging any particular function soundly, honestly, and professionally. We believe that the benefits of a unified standard on this matter outweigh the costs – in particular, because safeguards for employees performing multiple roles minimise operational risks (such as negligence or fraud). This promotes our statutory objectives of market stability and consumer protection.

1 'Relevant person' is a technical term covering, broadly, directors, partners (or equivalent), managers and employees of the firm, or of a tied agent of the firm. It also covers a natural person who is involved in the provision of services to the firm or to its tied agent under certain outsourcing arrangements.

Q12: Do you agree with our proposal to create a unified standard concerning segregation of the duties of employees (rather than two parallel sets of requirements)?

Employees' competence

4.7. The common platform requirement in this area is based on the MiFID requirement that a firm, broadly, employs personnel with the skills, knowledge and expertise to discharge their responsibilities. We propose to supplement this requirement with some existing guidance concerning employees' competence (see paragraph 4.8). We believe the employment of competent staff is necessary for the effective and proper operation of all firms, not just those subject to MiFID. This proposal is substantially the same as our existing Handbook requirements and is in line with existing industry practice. We believe a unified standard is appropriate on this topic. If we introduce a MiFID-based standard (i.e. the requirement to employ competent employees) for employees of MiFID firms, but a different standard (such as no specific requirements at all) for employees of CRD firms, we would send a potentially confusing message to stakeholders. They might construe this as indicating that we are not concerned about standards in the non-MiFID parts of a firm's business.

Q13: Do you agree with our proposal to create a unified standard concerning employees' competence?

Retained Handbook material

4.8. In SYSC 5 we propose to duplicate the following guidance currently in SYSC 3 and transfer the following guidance currently in PRU:

- SYSC 3.2.13G, that a firm's systems and controls should enable it to satisfy itself of the suitability of anyone who acts for it;
- SYSC 3.2.14G, on assessing individual employees' honesty, competence and suitability; and
- PRU 1.4.30–32G, on the segregation of duties of employees, including:
- the potential benefits of segregation (e.g. ensuring that no one individual is completely free to bind the firm);
- specifying which functions (such as internal audit) should be segregated;
- identifying four functions (the authority to initiate a transaction, bind the firm, make payments and account for it) that should normally not be combined in the one individual; and

- that a firm should have compensating controls, if it is unable to ensure the complete segregation of duties.

Q14: Is this guidance on a firm's employees useful to have in the common platform?

5 Compliance (including internal audit)

Introduction

5.1. SYSC Chapter 6 contains our proposals for compliance and internal audit. The CRD does not contain explicit requirements on either function. The MiFID requirements are broadly in line with our existing requirements - that firms need to establish effective systems and procedures to help them meet their regulatory requirements.

Compliance

5.2. Regulators expect all firms to conduct their business in a way that protects the interest of consumers and fosters the integrity and efficient operation of the markets. Regardless of their size or complexity or the range of their business activities, compliance with the regulatory framework applicable to their operations is clearly central to meeting these expectations. In addition, regulators acknowledge that a business culture in which firms value and promote a compliance culture, that is, compliance with the spirit of the law, can play an essential role in preventing possible misconduct and promoting ethical behaviour. In turn, this contributes to fair and orderly markets in which consumers and firms have confidence. Regulators and firms and their senior managers will therefore be concerned that their management oversight and internal controls cover compliance by the firm and its employees complies with the applicable regulatory framework.

5.3. We believe that all firms should be subject to the same standards in this area, while recognising that the standards should be applied in a way that is proportionate to the nature, scale and complexity of a firm's business. The common platform proposals are for a unified set of requirements, which will apply to common platform firms. Limiting the proposals, for example, to firms subject to MiFID would send a confusing message to consumers and

firms that we are less concerned with firms' compliance activities in relation to non-MiFID business.

5.4. Our proposals require a firm to:

- establish and maintain policies and procedures aimed at ensuring effective compliance;
- establish procedures able to identify the risks associated with a failure by the firm to comply with its obligations;
- establish a monitoring programme to regularly assess and address any inadequacies or deficiencies arising from the firm's compliance and address any arising issues;
- have an independent compliance function which has the necessary authority and is structured, resourced and operated in a manner which fosters integrity and efficient operation; and
- appoint a compliance officer who has the necessary authority, responsibility for the compliance oversight function and that person reports to the governing body in respect of that responsibility.

5.5. The requirement for an independent compliance function will not apply if it is disproportionate given the nature, scale and complexity of the firm's business. We expect this proportionality will be most useful to less complicated small- to medium-sized firms. These firms might not have sufficient staff to warrant an independent compliance function; however, they will have to show that their compliance function continues to be effective.

5.6. Although the common platform proposals are broadly in line with existing Handbook provisions, a unified approach goes beyond Directive minimum requirements in that a unified standard will apply to CRD-only firms (which goes beyond the CRD's minimum requirements) and to all of a firm's regulated activities (which is super-equivalent for a MiFID-only firm). In addition, our proposal requires compliance with requirements and standards under the regulatory system. This is broader than MiFID as it includes requirements under the CRD and FSMA. The latter includes our policies in the financial sector which are aimed at consumer protection, market stability and financial crime. Limiting the scope of a firm's compliance function to MiFID requirements would send a confusing message to both firms and consumers that we are less concerned with firms complying with requirements other than MiFID proposals.

5.7. In response to our CBA survey, 78% of firms anticipated no material impact of the common platform proposals over existing Handbook provisions. We have conducted a Directive minimum CBA and believe the proposals are justified.

Q15: Do you agree with our proposal to create a unified standard for compliance as described above?

Internal audit

5.8. We view internal audit as an integral part of a firm's corporate governance framework, providing an assurance that its key business risks are being managed and that its internal control framework is operating effectively. For this reason, we propose a unified standard for this important control.

5.9. Our proposal is that a firm, where appropriate and proportionate, must establish and maintain an internal audit function which is separate and independent from its other functions and activities. There is no difference in substance between our proposal and the current requirements in our Handbook, but our proposal will be a rule while the material it replaces consists of guidance and evidential provisions.

5.10. Whether it is appropriate and proportionate for a firm to have an independent internal audit function will depend on the particular nature, scale and complexity of the firm's business. In general, the larger a firm and the more complex or risky its business, the more likely it will need to have an independent internal audit function.

5.11. Where it is not appropriate or proportionate to have an independent internal audit function, a firm will still need adequate internal control mechanisms. For example, a firm's compliance function could carry on the activities that would have been performed by an internal audit function had one been deemed necessary. Or a firm might have systems and procedures in place aimed at dealing with the same areas that would otherwise be covered by internal audit.

5.12. If a firm has an internal audit function, it must be separate from its compliance function and from its risk management function (where such functions exist). The internal audit function will be responsible for establishing, implementing and maintaining an audit plan, issuing recommendations based on the audit plan, verifying compliance with those recommendations, and reporting to senior management and the supervisory function of the firm.

5.13. Our proposal is not prescriptive about how the verification will operate or who is responsible for implementing the recommendations. So where senior management currently rectifies issues identified by the audit plan and satisfies the auditor that an issue has been resolved, this could continue.

5.14. Our proposal will involve some super-equivalence to the extent that the common platform will extend MiFID requirements, which apply to all of a firm's business, to CRD-only firms.

Q16: Do you agree with our proposal to create a unified standard for internal audit?

Q17: For CRD-only firms what are the costs involved?

5.15. We do not think that any guidance on this new rule is necessary. We have considered whether any guidance on internal audit in SYSC Chapter 3, Chapter 1.4 of the Prudential Sourcebook (PRU), Chapters GN and AR of the Interim Prudential Sourcebook for Banks (IPRU (BANK)) and Chapters 4, 7 and 9 of the Interim Prudential Sourcebook for Building Societies (IPRU (BSOC)) is sufficiently important to be retained and extended to all common platform firms[1]. We have concluded that none is.

Q18: Do you agree with our proposal not to include any guidance on internal audit?

Q19: Is there any guidance on internal audit in PRU, IPRU(BANK) or IPRU (BSOC) that you think is sufficiently important for us to retain and extend to all common platform firms? If so, please identify it and explain why.

Countering financial crime

5.16. SYSC Chapter 6 contains a separate sub-section which repeats the current requirements in SYSC Chapter 3 for countering financial crime, one of our statutory objectives. This repetition is to avoid any potential underlap for common platform firms when they move to the common platform. These proposals are outside the scope of MiFID and CRD.

1 There is no relevant guidance in the Interim Prudential Sourcebook for Investment Businesses (IPRU (INV)).

6 Risk control (including CRD risk-specific material)

Introduction

6.1. This Chapter describes our proposals for implementing CRD and MiFID risk control and certain CRD risk-specific requirements. The proposed rules and guidance are in SYSC Chapter 7, except for those on group risk, which are in SYSC Chapter 12[1].

6.2. Both MiFID and the CRD stress the importance of firms establishing effective risk control policies and procedures. Having proper arrangements for identifying and managing risks to a firm's business is a fundamental responsibility and is relevant to our statutory objectives. We believe a unified high-level standard which clarifies our expectations is appropriate. We do not propose a unified standard for certain specific risk requirements.

Risk control

6.3. Our proposed risk control requirements are not substantially different from our current Handbook material which is primarily detailed guidance. This will be replaced by high-level rules. A common platform firm will be required to establish, implement and maintain adequate risk management policies and procedures which identify and set the tolerable level of risk relating to its activities including employees' compliance with them. A firm must also have a separate risk control function, where this is proportionate, depending on the nature, scale and complexity of its business. The function will be responsible for assessing the risks that the firm faces and for advising the firm's governing body and senior managers on those risks.

6.4. Although the common platform proposals are broadly in line with existing Handbook provisions, a unified approach does go beyond the Directive minimum requirements in the following respects:

1 SYSC Chapter 12 is currently PRU Chapter 8.1, which is one of the chapters in PRU we are moving across to SYSC when our Handbook is recreated on 1 January 2007. To avoid confusion, we refer to it here by its SYSC chapter number.

- by extending the MiFID requirements concerning risk management to CRD-only firms; and
- by extending these requirements to cover all employees, regardless of seniority and whether or not they are involved in MiFID or non-MiFID business.

Our CBA indicates that the common platform in these areas should not impose significant costs on firms. We believe that appropriate risk controls in a firm help protect the firm from insolvency and from operational risks, thus promoting our statutory objectives.

Q20: Do you agree with our proposal to create a unified standard concerning risk controls?

6.5. We also propose to extend to MiFID-only firms the CRD requirement to document the organisation and responsibilities of the risk assessment function; without appropriate documentation, a firm cannot easily show that it has properly established and maintained a risk assessment function. Our CBA here indicates that the incremental economic benefits of applying this documentation requirement to MiFID-only firms look very limited, but the incremental costs also look correspondingly small. We therefore propose to extend this requirement to all common platform firms.

Q21: Do you agree with our proposal to extend to MiFID-only firms the CRD requirement in relation to documentation of the organisation and responsibilities of the risk assessment function?

CRD risk-specific requirements

6.6. A CRD firm's risk management strategy will also be required to cover:

- credit and counterparty risk – a firm must have robust credit risk arrangements including effective policies and procedures to approve, amend, renew and refinance credits. These requirements also include monitoring and reporting credit risk-bearing portfolios, identifying and making provisions and ensuring a firm has sufficient levels of diversification;
- residual risk – a firm must address and control by written policies and procedures the risk that recognised credit risk mitigation techniques used by it prove less effective than expected;
- market risk – a firm must implement policies and processes for the measurement and management of all material sources and effects of market risks; and

- operational risk – a firm must have effective policies and procedures to identify, evaluate, manage, monitor and report operational risks, including low frequency high-severity events.

6.7. These requirements are all CRD-based. We do not propose a unified standard on these matters. Our CBA does not support extending them to MiFID-only firms. Such requirements would either have no effect on a firm's operations, (other than an administrative cost in determining that the rules were not relevant), or, if relevant, there would be no market failure requiring regulation because the firms would not hold client money in respect of MiFID instruments.

Q22: Do you agree that these CRD-based risk-specific proposals should not be extended to MiFID-only firms?

Q23: If you do not agree, please say which proposals should be extended to MiFID-only firms and why.

Liquidity risk

6.8. Liquidity risk is the risk that a firm, although solvent, either does not have available sufficient financial resources to enable it to meet its obligations as they fall due, or can secure such resources only at excessive cost.

6.9. SYSC Chapter 7 copies out the specific CRD liquidity risk requirements, which we propose will only apply to a firm subject to the CRD for the same reasons as the other CRD risk-specific requirements. We are including this material in SYSC Chapter 7 for the time being to ensure that we have properly consulted on it and can meet the 1 January 2007 implementation date for the CRD. Our intention is that on 1 January 2007 the material will form part of SYSC Chapter 11[2].

Q24: Do you agree that the CRD liquidity risk proposals should not be extended to MiFID-only firms?

Q25: If you do not agree, please say why.

Group risk

6.10. CRD requires us to apply systems and controls requirements at group and sub-group level to firms within its scope. Our existing group risk systems and controls requirements currently located within PRU Chapter 8.1 apply to a wider range of firms but deliver much of what is needed to implement the relevant provisions of the CRD. So we intend to transfer PRU 8.1 to SYSC Chapter 12 with only limited amendments.

2 Liquidity risk – currently PRU Chapter 5.1 - will move across to SYSC, as part of the Handbook streamlining on 1 January 2007. We are currently reviewing the material in that Chapter and will consult on it later this year. PRU Chapter 5.1 covers liquidity risk, mainly for insurers, though some material applies more widely.

6.11. The general group risk systems and controls requirements in PRU Chapter 8.1 already apply to many firms including credit institutions, investment firms and insurers. The chapter also contains more specific requirements that implement existing provisions in various Directives applying to:

- firms that are members of financial conglomerates;
- credit institutions and investment firms; and
- insurers.

6.12. We do not need to alter the requirements in PRU Chapter 8.1 except as required to implement the CRD. The changes that we are proposing in this CP will affect firms that are subject to the risk-based requirements of the CRD – that is, BIPRU firms – and electronic money institutions (ELMIs). They will also affect any non-BIPRU firm that is the parent of a 'UK consolidation group'[3]; this is consistent with our proposed implementation of the other requirements of the CRD that relate to groups.

6.13. We must require a firm within the Directive's scope to meet the systems and controls obligations of the CRD in relation to any UK consolidation group or 'non-EEA sub-group'[4] of which it is a member. In particular, such a firm must ensure that:

- the group's (or sub-group's) arrangements, processes and mechanisms are consistent and well-integrated; and
- any group data and information relevant to the purpose of supervision can be produced.

6.14. We believe the requirement in the first bullet point above is dealt with by the existing rule (which will become SYSC 12.1.8R (2)), provided that rule is applied at the appropriate group level. To implement the requirement in the second bullet point, we are proposing a minor amendment to the existing rule (which will become SYSC 12.1.10R) to clarify that 'prudential requirements' encompasses those relating to systems and controls.

6.15. We propose introducing two new rules (SYSC 12.1.13R and 12.1.14R) to complete our implementation of the CRD's group risk systems and controls requirements. These rules are intended to ensure that the relevant firms:

- apply the general group risk systems and controls obligations at the level of any UK consolidation group or non-EEA sub-group of which they a member; and

3 This term is defined in BIPRU 8 in the draft Handbook text contained in the Appendix to CP 06/3. In broad terms, a UK consolidation group is a group to which the CRD applies on a consolidated basis and of which the FSA is the consolidated supervisor. The application provisions of PRU Chapter 8.1 now reflect the terminology we use in CP 06/3.

4 This term is also defined in BIPRU 8. Broadly, it is a sub-group of a UK consolidation group that contains a BIPRU firm and at least one non-EEA credit institution, investment firm, financial institution or asset management company.

- in doing so, ensure that the group's (or sub-group's) systems and controls cover the specific requirements of the CRD, as implemented in the common platform.

Q26: Do you agree with our 'minimum change' approach to implementing the group risk systems and controls requirements of the CRD?

Q27: If you do not agree, what would you suggest instead? Do you think that our proposals achieve our intention of minimum change?

7 Outsourcing

Introduction

7.1. Our proposals for outsourcing are in SYSC Chapter 8.

7.2. We continue to believe that the operational risk posed by outsourcing arrangements could present a significant threat to three of our statutory objectives, those of securing the appropriate degree of protection for consumers, of maintaining confidence in the financial system and of reducing financial crime. Firms use third parties to carry out activities that the business itself would normally undertake. These arrangements have the potential to transfer risk, management and compliance to third parties who may not be regulated and may operate offshore.

7.3. In 2002 we consulted in CP142 on implementing provisions concerning operational risk systems and controls, including outsourcing. We subsequently implemented those proposals in 2004 only for insurers, pending the finalisation of MiFID and CRD. Our proposals are consistent with the findings of CP142.

7.4. This chapter does not include proposals to implement the conditions for outsourcing retail portfolio management services to non-EEA service providers (Article 15 of the Draft Implementing Measures) as we believe that Article may change before adoption by the European Parliament (EP). Our proposals to implement this measure, when adopted by the EP, will be in our *Reforming COB Regulation* CP.

The new requirements

7.5. Firms choose to outsource for a variety of reasons but it is probably unlikely that the activities outsourced will be segregated into MiFID or CRD business activities. Outsourcing, for example, of back office operations is likely to cover business and information ancillary to both. And firms tend to outsource

a function or service for all of their business. Outsourcing of critical or important functions could threaten our statutory objectives and the conditions for a firm's authorisation. We consider that a unified standard is sensible in this area.

7.6. In our view, compliance with the general principle in the recast BCD Article 22 (that a firm has robust governance arrangements and adequate internal control mechanisms for example) can cover all outsourcing arrangements (both material and non-material) in relation to the whole of a firm's business. Failure by a firm to have adequate arrangements regarding its outsourcing would be a failure to have robust governance arrangements or internal control mechanisms under Article 22.

7.7. In contrast, the detailed MiFID requirements apply to outsourcing of critical or important operational functions ('material' outsourcing) related to MiFID business.

7.8. The common platform proposals therefore will extend the detailed MiFID requirements (if proportionate) for all of a common platform firm's material outsourcing in relation to:

- regulated activities whether MiFID business or not (e.g. deposit taking activities and the safeguarding and administration of investments as well as MiFID investment services and activities);
- listed activities under the BCD (e.g. lending activities); and
- ancillary services under MiFID (e.g. the provision of investment research).

7.9. We have also included guidance in our draft outsourcing rules that the application of the outsourcing provisions is limited by the wider application provisions of SYSC.

7.10. We consider that non-material outsourcing (i.e. outsourcing of non-critical or important business functions) is not entirely risk free and that the risks it poses can also threaten our statutory objectives. However, our requirements for non-material outsourcing should be proportionate to the risks of the arrangements. So we do not propose to apply the material outsourcing requirements as rules for non-material outsourcing. Instead, we propose guidance that a firm should take the material outsourcing rules into account, as appropriate and proportionate, for its non-material outsourcing. This approach, as well as reflecting BCD Article 22, will give a firm and its management the flexibility needed to control the risks arising from non-material outsourcing in a manner appropriate and proportionate to the firm's needs.

7.11. Our proposals involve some super-equivalence. First, they are above the Directive's minimum requirements for a CRD-only firm. Secondly, to the extent that our unified standard applies to material outsourcing generally, it is super-equivalent for a MiFID firm which also does non-MiFID business

because it is not limited to just MiFID business. We believe our proposal reflects market practice as firms do not organise their outsourcing according to which Directive applies to a particular element of their business. We also believe that our proposal is better than the alternative of devising a different set of rules for material outsourcing for non-MIFID business.

7.12. We do not intend to give guidance on what is meant by a 'critical' or 'important' function beyond what is set out in MiFID. This is because what is critical or important is likely to vary according to the nature and circumstances of each firm. Crucially, we believe that this is a matter for a firm's management to determine and take responsibility for, in the context of their firm.

Q28: Do you agree with our proposal to create a unified standard concerning outsourcing of critical or important operational functions?

Q29: Do you agree that our proposal for outsourcing of non-critical or important operational functions is proportionate?

Q30: If you do not agree, what approach should we take for outsourcing of non-critical or important operational functions?

Q31: Do you agree that no further guidance is necessary on the meaning of a 'critical' or 'important' function?

8 Record keeping

Our implementation plans

8.1. Our proposals to implement the MiFID record-keeping requirements will be in our '*Reforming COB Regulation*' CP. This is because some elements are liable to change before the Draft Implementing Measures are finally adopted by the European Parliament and because they mainly affect our Conduct of Business Sourcebook. We also wish to undertake more extensive CBA to determine the extent to which it might be appropriate to extend the MiFID requirements beyond MiFID business.

8.2. Our high level record-keeping requirements form SYSC Chapter 9. We are currently considering whether firms might prefer us to amend the transitional provision so that the record-keeping requirements in SYSC Chapter 3 remain in force until 1 November 2007 for firms that adopt the common platform early. This would enable such firms to make only one set of changes for record-keeping while allowing them the full ten months to 1 November 2007 to implement any changes they need to make. Firms that do not adopt the common platform before 1 November 2007 will remain subject to the SYSC Chapter 3 record-keeping requirements.

Existing Handbook requirements

8.3. We are maintaining the rules and associated guidance on financial information and record-keeping for investment firms in the relevant chapters of IPRU(INV) until 1 November 2007. These requirements will therefore remain in force for BIPRU firms when the rest of IPRU(INV) is switched off on 1 January 2007 as part of our Handbook recreation when PRU and most of the relevant IPRUs are replaced by GENPRU, BIPRU and INSPRU[1]. We will consider the future of the existing SYSC and IPRU(INV) record-keeping material as part of our record-keeping proposals later this year. That

1 For further details see CP 06/3 and our '*Strengthening Capital Standards – Restructuring the Handbook*' CP to be issued shortly.

consideration will also include the extent to which the record-keeping material in PRU, which only applies to insurers, might form part of the common platform for record keeping.

8.4. We have also reviewed the guidance on record keeping in IPRU(BANK) and IPRU (BSOC) against our higher hurdle for retaining guidance (see Chapter 2). We do not consider that any of this guidance is sufficiently essential to be included as part of SYSC Chapter 9. So we will delete it on 1 January 2007 as part of the Handbook recreation exercise.

Q32: Is there any guidance on record-keeping in IPRU(BANK) or IPRU(BSOC) that you think should be kept as part of the common platform?

Q33: If you do, please identify it and explain why it should be extended to all common platform firms.

9 Conflicts of interest

Introduction

9.1. Both MiFID and the CRD require Member States to introduce regulatory standards for the effective management of conflicts of interest by firms within their scope. We propose to implement these through rules and guidance within Chapter 10 of SYSC. For common platform firms this will replace our current material in COB Chapter 7.1, 5.10 and 2.4[1].

The importance of managing conflicts of interest

9.2. Conflicts of interest, and potential conflicts, are ubiquitous in the financial services industry. Although the potential for conflicts to arise is likely to be greater in large organisations providing a range of financial services, even the smallest intermediary firm might have interests which conflict with a duty owed to a client. Failure to deal appropriately with conflicts tends to undermine confidence in the financial markets generally and cause investor protection costs. At the firm level, firms may be exposed to the risk of litigation and loss of reputation (and, hence, future profits). Regulators around the world are therefore rightly concerned with standards in firms' organisational arrangements and expect strong management oversight and control of this aspect of firms' affairs.

9.3. Effective management of conflicts can therefore have significant benefits, in broad terms by preventing firms taking advantage of information asymmetries and of principal-agent issues. Examples include:

- where a firm is providing advice to a potential issuer and has advisory clients that may be interested in purchasing securities of that type: effective management of conflicts of interest will more likely lead to an efficiently priced and fairly distributed issue – with benefits to market

1 MiFID provisions on conflicts of interest in investment research and inducement will be consulted on in the '*Reforming COB Regulation*' CP.

confidence and to investor protection – and to better buying decisions by the advisory clients – with benefits to investor protection; and

- where a firm is managing a client portfolio and is some way off-target for a performance-related fee: effective management of conflicts of interest will more likely prevent the firm from taking on overly risky positions close to a valuation date in the hope of reaching the performance target – with benefits to investor protection and to market confidence.

Common platform approach

9.4. Our view is that regulatory standards in this area should be clear and reflect the importance of this aspect of firms' systems and controls and senior management's responsibility for it. (For example, our thematic work in 2005 showed the attitude of senior management and the firm's culture to be significant drivers of good practice in conflicts management.) We also believe that requirements should be principles-based and provide flexibility for firms to comply in a way that is appropriate for their business models.

9.5. Both the CRD and MiFID have the effect of requiring a firm to establish and maintain an effective policy to manage conflicts of interest between the firm and its clients and between clients of the firm, appropriate to the size and organisation of the firm and to the nature, scale and complexity of its business. The common platform proposal contains a unified requirement in these terms with the effect that firms will be required to manage conflicts of interest wherever they arise in the regulated activities and ancillary activities they carry on[2].

9.6. Requirements in MIFID, which supplement the high level requirement, will also be carried into the common platform. These include, for example, requirements that a firm's policy should be in writing, identify the circumstances which may give rise to a conflict of interest entailing material risk of damage to clients, specify the measures adopted to manage the conflicts, and keep records. They also include requirements for firms to insulate staff from conflicts where this is an appropriate and proportionate approach. Our understanding, based in part on our 2005 thematic work, is that firms generally consider having a policy, identifying conflicts and establishing procedures for managing conflicts, including by insulating staff, to be very much part of existing normal business practice.

9.7. We do not currently define 'conflict of interest' in our Glossary. We explain in our draft rules and guidance that, for there to be a conflict, it is not sufficient for the firm to stand to gain if there is not also a possible disadvantage to the client. There must be a conflict between the firm's own interests and a duty

2 Therefore, firms subject to CRD will have to comply with proposed SYSC 10.1.7.R (1) for the period in time that runs from the entry into force of MiFID.

owed to a client or between the separate interests of two or more clients to whom the firm in each case owes a duty.

9.8. Under MiFID, the regulatory classification of the client to whom the duty is owed is not relevant – retail, professional or eligible counterparty. This represents a change from our existing conflicts management principle (PRIN 8) which does not apply in relation to market counterparties. The 'interest' of the firm could arise from activities conducted by the firm or by other members of the firm's group. So it is important that the firm look across the full range of its activities when identifying conflicts.

9.9. MIFID expressly recognises that, given the diversity of firms which engage in MIFID services or activities, the provisions need to apply proportionately, giving firms' flexibility to adopt policies and measures that are appropriate for their circumstances. The common platform proposals use this approach. Thus, the procedures and practices we would expect to see in firms are likely to depend on the size and complexity of the firm's business. Large multi-service firms may wish to review the best practice identified in our Dear CEO letter of November 2005. The policies and procedures for firms that are smaller and less complex may be simpler than those of large or more complex firms, but they will also need to be effective.

Disclosure

9.10. Our current requirements in COB 7.1.4 E cite disclosure to a customer of an interest in a transaction as one of the reasonable steps a firm may take in order to manage a conflict of interest. The common platform proposals require disclosure of an actual or potential conflict of interest as a method of managing a conflict, but only where the firm is not reasonably confident that its procedures and measures for managing the conflict or potential conflict will prevent the risk of damage to the interests of its clients. MiFID and our common platform proposals make clear that this test applies in relation to specific conflicts of interest, rather than generally, and that the purpose of disclosure is to give the client an opportunity to consider whether or not to accept the service offered by the firm. These proposals do not imply that disclosure cannot be the appropriate tool for a firm to employ. But a firm must consider whether other reasonable measures would be effective to reduce the potential damage to the client's interest before making a disclosure.

9.11. Circumstances in which disclosure alone is unlikely to be appropriate as a means of managing conflicts of interest include:

- A firm trades on its own behalf in instruments for which it also has discretionary or advisory clients: information barriers and segregation of

activities will reduce the risk of damage to clients' interests, though disclosure may still be required;

- The firm is advising an issuer and has advisory or discretionary clients that may be interested in taking up the offer: effective information barriers will reduce the risk of damage to clients' interests, though disclosure might still be appropriate;
- The firm's clients have competing interests: for example, the firm is discretionary manager for more than one client or fund: procedures to ensure fairness to each client such as informing clients in advance of the firm's policy approach to aggregating demand or allocating supply will reduce the potential for conflict; but disclosure might still be appropriate in particular circumstances.

9.12. Disclosure alone is more likely to be appropriate in limited circumstances in relation to conflicts which affect the interests of professional clients - who might reasonably be expected to protect their own interests and who are more likely to be able to use the information provided to them for example, to influence the investment firm or choose another firm. For example, a firm may have multiple interests in the success of a private equity transaction; if its clients also wish to participate in the transaction, disclosure alone may be appropriate where it is clear to clients in what respects they are unable to rely on the firm to act in their interests.

9.13. Firms may wish to use disclosure even where they have employed other measures to manage conflicts and those measures, such as functional independence or information barriers, have the effect that the risk of damage to clients' interests is low. Our proposed measures do not prevent this.

Q34: Do you agree with our view of the circumstances in which disclosure might or might not be appropriate as a means of managing conflicts of interest?

Q35: If you do not agree, in what circumstances might disclosure be, or not be, appropriate as a means of managing conflicts of interest?

Application to groups

9.14. Where the firm is a member of a group, its policy must take into account any circumstances of which the firm is or should be aware, which may give rise to a conflict of interest posing a risk of damage to its clients' interests arising as a result of the structure and activities of other members of the group.

Retained Handbook material not in MiFID or the CRD

9.15. We propose to retain some guidance on the management of conflicts of interest in corporate finance business which was introduced in 2004 within COB 5.10. We believe firms continue to find some value in this material. It has been reconstituted as SYSC 10.1.13 to 10.1.15.

9.16. We also intend to retain provision for the legal effect of information barriers in SYSC 10.2, as provided in current COB 2.4.4R and COB 2.4.6R. Firms will continue to be able to rely on effective Chinese walls for rules which apply to a firm acting with knowledge.

9.17. The implementation of the common platform will lead to significant changes to COB for common platform firms. As explained in Chapter 1 we shall be publishing a further Annex in due course in which we shall consult on consequential changes to COB and as necessary to any other Handbook modules.

To what extent do the proposed requirements go beyond the minimum required by the Directives?

9.18. The common platform proposals are to apply in relation to the management of conflicts of interest in respect of all clients of a firm. The proposals will require firms to consider whether it has interests, anywhere in its business, which conflict with the interests of its clients – that is, those to whom it provides or intends to provide a service or whether the separate interests of two or more of its clients or potential clients are in conflict. And in this context, provision of a service can include any regulated or ancillary activity, including investment services and ancillary services, other designated investment business (including business in respect of investment life insurance), deposit-taking, mortgage lending and mediation and insurance intermediation and activities carried out in connection with them. Proposed rules do not generally extend to clients of activities that the FSA does not regulate; consumer credit is an example of such an activity.

9.19. These proposals go beyond the minimum required by the Directives by extending to business other than MiFID business:

(i) The proposals for a firm to establish and maintain an effective written policy to manage conflicts of interest between the firm and its clients and between clients of the firm (but see also paragraph 9.5 above) and to adopt, as necessary and appropriate, particular procedures and measures in drawing up its policy; and

(ii) The proposed limitation on disclosure as a method of managing a conflict to where the firm's procedures and measures have failed to prevent the risk of damage to a client's interests.

9.20. The common platform proposals only apply to in-scope firms. Existing conflicts of interest provisions will be unaffected for firms other than common platform firms and we have no current plans to extend the conflicts management requirements more generally to, say, other firms that are carrying on insurance or mortgage mediation. However, we shall be considering this as part of future Handbook work as explained in Chapter 1.

9.21. Consistently with our commitments on better regulation set out in Chapter 2, we have considered whether the benefits of the unified approach outweigh the costs. The CBA is set out in annex 2. Our information about the costs to firms is incomplete and we seek further information from firms on this issue (see Annex 2).

Q36: Do you agree with our proposals to create a unified standard for management of conflicts of interest as described above?

Q37: What would be the impact on your firm of the two aspects of super-equivalence in the unified standard described in paragraph 9.19

10 CAD/MiFID perimeter guidance

Introduction

10.1. This chapter outlines the scope of MiFID and the recast CAD.

10.2. These issues are explored in more depth in our draft perimeter guidance in Annex 5. The purpose of the guidance is to help firms in considering whether they fall within the scope of MiFID and of the recast CAD. We have used a Q&A format supplemented by flow charts and tables to help firms consider whether and how their business is impacted by these Directives. In preparing the guidance we sought input from industry experts and the consultation text reflects these contributions in several places. The draft perimeter guidance refers to Draft Implementing Measures and draft Treasury legislation,[1] which is currently not finalised.

10.3. The guidance is aimed primarily at regulated and unregulated firms and focuses on questions that are likely to be of wide relevance. In order to maintain the accessibility of the text, we do not propose to deal with questions that are likely to be of narrower relevance.

10.4. Previously, FSA perimeter guidance has focussed on issues of domestic scope, whereas the draft perimeter guidance focuses on the scope of European legislation. MiFID will result in some modifications to the scope of financial services regulation in the UK (for example, in relation to the range of derivative instruments covered) and the draft guidance will assist firms in identifying these areas of change. However, the guidance is primarily intended to assist firms that fall within the scope of regulation to identify whether they are subject to MiFID and the recast CAD. This will help them determine whether they are subject to FSA rules and other domestic legislation implementing MiFID and the recast CAD and to any directly applicable European regulations made under MiFID.

1 '*UK implementation of the EU Markets in Financial Instruments Directive (Directive 2004/39/EC): A consultation document*', December 2005. Annexes D and F.

10.5. In our view, MiFID does not apply to the EEA branches of non-EEA firms. We understand, however, that this is the subject of ongoing discussion at European level.

10.6. We are aware that some firms may wish to consider applying for variations of permission having read the draft guidance. We plan to communicate with firms in the near future about such applications, including how and by when these should be made.

Principal changes from the Investment Services Directive

10.7. The scope of MiFID differs from that of the Investment Services Directive (ISD) in several places, notably in relation to investment advice, which moves from being a non-core service under ISD to an investment service in its own right under MiFID. MiFID also extends EU regulation to operation of multilateral trading facilities, an increase in Directive scope relevant to firms with Part IV permissions to operate alternative trading systems.

10.8. As regards financial instruments, MiFID applies to a wider range of derivative products than the ISD including:

- commodity derivatives;
- credit derivatives;
- miscellaneous derivatives, including weather derivatives and derivatives relating to emission allowances.

10.9. MiFID also contains a broader definition of "investment firm" than the ISD and this is the starting point for considering issues of scope generally.

What is an investment firm? (Section 1 draft guidance)

10.10. An investment firm for MiFID purposes is any legal person whose regular occupation or business is:

- the provision of one or more investment services to third parties; and/or
- the performance of one or more investment activities on a professional basis.

10.11. An important difference between MiFID and the ISD is that you can be an investment firm where you do not provide any services to a third party but simply carry on activities for yourself and nobody else. This does not mean that large numbers of firms who are outside the scope of UK regulation will necessarily be subject to MiFID and therefore brought within the scope of the UK regulatory perimeter. Even in those cases where what a firm does means that the firm is an investment firm, the firm may be able to rely on one of the

exemptions in article 2 MiFID (see our Perimeter Guidance Manual (PERG) 13.5). However, as these exemptions are not available to credit institutions, there may be an impact on the MiFID status of some credit institutions (see Questions 7 and 11 in PERG 13.2).

Investment services and activities (Section 2 draft guidance)

10.12. The services and activities listed in Annex 1 Section A MiFID are:

- reception and transmission of orders in relation to one or more financial instruments;
- execution of orders on behalf of clients;
- dealing on own account;
- portfolio management;
- investment advice;
- underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis;
- placing of financial instruments without a firm commitment basis; and
- operation of multilateral trading facilities.

10.13. In addition to the investment services and activities above, MiFID contains a list of ancillary services in Annex 1 Section B. An investment firm can apply for passporting rights that include ancillary services but only if these are carried on together with one or more investment services and activities. Some of the ancillary services are not regulated activities under the Regulated Activities Order (RAO). However, MiFID is likely to require the application of some conflicts management and conduct of business requirements to all ancillary services, including those that are unregulated in the UK.

Financial instruments (Section 3 draft guidance)

10.14. The MiFID financial instruments are listed in Annex 1 Section C1-10 and include:

- transferable securities (C1);
- money-market instruments (C2);
- units in collective investment undertakings (C3);
- financial derivatives (C4 and C9);

- commodity derivatives (C5, C6 and C7);
- credit derivatives (C8); and
- other miscellaneous derivatives (C10).

10.15. Transferable securities, money market instruments and units in collective investment undertakings are already categories of financial instruments under the ISD, albeit that the definition of transferable securities (Article 4.1.18) is wider than the corresponding ISD definition. In the case of certain commodity derivatives (C7) and other miscellaneous derivatives (C10), their scope is subject to the Draft Implementing Measures.

10.16. MiFID will result in some extensions to the range of financial instruments that fall within the scope of the RAO perimeter. For example, it will bring a wide range of commodity options within the perimeter for the first time. We are aware of questions about whether MiFID will also bring foreign exchange instruments within the scope of the perimeter for the first time. In our view, the categories of financial instruments listed in paragraphs C4 and C9 do not require an extension in the current scope of the RAO perimeter in relation to foreign exchange instruments. We are considering whether to include a statement to similar effect in the PERG Q&A in due course.

Exemptions (Section 4 draft guidance)

10.17. Article 2 MiFID contains various exemptions relevant to a wide range of persons, services and activities including insurers, group treasurers, members of professions providing incidental investment services, professional investors who invest only for themselves, company pension schemes, collective investment undertakings and their operators, commodity producers, commodity traders and locals. If what you do is subject to an exemption, MiFID does not apply to you and you cannot, for example, acquire passporting rights under the Directive. However, the fact that you have an exemption under MiFID does not necessarily mean you will be excluded from the scope of the RAO. You will still need to consider the RAO to ascertain whether you require FSA authorisation. In each case, it will be for firms and individuals to consider their own situation and whether MiFID applies to them.

10.18. It may be that more than one exemption is relevant to your business, depending upon your individual circumstances. For example, in some cases you may be able to rely upon one exemption for the services you provide and another in relation to your activities.

10.19. As well as the exemptions in article 2, article 3 MiFID creates an optional exemption for certain receivers, transmitters and advisers who do not hold client money or securities and comply with other prescribed conditions. The

optional exemption is cast in similar terms to the existing (non-optional) exemption for these firms in article 2.2(g) ISD.

10.20. The Treasury consultation proceeded on the basis that:

- the optional exemption is exercised for UK firms; and
- domestic legislation includes a mechanism enabling those firms that fall within the exemption but wish to acquire passporting rights to do so by first notifying us that they no longer wish to be treated as exempt.

Recast CAD – who is subject to its requirements?

10.21. In addition to perimeter guidance on MiFID, we have prepared draft guidance in relation to the scope of the recast CAD. Only investment firms subject to MiFID are subject to the requirements of the recast CAD, but, as PERG 13.6 explains, the recast CAD imposes different requirements in relation to different investment firms.

10.22. PERG 13.6 is designed to help UK investment firms consider whether the recast CAD applies to them and, if so, how. More specifically, the Q&A and flow charts aim to help firms decide:

- which category of firm they fall into for the purposes of the FSA's base capital requirements, for example are they a BIPRU 50K firm, a BIPRU 125K firm or a BIPRU 730K firm[2]?
- how CAD otherwise applies to their business; for example are they a limited licence firm, a limited activity firm or a full scope BIPRU investment firm?

The common platform – who is subject to its requirements?

10.23. Broadly speaking, you will be subject to the common platform if you are:

- an investment firm to which MiFID applies;
- a bank or a building society.

10.24. PERG 13 provides guidance (PERG 13.1-13.5) to help firms work out whether MiFID applies to them.

Q38: Do you believe it is helpful for us to prepare perimeter guidance in relation to EU Directives?

2 See draft Handbook text for BIPRU 1 in CP 06/3: '*Strengthening Capital Standards 2*', February 2006.

Q39: Do you have any comments on the draft text of the guidance?

Q40: Do you think there are any issues not covered in the draft of the guidance that it should address?

Compatibility with our objectives and the principles of good regulation

Introduction

1 As required under Sections 155 and 157 of the Financial Services and Markets Act 2000 (FSMA), this Annex states how the proposals relating to organisational arrangements and systems and controls in this Consultation Paper (CP) are compatible with our general duties under Section 2 of FSMA and with the regulatory objectives and the principles of good regulation set out in Sections 2 to 6.

Compatibility with our statutory objectives

2 We have statutory objectives relating to maintaining market confidence in the UK financial system, protecting consumers, reducing the scope of financial crime and increasing public awareness. Our proposals in this CP are designed primarily to help us to meet our market confidence objective; however, we also indicate below where there are implications for consumer protection and reducing financial crime. We do not expect our proposals to have any significant impact on our public awareness objectives.

Market confidence

3 While we do not have a zero failure regime, the FSA has a responsibility for maintaining confidence in the financial system. Our proposals will assist achievement of this statutory objective by helping to ensure that firms have robust internal governance and organisational arrangements. In particular, there may be incremental benefits in terms of a reduction in the risk of market disruption arising from financial failure of an authorised firm, or group of firms from among banks, building societies and investment firms.

Consumer protection

4 In meeting our statutory objective to protect consumers we are required to determine the degree of protection that is appropriate. Where we have regulatory discretion, we apply a market failure test to the case for intervention. In many cases, firms' own policies concerning high-level governance, or systems and controls arrangements will be derived from their own assessment of reputation or compliance risk. However, we must also consider benefits wider than the private benefits internalised by firms when making their decisions. Where social benefits are potentially significant, there may be underinvestment by firms and it may be appropriate for us to intervene, in the form of rules or guidance, to address the potential shortfall. Though directed at market confidence, the proposals also should provide some benefits to help the achievement of our consumer protection objective. For example, our proposals for conflicts of interest management will tend to prevent firms from taking advantage of information asymmetries and principal-agent issues, so bringing benefits to consumer protection.

Reducing the scope for financial crime

5 To meet this statutory objective, we are proposing to retain some existing policy in relation to financial crime and money laundering in SYSC which is not covered by either Directive.

6 Although not addressed directly by MiFID or CRD, our proposals in this CP also contribute to this objective in a number of indirect areas. For example, an effective internal audit function will be beneficial to a firm's governance framework. To the extent that such requirements help indirectly reduce the scope for financial crime, then confidence in the markets will be enhanced.

Compatibility with the requirement to have regard to the principles of good regulation

7 In this section we explain how we have had regard to each of the principles of good regulation set out in Section 2(3) of FSMA.

The need to use our resources in the most efficient and economic way

8 Our approach to implementation of MiFID and the CRD is set out in detail in Chapters 1 and 2. This describes several important elements designed to ensure that we use our resources efficiently:

- the adoption of a unified set of reasonably high level risk management and systems and control requirements where these are proportionate;

- the placing of increased responsibility for compliance on firms and their senior management (see below), enabling us to concentrate our resources in the most appropriate areas;
- following a commitment to intelligent 'copy-out' where appropriate; and
- avoiding the over-elaboration of our rules.

The responsibilities of those who manage the affairs of authorised persons

9 We have followed an intelligent 'copy-out' approach to implementation of the EU Directives wherever possible in proposing a unified set of reasonably high level risk management and systems and control requirements. Thus, rather than impose detailed regulation, we have generally left it to firms and their senior management to determine for themselves what is necessary for them to do to meet our requirements.

The principle that a burden or restriction should be proportionate to the benefits, considered in general terms, which are expected to result from imposing that burden or restriction

10 In 2005, we committed to implementing directives in a proportionate way without 'gold-plating' EU requirements and only adding measures when these were justified in their own right and consistent with Directive provisions (Better Regulation Action Plan, December 2005 CP). We undertook a comprehensive CBA to help inform this consultation; the findings are presented in Annex 2. In addition, we sought to examine those few areas where proposals go beyond Directive minima and where the incremental costs are potentially greater than minimal significance. Differences of opinion may arise over the nature and extent of some of the impacts and we welcome the input of respondents on these in particular. Finally, MiFID has a qualifying provision that requirements be 'proportionate to the nature, scale and complexity of the firm's activities', and this means that while many of the provisions of the common platform derived from MiFID are more detailed than existing regulation, each firm should be able to take an appropriate and proportionate approach to meeting the requirements.

The desirability of facilitating innovation connected with regulated activities

11 We do not expect product innovation to be restricted for the same reason set out above. The proposals in this CP are high level, proportionate and broadly similar to existing guidance in practice.

The international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom

12 There may be competitive impacts between UK-regulated firms and firms regulated in other EEA jurisdictions where 'copy out' is adopted with no elaboration or common platform. However, determining such comparative effects is impossible while the detail of implementation elsewhere is still to be determined.

The need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions

13 Our cost benefit analysis indicates that the proposed changes should not, in general, have material adverse effects on competition.

The desirability of facilitating competition between those who are subject to any form of regulation by the FSA

14 This is difficult to assess at this point since we have not considered what requirements are appropriate for non-scope firms, but we do not believe our proposals in this CP for what are mainly high level organisational controls, will have a significant impact on competition.

The most appropriate way of our meeting our statutory objectives

15 Our overall policy stance is set out in Chapter 1. Under the Treaty of Rome, MiFID and the CRD are EU directives that we must implement in the UK. This CP has focused on implementation through a single unified approach to directives with different implementation dates that blend provisions on similar areas to maintain regulatory constancy and minimise the impact on the industry from change. We consider that our proposals in this CP are the most appropriate way of meeting our statutory objectives.

Cost benefit analysis

Introduction

1 This CP sets out our proposed rules and guidance to implement the organisational requirements contained both in the Market in Financial Instruments Directive (MiFID) and the Capital Requirements Directive (CRD) for the firms subject to either or both of these Directives. As described in Chapter 1, we are proposing an approach to implementation which in many areas proposes a unified set of organisational requirements to apply to all common platform firms based on the requirements in both of these Directives.

2 This Annex sets out two cost benefit analyses (CBAs) that we have undertaken in connection with this work.

3 The first of these is a CBA to meet our requirements under Sections 155 and 157 of the Financial Services and Markets Act. This requires that we undertake a CBA of proposed rules or proposed general guidance on rules, and publish the results. The purpose of this is to assess, in quantitative terms where possible and in qualitative terms where not, the economic costs and benefits of a proposed policy. Specifically, we are required to publish an estimate of the costs together with an analysis of the benefits to accompany the proposed draft rules.

4 This first CBA, presented in part 2 of this Annex, assesses the costs and benefits of the proposals with our current rules and guidance as the baseline.

5 In our Better Regulation Action Plan published in December 2005, we committed to implement Directives in a way which added national measures to Directive provisions only where justified and where consistent with Directive provisions. The Better Regulation Action Plan also notes that where the FSA exercises discretion (for example by adding requirements to its Handbook which go beyond the requirements of a Directive) it will only do so 'when there is a market failure and where regulatory intervention is likely to be cost-effective'. This point is re-emphasised in the HMT/FSA MiFID Joint

Implementation Plan, published on 5 May 2006, which describes the FSA's approach to implementing MIFID in more detail.

6 For these reasons, where our implementation proposals go beyond Directive-minima - for example as a result of applying requirements derived from MiFID to activities other than MiFID services and activities or to firms subject only to the CRD or applying requirements derived from the CRD to firms subject only to MiFID – then we have undertaken a second CBA, beyond the statutory requirement, against this Directive-minima baseline (see part 3).

7 The CBA set out below does not cover all implementation proposals on organisational requirements. In two cases, on record keeping and some proposals relating to outsourcing, our proposals and an analysis of the potential impacts will be presented as part of the MiFID consultation paper planned for publication in the fourth quarter of 2006.

8 The approach to data gathering and analysis is described more fully in part 4 below. The primary source is the survey work carried out this year by consultants Capgemini. This work focussed specifically on an investigation of the impact of the provisions captured within the common platform compared with current rules and guidance. For the limited number of areas where this analysis suggested the impact could potentially be more than of 'minimal' significance, we engaged economic consultants, Europe Economics to carry out some further scoping work.

9 In some areas, the CBA of our proposals which go beyond Directive-minima is not clear. We would welcome comments from respondents on our assessment of the costs and benefits on these points - in particular where our proposals are substantially the same as existing provisions. We have included specific questions in the CBA for this purpose. We will review our proposals in the light of additional information obtained.

Draft perimeter guidance

10 The purpose of the draft perimeter guidance is to help firms understand how MiFID or the recast CAD as implemented in the UK apply to them. Since the perimeter guidance contains neither rules nor guidance on rules, we have not undertaken any cost benefit analysis in respect of it.

Part 1 Cost Benefit Analysis: Key findings

Overview of the population of firms affected

11 The common platform proposals are for new rules and guidance on systems and controls that apply to all firms that come within the scope of CRD and MiFID (common platform firms). A precise estimate of the population size of

common platform firms is not possible because the FSA only has data on firms' permissions. These may not correspond with the activities and instruments covered by MIFID and CRD. A particular complexity is the extent to which firms may fall within the exemptions provided by MIFID. Our estimate of the in-scope population is in the range of 2000-2500 firms. Of these, the number which are subject to MIFID only (and not CRD) is estimated to be in the range 200-300. The number of CRD only firms is discussed in detail in part 3 and is estimated to be in the range 10-20. For the purposes of this CBA, of the total population of common platform firms, 1.5 % have been categorised as large firms.

Cost analysis

12 This section sets out our estimates of the incremental costs of the common platform proposals from the baseline of current rules and guidance. These estimates are based on data collected by Capgemini and aggregated for our estimate of the population of common platform firms.

13 To implement the Directives we need, in many areas, to replace existing guidance with rules – although in many cases the rules will be broadly in line with existing guidance – reflecting the common ground between existing guidance and Directive standards. Information from the Capgemini survey indicates that most firms already have appropriate systems and controls that are compliant with the proposals, implying that most firms follow existing guidance, or that there are strong market forces which lead to similar behaviour[1]. As a result, costs are expected to be minimal for most firms, but more significant for those that need to improve their systems and controls to meet Directive standards.

14 One factor that is likely to mitigate the impact of the change from guidance to rules is the qualification in relation to many of the requirements in MiFID that the requirements are to apply in a proportionate way i.e. taking into account the nature, scale and complexity of each firm.

15 Table 1 below sets out the aggregate incremental costs of the proposals by activity and firm size, with initial and ongoing costs shown separately. The aggregate cost for the industry across all activities is estimated to be about £45–57 million for one-off expenditures and £45–56 million on an ongoing per annum basis.

16 We observe that, of total costs, a significant proportion is attributable to proposals on internal audit, compliance, and risk controls. Individual areas are analysed in detail in part 2.

1 In most areas 80 – 90 % of firms in the Capgemini survey reported no material impact of common platform proposals.

Table 1: Aggregate industry incremental costs for common platform firms of the proposals set out in the CP – by activity and size of firm (£m)

	Small Firms	Large Firms
B3. General Organisation		
Governance, internal controls and organisation		
One–off	£ 3.5 - 4.5 m	£ 0.2 – 0.3 m
Ongoing	£ 3.5 - 4.5 m	£ 0.2 – 0.3 m
Accounting		
One–off	£ 0.9 – 1.1 m	£ 0.6 – 0.8 m
Ongoing	£ 0.9 – 1.1 m	£ 0.4 – 0.5 m
Business Continuity		
One–off	£ 4 – 5 m	0
Ongoing	£ 0.1 – 0.2 m	0
Persons controlling a firm		
One–off	£ 0.7 – 1 m	£ 0.1 m
Ongoing	£ 0.9 – 1.2 m	£ 0.1 -0.2 m
Verification of Compliance		
One–off	£2.5 m	£0.5 m
Ongoing	£2.5 m	£0.5 m
B4. Employees and agents		
Awareness and Segregation of Duties		
One–off	£ 0.7 – 1 m	£ 0.1 m
Ongoing	£ 2 – 3 m	£ 0.1 m
Employees competence		
One–off	0	£ 0.1 m
Ongoing	0	0
"Relevant Persons"		
One–off	0	£ 0.1 m
Ongoing	0	0
B5. Compliance		
Compliance		
One–off	£ 4.5 – 5.5 m	0
Ongoing	£ 6.5 – 8.5 m	0
Internal Audit		
One–off	£ 13 – 17 m	£ 0.6 – 0.8 m
Ongoing	£ 18 – 22 m	£ 0.6 – 0.8 m
B6. Risk control		
One–off	£ 4 – 5.5 m	£ 6.5 – 8.5 m
Ongoing	£ 6 – 8 m	£ 1 – 1.2 m
B7. Outsourcing		
One–off	£ 0.5 – 0.6 m	0
Ongoing	£ 1.5 – 1.8 m	0
B9. Conflicts of interest		
One–off	£ 0.1 m	£ 0.7 – 0.9 m
Ongoing	£ 0.2 m	£ 0.2 – 0.3 m
Grand Total		
One–off	£ 35 – 44 m	£ 10 – 13 m
Ongoing	£ 42 – 52 m	£ 3 – 4 m

Benefits

17 We anticipate that there may be incremental benefits in terms of improvements to market confidence, consumer protection, and, to a lesser degree, a reduction in the scope for financial crime. These benefits are considered case-by-case in sections 2 and 3 below.

18 In considering what degree of protection for consumers is appropriate, we must take into account the extent to which wider benefits ('social' benefits) are not fully internalised by firms when they make decisions about the arrangements to put in place for management oversight and systems and controls ('private' benefits). Where the social benefits are potentially significant, there may be underinvestment by firms and the shortfall may warrant regulatory intervention.

Market impacts

19 In summary, the incremental costs from the common platform proposals described in this CP appear modest. In the main, the proposals do not differ materially from existing guidance. Most firms currently choose to follow our existing guidance, the exceptions tending to be smaller businesses to which the qualifying MiFID provision requiring that proposals be proportionate to the nature, scale and complexity of the firm's activities may be relevant. We expect firms to absorb the costs that do arise and, as a result we do not expect the proposals to impact materially on markets.

Part 2: FSMA CBA by activity

General Organisation (including business continuity)

Governance, internal controls and organisation

20 The existing regulatory framework consists of rules and guidance on governance, internal controls and other organisational issues. These require a firm to have appropriate systems and controls in place to ensure that the firm exercises the degree of management oversight necessary in a well-run firm to address the risks to its operations and secure compliance with its legal and regulatory obligations. In content, the common platform requirements cover much the same ground as the current Handbook although, in implementing Directives, requirements need to be expressed as rules.

Costs analysis

21 83% of firms from the Capgemini survey stated that they would suffer no material impact from the requirement to have adequate internal control

mechanisms. Similarly 92% and 90% of firms stated that there would be no material impact from complying with the information safeguarding and internal reporting requirements respectively.

22 Aggregated for the entire population of 2000-2500 common platform firms, we estimate incremental costs be around £1.4–1.8 million on a one-off basis and £1-1.3 million per annum on an ongoing basis for internal control requirements. We estimate that figures for information safeguarding are £1.4–1.8 million one-off and £1.4–1.8 million ongoing. And for internal reporting and communication, £0.3–0.4 million one-off and £0.6–0.8 million ongoing. As suggested by the high proportion of firms indicating no material impact from the proposals, costs will not be spread across the entire population of firms but will be incurred by the smaller proportion of firms not complying with existing requirements.

23 The major cost driver identified by firms for these changes is staffing costs. These may include training costs and the recruitment of new staff to help implement the policies.

Benefits

24 Theoretically there are potential benefits for consumers and for the maintenance of confidence in the financial system from firms having internal controls and governance arrangements to support effective management oversight. However, we do not claim significant incremental benefits from these changes. We know that firms face strong incentives to establish robust governance arrangements, and that only a small proportion of firms report a material impact from the change.

Accounting

25 We do not expect the requirement for firms to have sound accounting procedures to have a significant incremental impact. There is existing guidance in SYSC and IPRU concerning accounting requirements, and we expect most firms already have sound accounting policies. The requirement that firms produce financial statements at the request of the FSA is new. Most of the costs and benefits discussed below arise from this new requirement.

Costs analysis

26 83% of respondents to the Capgemini survey stated that they would face no material impact as a result of having to meet the more detailed requirements concerning the production of financial statements at the request of the FSA. So we believe that, for the sector as a whole, the impact will be small given that most firms already meet (or are in a position to meet) the common platform proposals.

27 Where firms do not follow existing Handbook guidance and are not already in a position to supply the FSA with timely financial statements, some costs will be incurred in adjusting to the new standard. For common platform firms we calculate that these one-off costs will total around £1.5–1.9 million, and that ongoing costs will be approximately £1.3–1.6 million. The costs reported are proportionate to firm size.

28 Firms were asked to comment on the areas where they thought that incremental costs were most likely to arise. The main potential cost identified by firms was staffing cost. This may mean increased senior management time, training costs or the possible recruitment of new staff to help meet the new standard. For small firms, however, on a per firm basis the low cost numbers suggest that they will not be recruiting new staff, not even on a part time basis.

Benefits

29 Timely, accurate information on a firm's financial affairs is essential for management oversight and, in particular, for compliance with prudential regulatory requirements. As well, in order to discharge its statutory duties effectively, the FSA needs to be able to access this information whenever it is relevant for it to do so - for example, to confirm that a firm is soundly managed and solvent – to better target supervisory effort on poorly behaving firms or those with a significant risk of failure. However, because the FSA has other specific reporting requirements, the incremental benefit of this particular requirement is likely to be small.

Audit committee

30 We are proposing to retain existing guidance in SYSC 3.2.15 concerning a firm's audit committee. Neither MiFID nor the CRD provide for audit committees. We expect no additional costs or benefits.

Business continuity

31 *Note to the reader: This CBA exercise looked at the incremental impacts of a common platform for business continuity planning. However, the CBA of this proposal was not supportive so we decided not to proceed with the common platform proposal. Instead, we shall have a parallel set of rules: one set implementing the MiFID requirements for firms subject to MiFID; another set implementing the CRD requirements for firms subject to the CRD (see chapter 3 of the CP for more detail). The analysis below most likely includes costs which are no longer relevant.*

32 The existing regulatory framework consists of high level guidance on business continuity which applies to all firms. If firms choose to follow this guidance they will have appropriate arrangements in place to ensure that they can continue to function in the event of an unforeseen business interruption. The

unified set of rules were not materially different from current guidance although more detailed, and would apply in the event of an interruption rather than 'unforeseen' interruption.

Costs analysis

33 We do not expect the change from unforeseen interruption to interruption to have any impact. Firms are likely to have arrangements which deal with all forms of potential interruption, both foreseen and unforeseen.

34 So, if most firms already have business continuity arrangements that follow current guidance, given the similarity, incremental compliance costs of a unified standard would be minimal for these firms. 85% of respondents to the Capgemini survey said that they expected little or no impact from business continuity provisions becoming rules. Qualitative data from interviews with large banks shows they conform to a higher standard than is currently set out in FSA guidance.

35 Overall, the aggregate one-off costs of complying with the new provisions are estimated to be around £4–5 million. Ongoing per annum costs are estimated to be around £0.1–0.2 million. Smaller firms are most likely to face a material impact. None of the overall costs reported ensue from large firms.

Benefits

36 Business continuity plans aim to prepare firms for unforeseen interruptions to their business activities by encouraging firms to consider the possible impact of various events on the business and to prepare beforehand – including by developing plans for responding. Potential systemic effects of interruptions may prove costly for financial services markets, or have knock-on effects that affect consumers or other businesses. Potential benefits could be lost should individual firms decide not to prepare.

37 In practice, firms face a strong commercial imperative to be suitably prepared to deal with the consequences of business interruptions. The fact that 85% of common platform firms appear to have appropriate procedures in place, as indicated by the Capgemini survey, suggests that the combination of commercial incentives and existing guidance has been successful in delivering these benefits. So we expect incremental benefits to be correspondingly small.

Persons controlling a firm (the four eyes requirement)

38 The four eyes policy in the common platform proposal requires broadly that the management of a firm is undertaken by at least two persons of sufficiently good repute and experience. This is not a substantive change from existing regulatory requirements. Such requirements are currently in place for banks, building societies, and those investments firms currently subject to IPRU

(INV). The requirement will be new only for a small group of other common platform firms. So we expect the overall impact of the common platform proposal to be small.

Costs analysis

39 94% of firms in the Capgemini survey anticipated no material impact from the change. From information provided by the small proportion of firms who did report an impact, incremental costs for the entire population of firms are expected to be around £0.8–1.1 million one-off and £1–1.4 million on an ongoing basis.

Benefits

40 Theoretically the four eyes requirement provides a safeguard bearing on the quality of management oversight of a firm's activities. An additional check and balance may impact positively on important business decisions and compliance with legal and regulatory requirements, and reduce the likelihood of firm failure and the scope for financial crime. Given the low level of impact reported, we expect little incremental benefit.

Verification of Compliance

41 We propose to implement the CAD requirement that a firm ensure that its internal control mechanisms and administrative and accounting procedures permit the verification of its compliance with CAD at all times, to firms subject to CAD. While there is no explicit current requirement which matches this, several SYSC Handbook provisions present guidance which implicitly covers similar ground.

Costs analysis

42 Where firms are not already in a position to permit the verification of compliance with CAD at all times, some costs will be incurred. Extrapolating from the results of the Capgemini survey, and employing assumptions from desk-based research, we expect for the population of CRD firms the incremental aggregate one-off costs to not be more than around £3 million, and for incremental ongoing costs to not be more than approximately £3 million per annum. Actual incremental costs may be significantly less. As with other proposals we expect costs to accrue to a limited proportion of firms whose behaviour does not already match the proposed requirement.

Benefits

43 Systems permitting verification of compliance at all times may enhance compliance. As far as CAD requirements are beneficial, and this requirement enhances compliance with the CAD requirements, it has benefits. The

substantive CAD requirements enhance consumer protection and increase market confidence. As far as the proposed requirement enhances compliance with CAD requirements it may further augment both these benefits.

Employees and agents

44 Existing Handbook guidance covers employees' honesty, competence and suitability, and remuneration policies. For credit institutions there is additional guidance concerning the segregation of duties. The common platform proposals introduce additional requirements in four areas: awareness of duties; employees' competence; segregation of duties and ongoing monitoring. Chapter 4 discusses changes in detail.

45 We would expect firms to hire personnel with the skills, knowledge and expertise to discharge their responsibilities and to ensure that relevant persons are aware of the procedures to be followed to do their job properly. Insofar as firms already do this, we would expect the effect of the common platform proposals to be minimal.

46 It is likely, however, that some firms do not currently have procedures which ensure that staff do not inappropriately perform multiple functions – that is, where performing these functions prevents them from discharging any particular function soundly, honestly and professionally. Consequently, we believe that the only significant incremental costs and benefits arising from the common platform proposals will arise from the proposal concerning the segregation of duties.

Costs analysis

47 The Capgemini survey queried firms on the costs of the proposals concerning competence, honesty and awareness. As expected firms anticipated that the proposals would have a minimal impact.

48 Firms were also asked about the costs of complying with the common platform proposals concerning the segregation of staff duties. Most firms (87%) reported no material impact from the proposal. For the entire population of common platform firms, the compliance costs aggregate to approximately £0.8–1.1m on a one-off basis, and per annum ongoing costs of £2-3m. The greater part of these costs accrues to small firms. This implies that while large firms for the most part comply, it is only in a section of small firms where there are no procedures ensuring appropriate segregation of duties of certain key personnel.

49 The segregation of duties requirement is of itself not onerous in that it only imposes costs if it prevents the relevant person from carrying out multiple functions where this would not be appropriate; and moreover, the

requirement applies to the firm taking into account its nature, scale and complexity (Article 5 of the Draft Implementing Measures).

Benefits

50 Firms bear the costs that can arise when multiple duties are performed inappropriately and, in severe cases, costs can also be borne by the wider financial system and therefore by consumers. Benefits flow from the requirement to segregate duties to the extent that this prevents such operational risks from crystallising. The Capgemini survey indicates that a number of smaller firms, in particular, will have to change their current arrangements. This suggests that the proposed extension of this requirement could realise incremental benefits, though they will be limited because of the small proportions of firms that do not already comply and the relatively low impact that smaller firms have on the wider financial system.

Ongoing monitoring (relating to proposals in Chapters 3 & 4)

51 Article 5(5) of the Draft Implementing Measures requires a firm to monitor and regularly evaluate the effectiveness of the systems, internal controls and arrangements regarding most of the common platform described in Chapters 3 and 4 including internal reporting, information safeguarding, business continuity, accounting, and all employees and agents policies, and to remedy any deficiencies. Existing Handbook guidance suggests firms regularly review their systems and controls. In substance the policy is similar to before, but to implement the Directives, requirements must be expressed as rules.

Costs analysis

52 In the Capgemini questionnaire respondents were asked about the impact of the obligation to monitor compliance for the entirety of the common platform proposals (not just the proposals covered above). This is substantially wider than actually required. 22% of respondents stated they expected a material impact. We believe that this figure over-represents the percentage of firms who would expect a material impact from the requirement to monitor systems and controls in the limited number of areas defined above. Actual incremental cost information in money terms was not collected in the survey.

Benefits

53 Ongoing monitoring makes explicit a key aspect of management oversight – to ensure the firm's systems and controls are effective. If there are benefits from the substantive requirements, and ongoing monitoring enhances their effectiveness, then monitoring would be beneficial. The extent of the incremental benefit depends on: i) the degree to which monitoring enhances

effectiveness, and ii) the proportion of firms who do not already regularly evaluate /review their systems and controls.

Compliance (including internal audit)

Compliance

54 Our proposals for compliance are set out in Chapter 5. They are designed to ensure that firms' management oversight extends to the firm's compliance with all of its regulatory requirements and thereby enhance the prospect of firms meeting these. The common platform proposals go beyond the existing Handbook provisions as described in Chapter 5. Most significant is the proposal that firms have an independent compliance function that is structured, resourced and operated in a manner that fosters integrity and efficient operation. Another potentially significant proposal is that remuneration of compliance personnel not be likely to undermine their independence.

Costs analysis

55 Data from the Capgemini survey indicates that 78% of firms anticipated no material impact from establishing a separate and independent compliance function compared with existing requirements. As with most of the results reported, incremental costs will not be borne by the entire market but by the smaller proportion of firms who do not already have systems and controls which comply with those proposed. Across the entire population of common platform firms the one-off costs of complying are expected to be around £4.5–5.5 million, and the ongoing per annum costs £6.5–8.5 million.

56 Most of those who reported a material impact report staffing as the major cost driver. This is unsurprising given the new requirement for a separate and independent compliance function.

57 All firms who indicated a material impact from the change are smaller firms, though the common platform compliance proposals should not be overly burdensome because of the proportionality clause which allows firms to take into account the nature, scale and complexity of each firm. The information collected suggests compliance functions in large firms already meet the requirement to be independent.

58 Cost data on the remuneration proposal for compliance indicates minimal incremental costs across the board.

Benefits

59 The purpose of the proposals is to secure firms' compliance with regulatory requirements, in particular, by making firms, via their responsibility for management oversight, responsible for compliance. They are meant to

enhance the ability to identify risks within firms, and to help target resources towards areas where firms may not be compliant, thereby reducing potential costs to consumers.

60 The absence of an effective compliance function supported by appropriate practices and procedures may increase the probability that firms will not meet regulatory requirements, either because the monitoring of staff activities is less effective than it might be, or because firms do not examine their activities to identify any practices which might not be compliant. Such behaviour will have knock-on costs for consumers' and market confidence and financial crime. Thus, in so far as the compliance proposals do in a significant way enhance consumer protection, or increase market confidence, or lead to a reduction in the extent to which firms may be used for financial crime, there is social benefit in enhancing compliance.

61 Most firms already adopt practices which comply with the common platform proposals, as indicated by responses to the Capgemini survey. Incremental benefits of the new requirements are limited to the extent that compliance by firms with regulatory requirements improves as a result of the proposed changes.

Internal Audit

62 In terms of content, there is no significant difference between the common platform proposals for internal audit (which will be a rule) and existing Handbook guidance. Where appropriate and proportionate, the proposals will require firms to establish and maintain a separate and independent internal audit function. The internal audit function will be responsible for establishing and implementing an audit plan, issuing recommendations based on the audit plan, verifying compliance with those recommendations and reporting.

Costs analysis

63 The data from the Capgemini survey suggest that among all areas covered by the common platform proposals the biggest potential cost is associated with the internal audit requirements.

64 The aggregate one-off cost of establishing an internal audit function is estimated to be in the region of £5.5-7 million. The ongoing costs (incurred in maintaining the independent function) are estimated at £11.5–14 million. Most firms indicate that staffing costs would account for the bulk of these compliance costs.

65 Additional costs that accrue to the activity of the internal audit function as required by MiFID were identified. 9% of respondents reported a material impact due to the requirement to implement an audit plan, 19% reported a material impact in relation to issuing recommendations, and 13% in relation

to verifying compliance with recommendations. This suggests that most firms already have an audit plan in place but fewer use the plan to issue recommendations and verify compliance.

66 The total costs to the entire population of common platform firms of the proposals (that is, to establish an independent function that issues an audit plan, makes recommendations and verifies those recommendations) is estimated to be £13.5–18 million on a one-off basis and £18.5-23 million ongoing. Smaller firms reported almost the entirety of these costs, suggesting that large firms already follow procedures that are compliant with the common platform proposals in this activity.

67 Since the existing guidance is not materially different from proposals in the common platform, firms who follow existing guidance already have internal audit arrangements that will comply with the latter. Incremental costs for such firms are expected to be minimal. In line with this, 79% of firms in the survey expected there to be no material impact as a result of the new internal audit requirements.

68 It should be noted that the requirement to have an independent internal audit function need not impose a disproportionate cost for firms affected. If it is not appropriate and proportionate for firms to establish and maintain an independent internal audit function, there is no requirement to do so.

Benefits

69 Effective internal audit processes may reduce the risk of firm failure and the scope for financial crime. They may also increase consumer protection and market confidence. There are potentially some disadvantages for consumers if firms do not have independently audited records. It is possible, for example, that the quality of the financial information underlying regulatory capital/annual expenditure could diminish in the absence of such processes, and thereby firms could, intentionally or unintentionally, breach their regulatory requirements, or worse, become insolvent. In such cases, resources might be insufficient to deal with the failure, and as a result, costs might arise to consumers in the form of direct losses and opportunity costs associated with time spent dealing with the process of collecting due compensation.

70 The extent of the incremental benefits of independent audit functions depend on: (i) how effective they are in providing protection, and (ii) the probability of firms running into serious difficulties in the absence of these internal audit requirements. Both aspects are difficult to quantify.

71 Incremental benefits are limited to the extent to which firms already have internal audit arrangements that comply with the common platform.

Risk control

Costs analysis

72 The costs associated with implementing the common platform proposals on risk control are also a significant part of the total. We believe that many firms already have appropriate risk management systems and controls that are compliant with the proposals. As a result, costs are expected to be minimal for most firms, but more significant for those that need to improve their risk management in order to comply.

73 The existing regulatory framework includes rules and guidance on the establishment and maintenance of systems and controls for firms' risk management. So for many firms there will be no new implementation costs arising from the common platform proposals. The Capgemini survey suggests 80% of firms anticipate no material impact from the change. However, some firms will need to enhance their risk management policies and procedures as a result of the proposals.

74 50% of large firms reported the change would have a material impact in cost terms, compared to only 18% of all firms. Large firms also report costs many times as large as those reported by smaller firms. This suggests that the practice of risk management within firms varies considerably: small firms with simple businesses may need very straightforward risk management policies, whereas large firms operating in complex environments containing high levels of risk are more likely to require sophisticated, and therefore more expensive, risk management systems and controls.

75 Data from the Capgemini survey suggests that for the population of 2000-2500 firms as a whole, one-off costs of implementing effective policies and procedures to identify, manage, monitor, and report current and possible risks could be approximately £5.8-7 million. Approximately three quarters of this total is expected to accrue to large firms.

76 Incremental per annum ongoing costs for all common platform firms are estimated to be around £1.2–1.5 million. Notably only 15% of these costs arise for large firms. It is the short-term implementation costs which are high for large firms, whereas ongoing incremental costs are higher for small firms. This may be explained by the fact that smaller firms referred to staffing costs as the main cost driver here, while large firms expect most cost to arise from investment in technology.

77 Information collected for CP142 Operational Risk Systems and Controls suggested that large firms, depending on features of software programs and levels of sophistication, may spend considerable amounts on installing specialised software to help identify, assess, monitor and control risk. Small firms meanwhile, are unlikely to need to buy any dedicated software at all.

This suggests that such firms may not have to bear any significant technology driven one-off costs.

78 Further information collected on the documentation of the risk policies and procedures proposed suggests material costs, again mostly borne by large firms. Aggregate one-off and per-annum ongoing costs are estimated to be around £2.5–3.2 million and £2.2–2.8 million respectively for the entire population of firms. As with the actual implementation of the risk policies, one-off documentation costs are also skewed towards large firms, while ongoing costs are more evenly distributed (though as expected in proportion to firms' size).

Benefits

79 Increased risk can lead to an increased probability of firm failure, in particular if failure to identify and manage potential risks to a firm's soundness, reputation and operations threatens the continued operation or solvency of the business. Resources might be inadequate to deal with the failure, and consumers may incur either direct losses or opportunity costs associated with time spent dealing with the process of seeking compensation.

80 In less serious cases, where firm failures do not occur, consumers' welfare may still be adversely affected by processing errors and delays or by being incorrectly advised, or being mis-sold inappropriate investment products. If poor risk management leads to the quality of a firm's services declining, consumers may also suffer.

81 Systems and controls for risk management, as in the common platform proposals, may be beneficial in preventing such losses. Since we believe most firms already have effective risk management systems and controls, as indicated by the large proportion of firms who said the changes would have no material impact for them in the Capgemini survey, incremental benefits will be limited to the extent that firms enhance their risk systems and controls where necessary.

82 Requiring a firm to document its policies and procedures may strengthen the management oversight, making it more likely that senior management formally establish (or review) current practice to ensure it complies with the required standard. The benefit from documentation of risk policies and procedures is limited to the extent that documentation enhances the effectiveness of the policies themselves.

Outsourcing

83 Current guidance on outsourcing is in SYSC 3.2.4. The common platform proposals (see Chapter 7) are substantially the same as existing guidance, although they are more detailed. Outsourcing requirements in the common

platform will be expressed as rules for outsourcing of operational functions which are critical or important. We propose some guidance for other outsourcing.

84 At this stage we have not considered the impact of Article 15 of the Draft Implementing Measures which covers outsourcing to non-EEA service providers, as it is potentially subject to further change at a European level, which may have a significant market impact. Our proposals to implement this MiFID requirement will be contained in the 'Reforming COB Regulation' CP in the fourth quarter of 2006, along with the CBA.

Costs analysis

85 91% of all firms (and 100% of all large firms) in the Capgemini survey indicated that they anticipated no material impact from complying with the common platform proposals. This implies that most firms follow existing guidance in this area and that this is not materially different from complying with the common platform proposals.

86 For the entire population of common platform firms, incremental one-off compliance costs are estimated to be approximately £0.5–0.6 million. Additional ongoing costs are expected to be in the region of £1.5–1.8 million per annum. These incremental costs are relatively small. This suggests either that firms that currently do not follow our guidance outsource very little of their activities, and/or that their practice and procedures behaviour is not significantly below the standard in the proposals.

Benefit

87 Given the small proportion of firms that we believe do not follow existing guidance and the indication that it would not be a large impact for firms who do not follow guidance to do so, we expect little incremental change from the proposed policies in both cost terms, as discussed earlier, and also in terms of benefits.

88 The proposals for outsourcing aim to reduce risk and inhibit regulatory arbitrage. By reducing the probability of failure, or lowering of quality of services, the proposed rules may lead to some social benefit. Incrementally, though, we expect such benefits to be small.

Record keeping

89 As set out in Chapter 8 we will consult on record keeping as part of the 'Reforming COB Regulation' CP in the fourth quarter of 2006.

Conflicts of interest

90 The common platform proposals set standards for establishing and maintaining a conflicts of interest management policy for the identification and management of conflicts of interest that will apply broadly across the regulated activities of firms. In particular, they include a provision that disclosure should be used to manage conflicts of interest only where firms do not have confidence that other management approaches are totally effective. We expect this qualification to be the most notable change arising from the common platform proposals on conflicts.

Costs analysis

91 89% of firms surveyed by Capgemini anticipated no material impact from the requirement to maintain an effective conflicts of interest policy. We think this is an over-representation of the true figure because the survey collected information on conflicts of interest policy only for investment and ancillary services. We would expect a larger proportion of firms to anticipate a material impact from the change if it applied to conflicts of interest in other parts of their business as well. However, this estimation error is mitigated by our expectation of conflicts that might arise in business activities that are not related to MiFID business which were not already within Principle 8. A supplementary survey by Europe Economics reported that firms did not think conflicts of interest arose notably in these parts of their businesses.

92 From the small proportion of firms that did expect a material impact from the proposed change, aggregated incremental costs of compliance for the entire population of 2000-2500 firms are expected to be around £0.8–1 million one-off and £0.4–0.5 million on an ongoing per annum basis. These figures are biased downwards through the correction described above, so that we anticipate that costs will be somewhat higher.

93 Interestingly large firms report that one-off costs arise almost entirely through the qualification on the use of disclosure as a means of managing conflicts, while smaller firms report that incremental one-off costs arise almost entirely from training staff on conflicts of interest policy.

Benefits

94 Effective management of conflicts of interest has the potential to generate benefits for individual consumers and for the market as a whole by preventing firms taking advantage of asymmetries of information between buyers and sellers in the market place and of principal-agent issues. Additionally there is the possibility of enhancing market confidence leading to greater transactional activity, and consequently higher welfare for both firms and consumers.

95 The actual benefit of the changes proposed is potentially limited by three qualifications.

96 First, a very small proportion of firms report a material impact from the proposed change, suggesting little beneficial effect.

97 Secondly, while there may be some incremental costs of extending requirements (for firms to identify, and to establish policies for the management of, conflicts of interest) to business activities not covered before, notable conflicts are not expected to arise in these areas, so benefits may be limited.

98 Finally, this depends on the effect of the qualification on the use of disclosure as a means of dealing with conflicts. The management of conflicts of interest through means other than, or in addition to, disclosure may lead to more customers/clients accepting services offered (and hence benefiting) compared to a situation where after disclosure a smaller proportion may decide to accept services. Presumably disclosure would not prevent customers from seeking similar services elsewhere, so additional benefits might be limited to time and search cost savings.

Market Impacts

99 We do not expect the common platform proposals described in this CP to impact materially on markets because:

(i) most firms currently follow existing guidance;

(ii) as indicated by the Capgemini survey, those firms that do not follow the guidance tend to be smaller businesses for which the qualifying MiFID provision requiring that proposals be 'proportionate to the nature, scale and complexity of the firm's activities' will be relevant and

(iii) in most cases the common platform proposals do not differ materially from existing guidance.

100 As a result, and as indicated by the Capgemini survey, the incremental compliance costs arising from the common platform proposals appear modest when compared to the overall impact of CRD and MiFID. We expect firms to absorb these costs and do not expect any impact on prices. Nor do we expect there to be any implications for the quantity, quality or variety of products and services made available to customers, or for the efficiency of competition.

Part 3: Directive Minima CBA: Proposed requirements set out in our CP compared with Directive minimum requirements

Introduction

101 In this section we set out the CBA for common platform proposals that impose requirements on firms which go beyond Directive minima – for

example as a result of applying MiFID-derived proposals to firms which conduct activities subject to CRD but which do not conduct activities subject to MiFID (CRD–only firms) or to a broader range of business operations or activities than that contemplated by the MiFID requirements.

102 The rationale for the common platform relies on the benefits, for firms, consumers and market confidence more broadly, of a unified set of requirements, rather than having two sets of requirements, on broadly the same subjects. This is particularly relevant for the high proportion of MiFID firms also subject to the CRD. However, we have modified the common platform requirements, mindful of our commitment to avoid super-equivalent proposals, where cost-benefit analysis indicates that benefits are not likely to outweigh costs. Further, where CBA is equivocal, we have asked specific questions in this section, inviting firms to challenge our cost estimates.

103 Part 3 contains the following sub-sections:

- A discussion of the overall nature and scale of the super-equivalence contained in the proposals including a) the extension of requirements derived from MiFID to CRD-only firms; and b) the extension of requirements derived from MiFID to a broader range of operations or activities than that contemplated by the MiFID requirements.
- A discussion of instances of super-equivalence:

(i) which we do not expect to have a material impact;

(ii) where we have modified the common platform proposals because the CBA is not supportive;

(iii) where we have not conducted CBA but where we believe the common platform proposals do not impose costs disproportionate to benefits;

(iv) where we propose to extend MiFID-derived requirements to CRD-only firms and which may have a material impact; and

(v) where we propose to extend MiFID-derived requirements to a broader range of business operations or activities of firms than that contemplated by the MiFID requirements and which may have a material impact.

The nature and scale of the proposed super-equivalence

104 A clear understanding of the types and numbers of firms that fall into the categories listed above is necessary to understand the extent of economic impact of our proposals which involve some super-equivalence. The following paragraphs describe our understanding of where the boundary lies between CRD-only firms and the other common platform firms[2] and what that implies for the number of firms potentially affected.

2 Although this boundary is not drawn with legal precision, it is suitable for CBA purposes.

a) The extension of requirements derived from MiFID to CRD-only firms

105 A CRD-only firm is, broadly, a firm that makes loans and accepts deposits but does not offer any of the services or perform any of the activities in relation to any of the financial instruments listed in Annex 1 of MiFID. Annex 1 of MiFID lists a broad set of activities and instruments and, therefore, for the purposes of CBA might be considered to cover a very large proportion of what market participants understand as 'securities and investment business'. The list of services includes 'reception and transmission of orders', 'execution of orders on behalf of clients', 'dealing on own account', 'portfolio management' and 'investment advice' – see Chapter 10. The list of instruments encompasses equities, bonds, and derivatives, including commodity derivatives and units in collective investment undertakings.

106 Most banks and building societies engage in some activities or services within the scope of MiFID. For example, all 63 firms which are primarily identified as being a "Building Society" according to FSA data have a permission for 'dealing in investments as principal'. To the extent that these firms 'deal on their own account', they will be conducting activities or providing services to which MiFID applies.

107 Analysis of existing FSA permissions data is not a perfect guide to the population of firms covered by MiFID because existing permission types do not match exactly the list of services, activities and instruments in MiFID. However, more detailed analysis of FSA permissions data suggests there are approximately 10-20 CRD-only firms.

108 According to the Capgemini survey however, 10% of firms to which MiFID or CRD applies thought that only CRD (that is, not MiFID) applied to them. This would suggest around 200 to 250 CRD-only firms according to our overall population estimate of 2000-2500. The difference between these estimates and those obtained from FSA permissions data implies either that firms have misunderstood that MiFID applies to them or alternatively that they have permissions for certain regulated activities that they do not use.

109 We believe that nearly all firms which accept deposits and make loans will have some kind of treasury function to manage their liquid assets and cash flow productively by trading against proprietary capital, even if only to invest in low risk securities or money market instruments. So we believe that the true number of CRD-only businesses is probably very small and will use an estimate of 10-20 firms.

Q41: Do you agree with our assessment of the number of CRD-only firms?

b) The extension of requirements derived from MiFID to other activities carried out by MiFID firms

110 MiFID establishes a regulatory framework for, among other things, firms providing investment services or conducting particular investment activities (as defined in MiFID). The Directive's organisational requirements look more broadly at the firm's functions, operations and activities, including its internal organisation and operation. For example, in some cases these look beyond MiFID services and activities to the rest of the firm's organisation and activities, such as its risk control. So the boundary can be subtle and flexible.

111 In addition many firms conduct other activities such as lending, deposit-taking, or selling and advising on non-MiFID products. In this case, some parts of a firm's business operations are likely to relate to these other activities. Whether or not these business operations are separable from business operations that relate to or concern MiFID activities will depend, in part, on the firm's own internal organisation. We understand that many firm's business operations are not segregated along Directive lines.

112 A number of common platform firms undertake business which falls outside the scope of this Directive, for example, analysis of permissions indicate that 13% of MiFID firms have permission which relate to regulated mortgage contracts and 20% have permissions relating to insurance intermediation.

113 For such firms, the proposal to extend some of the organisational requirements to the whole of their operations is an example of super-equivalence. We have attempted to analyse the costs and benefits associated with our super-equivalent proposals. We set out this analysis in the following sections.

114 This has been particularly challenging: the way in which a particular proposal is beyond Directive minima is different for each requirement. Costs associated with a proposal will also vary for different types of firms – not just in terms of their size, but also regarding the composition of their business, for example, the split between CRD and other non-MiFID activity.

(i) Super-equivalence which we do not expect to have a material impact

115 This section covers areas where the common platform proposals are super equivalent but where we expect the impact of the extended proposals to be non-material. Given the minor nature of the effects expected, individual areas are covered only briefly.

116 If we expect guidance in practice to have the effect that firms behave in a certain way, then guidance, even though not obligatory, may have effects not too different from rules. This section therefore also examines proposals that carry-forward existing guidance.

Internal controls

117 The common platform proposal is for a unified requirement which will apply this to common platform firms. We believe that the requirements of MIFID Level 1 Article 13(5) and MIFID Level 2 Articles 5(1)(a) and 5(1)(c) only elaborate the substance of the requirements of BCD Article 22 and do not require firms to do anything additional or materially different, and therefore expect the extension to be of minimal significance.

Internal reporting and communication

118 We propose to apply Article 5(1)(e) of the Draft Implementing Measures which requires 'effective internal reporting and communication of information at all relevant levels of the investment firm' to common platform firms. The extension to CRD-only firms is super-equivalent but is not expected to have a material impact on firms because we would expect such behaviour without regulation.

Ongoing monitoring

119 Article 5(5) of the Draft Implementing Measures requires firms to monitor their systems, internal controls and arrangements regarding most of the common platform described in Chapters 3 and 4 - including internal reporting, information safeguarding, business continuity, accounting, and all employees and agents policies - and to remedy any deficiencies. When the primary obligation (to which the monitoring obligation relates) is superequivalent, then so also will be this monitoring obligation. We believe that monitoring is implicit in the requirement in both the CRD and MiFID that firms have adequate internal controls. Hence we believe that this does not create incremental costs in addition to those flowing from the (non-super-equivalent) requirements of the Directives. It is further expected that if there are benefits to the internal control proposals there may be benefits in requiring firms to monitor the effectiveness of internal controls and to remedy any deficiencies.

Regular updating of business continuity plans (BCPs)

120 We propose to include some guidance about the content of a firm's business continuity plan. We believe that this guidance clarifies what firms need to do to meet the rules of BCPs, the costs of which are discussed elsewhere in the CBA.

Guidance on audit committee

121 Existing FSA guidance provides that it may be appropriate for firms to have an audit committee of its Board of directors. Given the terms of the guidance, the existence of other requirements for audit committees (such as the Combined Code, which applies to listed firms) and the fact that firms' shareholders have private incentives to ensure firms have an audit committee where appropriate, we do not believe this guidance creates incremental costs

of more than minimal significance nor do we claim it brings significant incremental benefits.

Employees' competence

122 The common platform proposal is to apply to all common platform firms Article 5(1)(d) of the Draft Implementing Measures, which requires a firm to employ personnel with the 'skills, knowledge and expertise' to discharge their responsibilities. The extension to CRD-only firms is super-equivalent. We would expect firms to hire competent personnel anyway since they have a private incentive to do so. So we expect this to be an area of minimal costs and benefits.

Segregation of duties

123 The common platform proposal is to apply the MiFID wording on segregation of duties (found in Article 5(1)(g) of the Draft Implementing Measures) and the CRD requirement on segregation of duties (found in Annex V paragraph 1) to common platform firms. We believe the two requirements are the same in substance, and so we expect this to be an area of minimal significance.

Risk Control

124 The common platform proposal is to apply the risk management requirements of Article 7 of the Draft Implementing Measures to CRD-only firms. We believe that these elaborate the substance of the requirements of BCD Article 22 and Annex V and do not require firms to do anything additional or materially different, and so do not create additional incremental benefits or costs.

125 The common platform proposal is also to extend specific Article 7 risk management requirements to cover non-senior employees involved in non-MiFID business. In light of results from the Capgemini survey we expect this to be an area of minimal significance.

Documentation of the organisation and responsibilities of the risk assessment function

126 The common platform proposal is to extend to MiFID-only firms[3] the BCD requirement for firms to document the organisation and responsibilities of their risk assessment functions. The benefits of documenting risk assessment are discussed in paragraph 83. Our understanding is that MiFID-only firms do not hold client money in relation to MiFID activities, so the scale of any risk to consumers (and associated market failures) is limited.

3 'MiFID-only' firms are described in CP paragraph 2.13. Since they are subject to prudential requirements i.e. in respect of 'own funds', they too have prudential obligations and so we are concerned that they monitor risks i.e. have some risk assessment and documentation requirements.

127 Data isolated for MiFID-only firms in the Capgemini survey suggests almost 90% report no material impact from the requirement to document the risk assessment function. While we expect any incremental benefits of the super-equivalence to be limited we also expect costs to be small.

Guidance on the documentation of the risk assessment function

128 We propose retaining, as guidance, SYSC 3.2.10(2)G which covers the organisation and responsibilities of a risk assessment function. Since BCD has a risk documentation requirement, we expect the retention of guidance will be relevant only for MiFID-only firms. Incrementally, since this is retention of current guidance in the same form, we expect no costs or benefits.

Q42: Do you agree with our view that the proposals above are not material for CBA?

(ii) Proposals where we have modified the common platform because CBA is not supportive

Security, integrity and confidentiality of information

129 We do not propose to apply the MiFID requirements to safeguard the security, integrity and confidentiality of information, to CRD-only firms. As we believe data protection legislation and market incentives lead firms to behave in a similar manner, we do not believe the benefits of a unified standard outweigh the costs.

Informed employees

130 Article 5(1)(b) of the Draft Implementing Measures requires that firms must ensure that relevant persons are aware of the procedures to be followed to do their jobs properly. To apply this to CRD-only firms would be super-equivalent. It is not clear what market imperfection this requirement would correct. We would expect such behaviour from firms without regulation. We do not believe the benefits of a unified standard would outweigh the costs so we propose not to extend this requirement beyond the Directive minima.

Requiring MiFID-only firms to take account of CRD Annex V risk criteria

131 BCD Article 22 paragraph 2 requires firms to have comprehensive and proportionate arrangements in place to take into account the risk-specific criteria in BCD Annex V including operational risk, market risk, liquidity risk and credit risk. We propose not to extend this requirement to MiFID-only firms. The common platform proposals require all firms to have effective procedures for risk assessment. We do not believe it is proportionate to apply the additional risk-specific conditions in the CRD to MiFID-only firms.

132 MiFID-only firms do not hold client money in relation to MiFID activities, therefore credit or liquidity risk should not have a notable effect on their operations.

133 MiFID-only firms do face operational and market risk, but the major benefit of their having arrangements, mechanisms and processes in place to deal with such risks will accrue to the firms themselves. In the absence of a clear market failure and evidence that problems exist in the market in this case, we do not propose applying these requirements to MiFID-only firms.

Business continuity

134 MiFID requires firms to have a business continuity policy (BCPs) aimed at ensuring, in the case of interruptions to their systems and procedures, the preservation of essential data and functions and the maintenance of investment services and activities. For firms subject to MiFID and CRD, applying a requirement for firms to have a BCP covering interruptions to their systems and procedures, the preservation of data and functions and the maintenance of services and activities that are outside the scope of the MiFID requirement would be super-equivalent. This is because it would be outside the BCD requirement for BCP's to address 'severe disruptions'. For MiFID-only firms, applying the MiFID requirements to activities outside the scope of MiFID would go beyond Directive minimum requirements.

135 Most common platform firms are subject to both MiFID and the CRD. It is the impact of the super-equivalence described in the previous paragraph on this large number of firms that is the focus for this part of the CBA.

136 Most of the firms interviewed by Europe Economics had difficulty interpreting the difference between an 'interruption' and a 'severe disruption' and stressed the need for guidance from the FSA.

137 They all considered that there was a significant difference between the two terms, and believed that their BCPs currently covered 'severe disruption'. None of the firms interviewed was clear about the scope of 'interruption'. Subject to the uncertainties over the precise interpretation, half of those interviewed said that their current BCPs may not cover 'interruptions', and half stated that their current BCPs could only be considered to cover 'interruptions' if the term was interpreted extremely widely.

138 Firms who thought their current BCPs covered 'interruption' did not expect significant incremental costs arising from the super-equivalence. The rest of the firms interviewed stated they expected incremental costs, in most cases of a material nature. The one firm able to quantify costs gave an estimate of £10 million per year as the ongoing cost.

Summary / Conclusion

139 In light of incremental costs reported by firms, and the limited benefits associated with the proposal we do not believe that a unified standard on business continuity is justified. Therefore we propose not to have a unified standard but rather two standards. The MiFID requirements will be applied to systems and procedures, preservation of essential data and functions and the maintenance of investment services and activities within the contemplation of MiFID. Firms subject also to CRD will need to have CRD compliant BCP's. Some firms have group-wide BCPs. Our proposals would not prevent firms choosing to extend their BCPs to comply with the MiFID requirements across the whole business.

(iii) Super-equivalence where we have not conducted CBA but where we believe the common platform proposals to be justified

Compliance with the regulatory system

140 We propose to retain an existing requirement that firms have policies and procedures for compliance with the regulatory system as a whole, which is broader than the MiFID requirement. MiFID does not seek to address all the market failures which we must address, given our statutory objectives. For example, MiFID does not address damage to market confidence from market abuse or from negative externalities associated with financial crime. So there will be economic benefits from the policies and procedures firms need to have to comply with non-MiFID rules. We accept that the costs of this wider requirement may be greater than if the requirement related only to MiFID but in this instance we have not sought to quantify them.

(iv) Super-equivalences where the common platform proposals extend (non-CRD) MiFID-derived requirements to CRD-only firms and which may have a material impact

141 As discussed above we are working on the assumption that there are around 10-20 CRD-only firms, and that these are relatively small in size. In two cases where our proposals for the common platform go beyond the Directive minima for CRD-only firms, we believe there may be a material impact: in relation to accounting, and internal audit. These are discussed below.

Accounting

142 The CRD (specifically, BCD Article 22) requires that a firm have sound accounting procedures. In addition, Article 5(4) of the Draft Implementing Measures requires firms to deliver in a timely manner financial reports which reflect a true and fair value of their financial position, and which comply with all applicable accounting standards, when requested by the competent

authority. This latter requirement goes beyond the Directive minima for CRD-only firms.

Costs analysis

143 Where these firms do not follow existing Handbook guidance, and are not already in a position to supply the FSA with timely financial statements, some compliance costs will be incurred. Isolating the impact on CRD-only firms from an analysis of the results of the Capgemini survey, and employing assumptions from desk-based research, we believe that for a population of 10-20 firms the incremental aggregate one-off costs are estimated to be around £10,000–20,000, and ongoing costs similarly a few thousand pounds per annum compared with the Directive minimum requirements.

Benefits

144 In the main, the benefits arising from requirements concerning sound accounting policies and providing financial reports in a timely manner at the FSA's request are a reduction in the likelihood of failure and the consequent knock-on effects for consumers. These benefits are relevant to CRD-only firms, which provide banking services to customers.

145 The incremental benefit through applying the proposal to CRD-only firms depends on: i) how often these firms already report to the FSA, and ii) how often they will be required to report in the future. It may be that while the proposal requires firms to report in a timely manner when the FSA requests financial statements from firms, in practice the regularity of reporting requirements may not change. In such a case, both the costs and benefits of the proposed extension may be minimal.

Internal audit

146 The CRD (specifically, BCD Article 22) does not impose an explicit internal audit obligation, but it does require 'adequate internal control mechanisms'. For CRD-only firms the common platform proposals will require, where appropriate and proportionate, that such firms establish and maintain a separate and independent internal audit function. The internal audit function will be responsible for establishing and implementing an audit plan, issuing recommendations based on the audit plan, verifying compliance with those recommendations, and reporting.

Costs analysis

147 Isolating the impact on CRD-only firms from an analysis of the results of the Capgemini survey and employing assumptions from desk-based research, we believe that for a population of 10-20 firms, the incremental aggregate one-off

costs are expected to be not more than £10,000–20,000, and ongoing costs a few thousand pounds per annum.

148 We expect the bulk of this cost to arise from the independence requirement, but if it is not appropriate and proportionate for firms to establish and maintain an independent internal audit function, there is no requirement to do so.

Benefits

149 The potential benefits associated with an internal audit function are discussed in detail in paragraphs 69-71 above. While CRD-only firms do not carry out investment activities they do provide banking services to customers so there is scope for beneficial reductions in firm failure, financial crime and improvements in consumer protection.

150 The scale of the incremental benefits is affected by the extent to which firms are, in any event, required by the CRD to have adequate internal control mechanisms, the degree to which the function is enhanced by the more detailed MiFID requirements and how differently firms might behave in the absence of this detail. Certainly data from the Capgemini survey suggests that most CRD-only firms, 85%, meet internal audit guidance.

(v) Super-equivalences where common platform proposals extend MiFID-derived requirements to a broader range of business operations or activities than contemplated by MiFID requirements, which may have a material impact

151 In several areas the common platform proposals go beyond Directive minima by applying certain provisions to a broader range of business operations or activities than contemplated by MiFID requirements. Proposals in three areas have been identified that we believe are likely to have significant impacts on affected firms: conflicts of interest (COI), outsourcing, and compliance

152 Europe Economics collected information from a small sample of firms on the potential impact of these proposals on our behalf. The methodology of this survey is discussed in part 4. The potential impacts are discussed below.

Conflicts of Interest

153 We propose to extend the conflict of interest management policies specified in MiFID to the regulated activities of MiFID firms that are outside the scope of MiFID (non-MiFID business). These requirements are explained in Chapter 9.

154 If MiFID rules were not applied to non-MiFID business, the FSA's Principle 8 would still apply. This states that 'a firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client'. For firms subject to CRD, an additional high level CRD

requirement would apply to the entirety of the firm's in-scope business. This is that 'arrangements shall be defined by the management body…concerning the segregation of duties in the organisation and the prevention of conflicts of interest'. The COB, MCOB and ICOB sourcebooks also contain provisions requiring firms to manage conflicts of interest.

155 It is against this baseline that we attempt to measure the incremental costs and benefits of extending the MiFID conflicts' management policies to the non-MiFID business of firms. We expect the only notable difference from the extension of MiFID requirements to arise from firms not being able to place the same degree of reliance upon disclosure as a means of managing conflicts.

Costs analysis

156 Of the firms interviewed by Europe Economics, half had a common conflicts of interest policy in place that extended across their entire business, and half had different policies in place for different parts of the business.

157 All the firms interviewed expected the incremental costs of the proposal to be non-material. This was largely because they did not expect significant numbers of conflicts of interest issues to arise within the non-MiFID parts of their businesses. This was the case under the MiFID requirements and in relation to the existing FSA requirements, such as Principle 8.

158 One firm did quantify part of the one-off incremental costs of the proposal: the costs of the initial review of current non-MiFID business conflicts of interest policies to establish whether or not they comply with the MiFID requirements. From the information reported, we estimate the aggregated one-off costs for the population of common platform firms to be in the range £100,000 – £300,000.

159 Some firms also felt that proposals to limit the use of disclosure unduly constrained their choice of how best to deal with conflict situations.

Benefits

160 As discussed in paragraphs 94 to 98, effective management of conflicts of interest has the potential to generate benefits for consumers by preventing advantage being taken of asymmetries of information between buyers and sellers and principal-agent issues.

161 The incremental benefit of extending the MiFID requirements to cover non-MiFID business depends on i) how many conflicts situations arise in such business; and, ii) the enhancement provided by the MiFID requirement compared to the baseline.

162 In relation to the first point, we understand from information collected by Europe Economics that firms report no or low numbers of conflicts arising

from non-MiFID activities, which suggests that the incremental benefits (and also costs) of the proposal will be small.

163 With regard to the second factor, much depends on the effect of reducing the reliance on disclosure as a means of addressing conflict of interest situations. As previously discussed in this Annex, there may be time and search cost savings for customers if conflicts are effectively managed by firms. Moreover, doubts were voiced to Europe Economics about the effectiveness of making disclosures to retail consumers. Since this group makes up the majority of the customers of MiFID firms' non-MiFID business, this suggests that the proposals could yield significant benefits.

Q43: Do you have any comments on the nature and scale of the costs and benefits arising from our super-equivalent proposals on conflicts of interest?

Outsourcing

164 We propose to extend the requirements in MiFID concerning the outsourcing of critical or important operational functions related to MiFID business to other non-MiFID regulated activities, listed activities under the BCD, and ancillary services (collectively, non-MiFID business). We also propose to include guidance, in similar terms, concerning such outsourcing of functions which are not critical or important. These requirements are detailed in Chapter 7.

165 The high level organisational requirements in BCD Article 22 apply to outsourcing arrangements for all outsourcing, including non-MiFID business whether of critical or important functions or not. Article 22 of the recast BCD requires that credit institutions have robust governance arrangements with a clear organisational structure, well defined, transparent and consistent lines of responsibility and adequate internal control mechanisms. These requirements also apply to outsourcing arrangements. It is against this baseline that we attempt to measure incremental costs and benefits of the super-equivalent elements of our proposals.

Costs analysis

166 The firms interviewed by Europe Economics all reported that they had in place a common outsourcing policy for all their outsourcing arrangements, and that their arrangements were driven mainly by commercial considerations. Some of those interviewed believed that their arrangements would comply with the requirements of MiFID and did not, therefore, expect our proposals to impose material ongoing incremental costs. Two firms considered that their existing arrangements for outsourcing would not meet our common platform proposals and that the incremental ongoing costs

arising might be substantial. However, neither firm was able to provide an estimate of these costs.

167 Most of the firms interviewed said that they would have to conduct a review of, and possibly renegotiate the terms of, their existing arrangements in order to ensure compliance with our proposals. There was a divergence of views on whether or not the process of review (and potential renegotiation) would impose material one-off costs (no ongoing costs were identified). Some firms considered that it would not, and those that considered that it would, adopted different approaches to estimating costs which resulted in a wide range of cost estimates.

168 Two of the firms interviewed generated their estimates by assuming that the costs would be equivalent to a specific percentage of the value of their existing outsourcing arrangements. As these were large, the associated cost estimates were also large, running into several millions of pounds per annum. However, we do not think that this is an appropriate approach to take because we see no grounds for assuming that the costs of reviewing existing arrangements should rise in proportion to the value of outsourcing contracts. One firm provided cost estimates based on staff costs incurred in carrying out a review of outsourcing arrangements. Based on these figures we estimate that the incremental one-off costs for the population of 2000-2500 firms could total approximately £300,000 for outsourcing of critical or important functions concerning non-MiFID business and circa £1.5 million for other outsourcing (not critical or important) across these firms.

169 Clearly a wide margin of error applies to these estimates because they are based on information provided by only one firm. Further, outsourcing of functions which are not critical or important were of greater importance to this firm than the outsourcing arrangements in the non-MiFID parts of its business for critical or important functions, which will not be the case for all of the firms affected by these proposals.

Benefits

170 Firm failures or business interruptions that result from shortcomings in outsourcing arrangements may impose costs on third parties. The benefits from having appropriate outsourcing policies in place are discussed in paragraphs 87 and 88.

171 Firms have commercial incentives to ensure that their outsourcing arrangements do not fail so that they do not bear the financial costs of business interruptions or reputational losses. So it is not clear that the application of detailed MiFID requirements to the outsourcing arrangements concerning critical or important functions of firms' non-MiFID business is likely to generate material benefits because we have no evidence of

consumers or third parties suffering as a result of inadequate outsourcing arrangements. The scope of potential benefits is constrained further because we expect a sizeable proportion of firms already to have compliant outsourcing processes in place.

172 The guidance on the outsourcing of functions that are not critical or important in relation to all firms' activities is not expected to generate social benefits because such activities cannot by definition generate consumer or market detriments.

Q44: Do you have any comments on the nature and scale of the costs and benefits arising from our super-equivalent outsourcing proposals?

Compliance

173 We propose to extend the MiFID-derived requirements on compliance to a broader range of business operations and activities than contemplated by the MiFID requirements. These are discussed in detail in Chapter 5.

174 The alternative would be not to apply the detailed requirements but only to have a high-level requirement that firms establish policies and procedures sufficient to ensure compliance of the firm.

175 Against this baseline, the main super-equivalence is the condition that the function or persons responsible for the compliance of non-MiFID business should be independent from the activities that they monitor.

Costs analysis

176 Most of the firms interviewed by Europe Economics have a single compliance function overseeing compliance across their whole business. One firm reported that it had separate compliance arrangements for each of its business divisions.

177 Firms with a single compliance function told Europe Economics that they did not expect the proposals to add to their ongoing costs. They did expect to incur some one-off costs, however, but did not explain directly why they thought that these costs would arise. Some of the firms interviewed argued that the proposals would constrain choice but did not explain how this would add to costs. It is possible that one-off costs will be driven by the need for firms to review, and, where necessary, amend existing arrangements, to ensure that the independence requirement is met.

178 Based on the data provided by the firms interviewed by Europe Economics, we estimate that our proposal to extend MiFID requirements will generate additional incremental one-off costs of approximately £3m to the population of 2000-2500 firms affected.

179 Those firms with multiple compliance functions and which have to revise their existing arrangements are likely to incur both one-off and ongoing incremental costs. We do not have reliable information on which to base an estimate of these costs. However, we expect them to be modest because we believe that most large firms already have separate compliance functions and the proportionality clause will limit the costs to smaller firms.

Benefits

180 Paragraphs 59-61 discuss the potential economic benefits that can arise as a result of improving the effectiveness of firms' compliance functions. We believe that our proposals to apply MiFID compliance requirements to firms' non-MiFID activities extend these benefits. However, the potential benefits of doing so are limited to the extent that firms' arrangements already meet the proposed new requirements.

Q45: Do you have any comments on the nature and scale of the costs and benefits arising from our super-equivalent compliance proposals?

Part 4: Appendix – The methodology

The survey

181 We commissioned Capgemini to carry out a survey of firms to investigate the impact of the common platform. We anticipated that this would have a variety of consequences for firms depending on their size and type of business. The survey covered the financial implications of the regulatory changes and allowed firms the opportunity to provide feedback on the anticipated consequences for their organisations.

182 Detailed data was sought on the impacts both in overall terms and by each of the subject areas described in this CP. An additional section covering the general implications of policy invited more free-form comments.

183 Respondents were directed to consider only incremental compliance costs i.e. the additional costs that the firm is expected to incur as a consequence of meeting the requirements covered by the common platform.[4] The costs required to meet existing regulatory requirements to which they are subject were not to be included. Furthermore, firms were only asked to identify material (i.e. non-trivial) costs and savings in their responses. A detailed description of the current regulatory environment and what's changing was provided as the basis for the assessment.

4 In nearly all cases (except for 'persons controlling a firm'), the common platform will apply to any UK consolidation group or non-EEA sub-group of which a firm is a member, as well as to the firm itself. Responses were sought in the context of these as applicable.

Sample and population

184 Our preliminary analysis with supervisory colleagues had suggested that the impact, for those firms that are relationship managed at least, was expected to be relatively small. We sought confirmation of this hypothesis, but needless to say collected information for all types of common platform firms. A web-based survey using email was chosen to extend the reach of the research.

185 The survey was sent out to 768 firms. The sampling frame was differentiated by firms size and market. The number of firms in each size category was estimated using the FSA's 'firm impact ratings' as a proxy for firm size and grouping, on an unconsolidated basis, into three size categories – small, medium and large. When aggregating cost estimates for the entire population (see Table 1) the small and medium categories were grouped together as smaller firms.

186 Participation in the survey was not mandatory but an adequate overall response rate (17%) was obtained. A total of 131 firms took part including firms of all sizes and markets within the sampling frame.

Interviews

187 In addition, Capgemini conducted a total of nine supplementary interviews – face to face and by telephone – with a selection of respondents from the survey. The coverage of the survey material had been necessarily broad and these interviews allowed for more in-depth investigation in focussed areas.

Timing

188 Capgemini began collecting survey evidence of compliance costs for common platform proposals in early January 2006, a time when there was still some policy uncertainty affecting both the nature and extent of the proposals and their inclusion in the common platform itself. The relatively preliminary level of awareness among respondents of the implications may have constrained their ability to respond with confidence. That the proposals were not finalised at that stage was subsequently commented on by firms.

Research on potential impacts in specific areas against Directive-minima baseline

189 Additional work was carried out specifically focused on the cost implications of areas of super-equivalence. This work involved interviews with a limited number of firms and specific questions with Directive minimum requirements as the baseline.

190 Europe Economics interviewed three large banks and three large building societies to collect information on the incremental costs and benefits of the

super-equivalent proposals with potential material consequences for affected firms. The firms were selected because their core business activities are not within the scope of MiFID so any extension of MiFID requirements to non-MiFID activities would be expected to affect them most significantly.

191 Information on the incremental costs and benefits of each of the superequivalent proposals was gathered by asking firms to compare the difference in costs associated with the following two scenarios:

- Baseline: application of particular MiFID requirements to MiFID-only parts of firms on Directive minimum basis, plus certain overarching Handbook requirements that apply to non-MiFID parts of firms;
- Super equivalence: application of particular MiFID requirements to both the MiFID and non-MiFID parts of firms.

192 The following steps were taken when aggregating the incremental costs:

- the incremental cost estimates provided by the six firms interviewed by Europe Economics were added together, though a small number of outlying estimates were excluded;
- these totals were expressed as a percentage of the total assets of the non-MiFID business of these firms;
- the estimate of the total incremental cost impact on the population of affected firms was calculated by applying the percentages calculated at step two to figures for the total assets of the non-MiFID parts of all affected firms.

193 In the final step, it was assumed that the average share of non-MiFID business as a percentage of total business for banks (other than wholesale banks) and building societies is 80%, based on information provided by the firms interviewed. For other types of MiFID firms, it was assumed that the average share of non-MiFID business as a percentage of total business would range from 10-50%, based on information collected by our business intelligence unit.

194 The estimates presented here should be considered to be indicative only. The methodology and the assumptions are both open to challenge, but we believe they were fit for purpose given the information and time constraints involved. The statistical reliability of the incremental cost estimates is also undermined by the small sample size and a potential sample bias that arises because the firms interviewed were all relatively large. It is quite possible that smaller firms or those with other forms of core business might have different views on the scale of the incremental cost impacts arising from the super-equivalent proposals in question.

Q46: Do you have any comments on the methodology and assumptions employed in order to generate the aggregated incremental cost estimates set out below?

Annex 3

List of questions in this Consultation Paper

Chapter 2 – The common platform

Q1: Will your firm transition to the common platform before 1 November 2007?

Chapter 3 – General organisational requirements

Q2: Do you agree with our proposal to create a unified standard by extending the Draft Implementing Measures requirements on governance, internal controls and organisation to CRD-only firms?

Q3: Do you agree that we should create two, parallel, standards in relation to the integrity of information (i.e. a separate standard for CRD-only firms)?

Q4: Do you agree with our proposal to create a unified standard for accounting systems and controls?

Q5: Do you agree with our proposal to create a unified standard for on-going monitoring?

Q6: Would you like us to create a unified standard by extending the requirement concerning verification of compliance to MiFID-only firms and to cover the regulatory system?

Q7: Do you agree with our proposal to retain this guidance concerning audit committees in the common platform?

Q8: Do you think the costs of the business continuity common platform approach outweigh the benefits?

Q9: Would you prefer the common platform approach to a parallel set of rules?

Q10: Do you agree that this guidance on what the business continuity policy might cover is sufficiently useful to have?

Chapter 4 – Employees and agents

Q11: Do you agree that we should create two parallel standards in relation to employees' awareness of procedures (i.e. a separate standard for CRD-only firms)?

Q12: Do you agree with our proposal to create a unified standard concerning segregation of the duties of employees (rather than two parallel sets of requirements)?

Q13: Do you agree with our proposal to create a unified standard concerning employees' competence?

Q14: Is this guidance on a firm's employees useful to have in the common platform?

Chapter 5 – Compliance (including internal audit)

Q15: Do you agree with our proposal to create a unified standard for compliance as described above?

Q16: Do you agree with our proposal to create a unified standard for internal audit?

Q17: For CRD-only firms what are the costs involved?

Q18: Do you agree with our proposal not to include any guidance on internal audit?

Q19: Is there any guidance on internal audit in PRU, IPRU(BANK) or IPRU (BSOC) that you think is sufficiently important for us to retain and extend to all common platform firms? If so, please identify it and explain why.

Chapter 6 – Risk Control (including CRD risk specific material)

Q20: Do you agree with our proposal to create a unified standard concerning risk controls?

Q21: Do you agree with our proposal to extend to MiFID-only firms the CRD requirement in relation to documentation of the organisation and responsibilities of the risk assessment function?

Q22: Do you agree that these CRD-based risk-specific proposals should not be extended to MiFID-only firms?

Q23: If you do not agree, please say which proposals should be extended to MiFID-only firms and why.

Q24: Do you agree that the CRD liquidity risk proposals should not be extended to MiFID-only firms?

Q25: If you do not agree, please say why.

Q26: Do you agree with our 'minimum change' approach to implementing the group risk systems and controls requirements of the CRD?

Q27: If you do not agree, what would you suggest instead? Do you think that our proposals achieve our intention of minimum change?

Chapter 7 – Outsourcing

Q28: Do you agree with our proposal to create a unified standard concerning outsourcing of critical or important business functions?

Q29: Do you agree that our proposal for outsourcing of non-critical or important business functions is proportionate?

Q30: If you do not agree, what approach should we take for outsourcing of non-critical or important business functions?

Q31: Do you agree that no further guidance is necessary on a 'critical' or 'important' function?

Chapter 8 – Record-Keeping

Q32: Is there any guidance on record-keeping in IPRU(BANK) or IPRU(BSOC) that you think should be kept as part of the common platform?

Q33: If you do, please identify it and explain why it should be extended to all common platform firms.

Chapter 9 – Conflicts of interest

Q34: Do you agree with our view of the circumstances in which disclosure might or might not be appropriate as a means of managing conflicts of interest?

Q35: If you do not agree, in what circumstances might disclosure be, or not be, appropriate as a means of managing conflicts of interest?

Q36: Do you agree with our proposals to create a unified standard for management of conflicts of interest as described above?

Q37: What would be the impact on your firm of the two aspects of super-equivalence in the unified standard described in paragraph 9.19?

Chapter 10 – CAD / MiFID perimeter guidance

Q38: Do you believe it is helpful for us to prepare perimeter guidance in relation to EU Directives?

Q39: Do you have any comments on the text of the draft guidance?

Q40: Do you think there are any issues not covered in the draft guidance that it should address?

Annex 2: Cost benefit analysis

Q41: Do you agree with our assessment of the number of CRD-only firms?

Q42: Do you agree with our view that the proposals above are not material for CBA?

Q43: Do you have any comments on the nature and scale of the costs and benefits arising from our super-equivalent proposals on conflicts of interest?

Q44: Do you have any comments on the nature and scale of the costs and benefits arising from our super-equivalent outsourcing proposals?

Q45: Do you have any comments on the nature and scale of the costs and benefits arising from our super-equivalent compliance proposals?

Q46: Do you have any comments on the methodology and assumptions employed in order to generate the aggregated incremental cost estimates set out below?

Senior Management Arrangements, Systems and Controls (Markets in Financial Instruments and Capital Requirements) Instrument 2006

Annex 4

SENIOR MANAGEMENT ARRANGEMENTS, SYSTEMS AND CONTROLS (MARKETS IN FINANCIAL INSTRUMENTS AND CAPITAL REQUIREMENTS) INSTRUMENT 2006

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 138 (General rule-making power);
(2) section 145 (Financial promotion rules);
(3) section 146 (Money laundering rules);
(4) section 147 (Control of information rules);
(5) section 150(2) (Actions for damages);
(6) section 156 (General supplementary powers); and
(7) section 157(1) (Guidance).

B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force as follows:

(1) Annex E on 1 November 2007;
(2) otherwise, on 1 January 2007.

Amendments to the Handbook

D. (1) In relation to the "Amended text" in column (3) of the table in D(5), SYSC is amended in accordance with Annex A of this instrument.

(2) In relation to the "New text" indicated in column (3), SYSC is amended by inserting the provisions in Annex B to this instrument.

(3) In relation to the "Transferred and Amended text" in column (3), SYSC is amended by inserting the provisions in Annex C in this instrument (which has the effect of transferring the provisions in PRU identified in column (2), with amendments, to the location indicated in column (1)).

(4) In relation to the "Transferred text" in column (3), SYSC is amended by inserting the provisions of Annex D in this instrument (which has the effect of transferring the provisions in SYSC and PRU identified in column (2), with necessary consequential changes, to the location indicated in column (1)).

(5) The table referred to is:

(1) SYSC	(2) Current designation in PRU or SYSC (where applicable)	(3) Type of text	(4) Annex in this Instrument
SYSC TP		New text	Annex B
SYSC 1	SYSC 1	Amended text	Annex A
SYSC 3	SYSC 3	Amended text	Annex A
SYSC 4		New text	Annex B
SYSC 5		New text	Annex B
SYSC 6		New text	Annex B
SYSC 7		New text	Annex B
SYSC 8		New text	Annex B
SYSC 10		New text	Annex B
SYSC 12	PRU 8.1	Transferred and Amended text	Annex C
SYSC 13	SYSC 3A	Transferred text	Annex D
SYSC 14 (except 14.1.65G)	PRU 1.4	Transferred text	Annex D
SYSC 14.1.65G	PRU 6.1.9G	Transferred text	Annex D
SYSC 15	PRU 3.1	Transferred text	Annex D
SYSC 16	PRU 4.1	Transferred text	Annex D
SYSC 17	PRU 7.1	Transferred text	Annex D
SYSC 18	SYSC 4	Transferred text	Annex D
SYSC Schedule 5	SYSC Schedule 5	Amended text	Annex A
SYSC Schedule 6	SYSC Schedule 6	Amended text	Annex A

Further amendments to SYSC

E. SYSC is further amended by the provisions in Annex E to this instrument.

Amendments to the Glossary

F. The Glossary is amended by the provisions in Annex F to this instrument.

Citation

G. This instrument may be cited as the Senior Management Arrangements, Systems and Controls (Markets in Financial Instruments and Capital Requirements) Instrument 2006.

By order of the Board
[ ] 2006

Annex A

Amended text to be inserted in the Senior Management Arrangements, Systems and Controls Handbook

In this annex, underlining indicates new text and striking through indicates deleted text. Where an entire section of text is being inserted, the place where the change will be made is indicated and the text is not underlined.

1.1 Application of SYSC 2 and SYSC 3

Purpose of this section

1.1.-2 G [Deleted]

1.1.-1 G [Deleted]

1.1.1 R Who?

SYSC 2 and *SYSC* 3 apply to every *firm* except that:

…

(c) *SYSC* 3 applies, but only with respect to the activities in *SYSC* 1.1.4 R; ~~and~~

(5) for an *authorised professional firm* when carrying on *non-mainstream regulated activities*, *SYSC* 3.2.6A R to *SYSC* 3.2.6J G do not apply~~.~~; and

(6) *SYSC* 3.2.23R to *SYSC* 3.2.37R apply only to a *BIPRU firm*.

…

1.2 Purpose of SYSC

1.2.1 G The purposes of *SYSC* are:

(1) 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*;

(2) 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; ~~and~~

(3) to encourage *firms* to vest responsibility for effective and responsible organisation in specific *directors* and *senior managers*~~.~~;

(4) to create a common platform of organisational and systems and controls requirements for *firms* subject to the *CRD* and *MiFID*; and

(5) to set out high-level organisational and systems and controls requirements for *insurers*.

~~1.2.2~~ ~~G~~ ~~The main matters, referred to in *SYSC*1.2.1G (1), which are likely to be of interest to the *FSA* are those which relate to confidence in the *financial system*; to the fair treatment of *firms*' *customers*; to the protection of *consumers*; and to the use of the *financial system* in connection with *financial crime*. The *FSA* is not primarily concerned with risks which threaten only the owners of a *financial business* except in so far as these risks may have an impact on those matters.~~

To be inserted after *SYSC* 1.2

1.3 Application of SYSC 4 to SYSC 10

Who?

1.3.1 R *SYSC* 4 to *SYSC* 10 apply to a *common platform firm* unless provided otherwise in a specific *rule*.

1.3.1A G From 1 January 2007 until 1 November 2007, the application of *SYSC* 4 to *SYSC* 10 is limited by *SYSC* TP 1.

What?

1.3.2 R *SYSC* 4 to *SYSC* 9[1] apply with respect to the carrying on of the following (unless provided otherwise within a specific *rule*):

(1) *regulated activities*;

(2) activities that constitute *dealing in investments as principal*, disregarding the exclusion in article 15 of the *Regulated Activities Order* (Absence of holding out etc); and

(3) *ancillary activities*.

1.3.3 G The application of *SYSC* 10 is set out in *SYSC* 10.1.1R and *SYSC* 10.2.1R.

1.3.4[2] R *SYSC* 9 applies as set out in *SYSC* 1.3.2R, except that it applies to the carrying on of *ancillary activities* that are performed only in relation to:

(1) *designated investment business*;

[1] SYSC 9 (Record-keeping) will be consulted on later this year.
[2] This rule will be considered when SYSC 9 is consulted on later this year.

(2) *regulated mortgage activity*; and

(3) *insurance intermediation activity*.

1.3.5 R *SYSC* 6.3 applies as set out in *SYSC* 1.3.2R, except that it does not apply:

(1) with respect to the activities described in *SYSC* 1.3.2R(2) and (3); or

(2) in relation to the following *regulated activities:*

(a) *general insurance business*;

(b) *insurance mediation activity* in relation to a *general insurance contract* or *pure protection contract*;

(c) *long-term insurance business* which is outside the *Consolidated Life Directive* (unless it is otherwise one of the *regulated activities* specified in this *rule*);

(d) business relating to contracts which are within the *Regulated Activities Order* only because they fall within paragraph (e) of the definition of "contract of insurance" in article 3 of that Order;

(e) (i) arranging by the *Society of Lloyd's* of deals in *general insurance contracts* written at Lloyd's; and

(ii) *managing the underwriting capacity of a Lloyd's syndicate as a managing agent at Lloyd's*; and

(f) *mortgage mediation activity* and *administering a regulated mortgage contract.*

1.3.6 R *SYSC* 4 to *SYSC* 9, except *SYSC* 6.3, also apply with respect to the *communication* and *approval* of *financial promotions* which:

(1) if *communicated* by an *unauthorised person* without *approval* would contravene section 21(1) of the *Act* (Restrictions on financial promotion); and

(2) may be *communicated* by a *firm* without contravening section 238(1) of the *Act* (Restrictions on promotion of collective investment schemes).

1.3.7 R *SYSC* 4 to *SYSC* 9, except *SYSC* 6.3, also:

(1) apply with respect to the carrying on of *unregulated activities* in a *prudential context*; and

(2) take into account any activity of other members of a *group* of which the *firm* is a member.

1.3.8 G *SYSC* 1.3.7R(2) does not mean that inadequacy of a *group* member's systems and controls will automatically lead to a *firm* contravening any of the *rules* in *SYSC* 4 to *SYSC* 9. Rather, the potential impact of a *group* member's activities, including its systems and controls, and any systems and controls that operate on a *group* basis, will be relevant in determining the appropriateness of the *firm's* own systems and controls.

Where?

1.3.9 R *SYSC* 4 to *SYSC* 10 apply to a *common platform firm* in relation to activities carried on by it from an establishment in the *United Kingdom*.

1.3.10 R *SYSC* 4 to *SYSC* 10, except *SYSC* 6.3, apply to a *common platform firm* in relation to *passported activities* carried on by it from a *branch* in another *EEA State*.

1.3.11 R *SYSC* 4 to *SYSC* 9, except *SYSC* 6.3, also apply in a *prudential context* to a *UK domestic firm* with respect to activities wherever they are carried on.

Actions for damages

1.3.12 R A contravention of a *rule* in *SYSC* 4 to *SYSC* 10 does not give rise to a right of action by a *private person* under section 150 of the *Act* (and each of those *rules* is specified under section 150(2) of the *Act* as a provision giving rise to no such right of action).

1.4 Application of SYSC 11 to SYSC 18

What?

1.4.1 G The application of each of chapters *SYSC* 11[3] to *SYSC* 18 is set out in those chapters.

Actions for damages

1.4.2 R A contravention of a *rule* in *SYSC* 11 to *SYSC* 18 does not give rise to a right of action by a *private person* under section 150 of the *Act* (and each of those *rules* is specified under section 150(2) of the *Act* as a provision giving rise to no such right of action).

[3] SYSC 11 (Liquidity risk) will be consulted on later this year.

Annex 4

To be inserted after *SYSC* 3.1.1

3.1.1A R *SYSC* 3.1 and *SYSC* 3.2.1G to *SYSC* 3.2.22G apply to a *BIPRU firm* only to the extent that they do not conflict with *SYSC* 3.2.23R to *SYSC* 3.2.37R.

…

To be inserted after *SYSC* 3.2.5

Organisation

…

3.2.5A R An *overseas bank* must ensure that at least two individuals effectively direct its business.

3.2.5B G In the case of an *overseas bank*, the *FSA* assesses whether at least two individuals effectively direct the business of the *bank* (and not just the business of its branch(es) in the *United Kingdom*). The *FSA* also takes into account the manner in which management decisions are taken in the *United Kingdom* branch(es) in assessing the adequacy of the *overseas bank's* systems and controls.

…

To be inserted after *SYSC* 3.2.22

CRD requirements

(1) General organisation requirements

3.2.23 R A *BIPRU firm* must have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and adequate internal control mechanisms, including sound administrative and accounting procedures.

[**Note**: *BCD* Article 22(1)]

3.2.24 R The arrangements, processes and mechanisms referred to in *SYSC* 3.2.23R must be comprehensive and proportionate to the nature, scale and complexity of the *BIPRU firm's* activities. The technical criteria laid down in *BIPRU* 2.3.6R, *BIPRU* 9.1.7R, *BIPRU* 9.12.21R, *BIPRU* 10.12.1R, *SYSC* 3.2.26R and *SYSC* 3.2.28R to [*SYSC* 3.2.37R[4]] must be taken into account.

[**Note**: *BCD* Article 22(2)]

[4] BCD Annex V paragraphs 13 and 14 will be implemented on 1 January 2007 in SYSC 11 (Liquidity risk), which will be consulted on later this year.

3.2.25 R A *BIPRU firm* must ensure that its internal control mechanisms and administrative and accounting procedures permit the verification of its compliance with *rules* adopted in accordance with the *CAD* at all times.

[**Note**: *CAD* Article 35(1) second sentence]

3.2.26 R A *BIPRU firm* must have contingency and business continuity plans in place aimed at ensuring its ability to operate on an ongoing basis and limit losses in the event of severe business disruption.

[**Note**: *BCD* Annex V paragraph 12]

3.2.27 R A *credit institution* must have at least two persons who effectively direct the business of the *firm*. These persons must be of sufficiently good repute and have sufficient experience to perform their duties.

[**Note**: *BCD* Article 11(1)]

(2) Employees, agents and other relevant persons

3.2.28 R The *governing body* of a *BIPRU firm* must define arrangements concerning the segregation of duties in the organisation and the prevention of conflicts of interest.

[**Note**: *BCD* Annex V paragraph 1]

(3) Risk control

3.2.29 R The *governing body* of a *BIPRU firm* must approve and periodically review the strategies and policies for taking up, managing, monitoring and mitigating the risks the *firm* is or might be exposed to, including those posed by the macroeconomic environment in which it operates in relation to the status of the business cycle.

[**Note**: *BCD* Annex V paragraph 2]

3.2.30 R A *BIPRU firm* must base credit-granting on sound and well-defined criteria and clearly establish the process for approving, amending, renewing, and re-financing credits.

[**Note**: *BCD* Annex V paragraph 3]

3.2.31 R A *BIPRU firm* must operate through effective systems the ongoing administration and monitoring of its various credit risk-bearing portfolios and exposures, including for identifying and managing problem credits and for making adequate value adjustments and provisions.

[**Note**: *BCD* Annex V paragraph 4]

3.2.32 R A *BIPRU firm* must adequately diversify credit portfolios given its target markets and overall credit strategy.

[**Note**: *BCD* Annex V paragraph 5]

3.2.33 R A *BIPRU firm* must address and control by means of written policies and procedures the risk that recognised credit risk mitigation techniques used by it prove less effective than expected.

[**Note**: *BCD* Annex V paragraph 6]

3.2.34 R A *BIPRU firm* must implement policies and processes for the measurement and management of all material sources and effects of market risks.

[**Note**: *BCD* Annex V paragraph 9a]

3.2.35 R A *BIPRU firm* must implement policies and processes to evaluate and manage the exposure to operational risk, including to low-frequency high severity events. Without prejudice to the definition of *operational risk*, *BIPRU firms* must articulate what constitutes operational risk for the purposes of those policies and procedures.

[**Note**: *BCD* Annex V paragraph 11]

(4) Liquidity risk[5]

3.2.36 R A *BIPRU firm* must ensure that policies and processes exist for the measurement and management of its net funding position and requirements on an ongoing and forward-looking basis. Alternative scenarios must be considered and the assumptions underpinning decisions concerning the net funding position must be reviewed regularly.

[**Note:** *BCD* Annex V paragraph 13]

3.2.37 R A *BIPRU firm* must ensure that it has contingency plans to deal with liquidity crises in place.

[**Note:** *BCD* Annex V paragraph 14]

[5] BCD Annex V paragraphs 13 and 14 will be implemented on 1 January 2007 in SYSC 11 (Liquidity risk), which will be consulted on later this year.

Annex 4

Schedule 5 to be amended as follows

…

Chapter/ Appendix	**Section/ Annex**	**Paragraph**	**Right of action under section 150**		
			For private person?	**Removed?**	**For other person?**
~~All *rules* in~~ *SYSC* 2 and *SYSC* 3			No	Yes *SYSC* 1.1.12R	No
SYSC 4 to *SYSC* 10			No	Yes *SYSC* 1.3.12R	No
SYSC 11 to *SYSC* 18			No	Yes *SYSC* 1.4.2R	No

Annex 4

Schedule 6 to be amended as follows

Schedule 6	Rules that can be waived
G	The *rules* in *SYSC* can be *waived* by the *FSA* under section 148 of the *Act* (Modification or waiver of rules) in so far as this is compatible with the *United Kingdom's* responsibilities to implement the requirements of any European Directive .

Annex B

New text to be inserted in the Senior Management Arrangements, Systems and Controls Handbook

In this annex, the place where the text is being inserted is indicated and the text is not underlined.

To be inserted in *SYSC* Transchedule

TP Transitional provisions

TP 1 Common platform firms

Application

1.1 R *SYSC* TP 1 applies to a *common platform firm*.

Commencement and expiry of SYSC TP 1

1.2 R *SYSC* TP 1 comes into force on 1 January 2007 and applies until 1 November 2007.

Purpose

1.3 G From 1 November 2007, a *firm* must comply with the merged organisational and systems and controls requirements under both the *MiFID* and the *CRD* ('the common platform requirements') and *SYSC* 3 will cease to apply to them. However, until 1 November 2007, a *firm* may choose to comply with the common platform requirements instead of *SYSC* 3. The purpose of *SYSC* TP 1 is to give a *firm* the option of complying with the common platform requirements sooner than 1 November 2007.

1.4 G The common platform requirements are in *SYSC* 4 to *SYSC* 10.

The decision to comply with the common platform requirements

1.5 R *SYSC* 4 to *SYSC* 10 do not apply to a *firm* unless it decides to comply with them sooner than 1 November 2007.

1.6 R If a *firm* decides to comply with the common platform requirements in accordance with *SYSC* TP 1.5R:

(1) it must make a record of the date of the decision and the date from which it is to be effective; and

(2) from the effective date, it must comply with *SYSC* 4 to *SYSC* 10 and *SYSC* 3 will not apply to it.

1.7	G	A decision by a *firm* to comply with the common platform requirements must be made in relation to all of the common platform requirements. The firm may not 'cherry-pick'.
		Definitions in SYSC TP1 and SYSC 4 to SYSC 10
1.8	R	The terms *common platform firm* and *MiFID investment firm* have effect as if *MiFID* applied generally from 1 January 2007.

Annex 4

To be inserted after *SYSC* 3

4.1 General organisational requirements

General requirements

4.1.1 R A *common platform firm* must have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and internal control mechanisms, including sound administrative and accounting procedures and effective control and safeguard arrangements for information processing systems.

[**Note:** *BCD* Article 22(1) and *MiFID* Article 13(5) second paragraph]

4.1.2 R The arrangements, processes and mechanisms referred to in *SYSC* 4.1.1R must be comprehensive and proportionate to the nature, scale and complexity of the *common platform firm's* activities and must take into account the specific technical criteria described in *SYSC* 4.1.8R, *SYSC* 5.1.7R and *SYSC* 7.

[**Note:** *BCD* Article 22(2)]

4.1.3 R A *BIPRU firm* must ensure that its internal control mechanisms and administrative and accounting procedures permit the verification of its compliance with *rules* adopted in accordance with the *CAD* at all times.

[**Note:** *CAD* Article 35(1) final sentence]

4.1.4 R A *common platform firm* must, taking into account the nature, scale and complexity of the business of the *firm*, and the nature and range of the *investment services and activities* undertaken in the course of that business:

[**Note:** *MiFID implementing Directive* Article 5(1) final paragraph]

(1) establish, implement and maintain decision-making procedures and an organisational structure which clearly and in a documented manner specifies reporting lines and allocates functions and responsibilities;

[**Note:** *MiFID implementing Directive* Article 5(1)(a)]

(2) establish, implement and maintain adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the *firm*; and

[**Note:** *MiFID implementing Directive* Article 5(1)(c)]

(3) establish, implement and maintain effective internal reporting and communication of information at all relevant levels of the *firm*.

[**Note:** *MiFID implementing Directive* Article 5(1)(e)]

4.1.5 R A *MiFID investment firm* must establish, implement and maintain systems and procedures that are adequate to safeguard the security, integrity and confidentiality of information, taking into account the nature of the information in question.

[**Note:** *MiFID implementing Directive* Article 5(2)]

Business continuity

4.1.6 R A *MiFID investment firm* must take reasonable steps to ensure continuity and regularity in the performance of *investment services and activities*. To this end the *firm* must employ appropriate and proportionate systems, resources and procedures.

[**Note:** *MiFID* Article 13(4)]

4.1.7 R A *MiFID investment firm* must establish, implement and maintain an adequate contingency and business continuity policy aimed at ensuring, in the case of an interruption to its systems and procedures, the preservation of essential data and functions, and the maintenance of *investment services and activities*, or, where that is not possible, the timely recovery of such data and functions and the timely resumption of its *investment services and activities*.

[**Note:** *MiFID implementing Directive* Article 5(3)]

4.1.8 R A *BIPRU firm* must have a contingency and business continuity policy in place aimed at:

(1) ensuring its ability to operate on an ongoing basis; and

(2) limiting losses;

in the event of severe business disruption.

[**Note:** *BCD* Annex V paragraph 12]

4.1.9 R A *firm* that is both a *MiFID investment firm* and a *BIPRU firm* must comply with *SYSC* 4.1.6R, *SYSC* 4.1.7R and *SYSC* 4.1.8R(2) in respect of its *investment services and activities* (its business falling within the scope of *MiFID*) and must comply with *SYSC* 4.1.8R in respect of all of its other business.

4.1.10 G The matters dealt with in a business continuity policy should include:

(1) resource requirements such as people, systems and other assets, and arrangements for obtaining these resources;

(2) the recovery priorities for the *firm's* operations;

(3) communication arrangements for internal and external concerned parties (including the *FSA*, *clients* and the press);

(4) escalation and invocation plans that outline the processes for implementing the business continuity plans, together with relevant contact information;

(5) processes to validate the integrity of information affected by the disruption; and

(6) regular testing of the business continuity policy in an appropriate and proportionate manner in accordance with *SYSC* 4.1.12R.

Accounting policies

4.1.11 R A *common platform firm* must establish, implement and maintain accounting policies and procedures that enable them, at the request of the *FSA*, to deliver in a timely manner to the *FSA* financial reports which reflect a true and fair view of its financial position and which comply with all applicable accounting standards and rules.

[**Note:** *MiFID implementing Directive* Article 5(4)]

Regular monitoring

4.1.12 R A *common platform firm* must monitor and, on a regular basis, evaluate the adequacy and effectiveness of its systems, internal control mechanisms and arrangements established in accordance with *SYSC* 4.1.4R to *SYSC* 4.1.11R and take appropriate measures to address any deficiencies.

[**Note:** *MiFID implementing Directive* Article 5(5)]

Audit committee

4.1.13 G Depending on the nature, scale and complexity of its business, it may be appropriate for a *firm* to form an audit committee. An audit committee could typically examine management's process for ensuring the appropriateness and effectiveness of systems and controls, examine the arrangements made by management to ensure compliance with requirements and standards under the *regulatory system*, oversee the functioning of the internal audit function (if applicable) and provide an interface between management and external auditors. It should have an appropriate number of *non-executive directors* and it should have formal terms of reference.

4.2 Persons who effectively direct the business

4.2.1 R The *senior personnel* of a *common platform firm* must be of sufficiently good repute and sufficiently experienced as to ensure the sound and prudent management of the *firm*.

[**Note:** *MiFID* Article 9(1) and *BCD* Article 11(1) second paragraph]

4.2.2 R A *common platform firm* must ensure that its management is undertaken by at least two persons meeting the requirements laid down in *SYSC* 4.2.1R.

[**Note:** *MiFID* Article 9(4) first paragraph) and *BCD* Article 11(1) first paragraph]

4.2.3 G In the case of a *body corporate*, the persons referred to in *SYSC* 4.2.2R should either be executive *directors* or persons granted executive powers by, and reporting immediately to, the *governing body*. In the case of a *partnership*, they should be active *partners*.

4.2.4 G At least two independent minds should be applied to both the formulation and implementation of the policies of a *common platform firm*. Where a *common platform firm* nominates just two individuals to direct its business, the *FSA* will not regard them as both effectively directing the business where one of them makes some, albeit significant, decisions relating to only a few aspects of the business. Each should play a part in the decision-making process on all significant decisions. Both should demonstrate the qualities and application to influence strategy, day-to-day policy and its implementation. This does not require their day-to-day involvement in the execution and implementation of policy. It does, however, require involvement in strategy and general direction, as well as knowledge of, and influence on, the way in which strategy is being implemented through day-to-day policy.

4.2.5 G Where there are more than two individuals directing the business, the *FSA* does not regard it as necessary for all of these individuals to be involved in all decisions relating to the determination of strategy and general direction. However, at least two individuals should be involved in all such decisions. Both individuals' judgement should be engaged so that major errors leading to difficulties for the *firm* are less likely to occur. Similarly, each individual should have sufficient experience and knowledge of the business and the necessary personal qualities and skills to detect and resist any imprudence, dishonesty or other irregularities by the other individual. Where a single individual, whether a chief executive, managing *director* or otherwise, is particularly dominant in a *firm* this will raise doubts about whether *SYSC* 4.2.2R is met.

4.2.6 R If a *common platform firm*, other than a *credit institution*, is:

(1) a natural person; or

(2) a legal person managed by a single natural person;

it must have alternative arrangements in place which ensure sound and prudent management of the *firm*.

[**Note:** *MiFID* Article 9(4) second paragraph]

4.3 Responsibility of senior personnel

4.3.1 R A *MiFID investment firm*, when allocating functions internally, must ensure that *senior personnel* and, where appropriate, the *supervisory function*, are responsible for ensuring that the *firm* complies with its obligations under *MiFID*. In particular, *senior personnel* and, where appropriate, the *supervisory function* must assess and periodically review the effectiveness of the policies, arrangements and procedures put in place to comply with the *firm's* obligations under *MiFID* and take appropriate measures to address any deficiencies.

[**Note:** *MiFID implementing Directive* Article 9(1)]

4.3.2 R A *MiFID investment firm,* must ensure:

(1) that its *senior personnel* receive on a frequent basis, and at least annually, written reports on the matters covered by *SYSC* 6.1.2R to 6.1.5R, *SYSC* 6.2.1R and *SYSC* 7.1.2R, *SYSC* 7.1.3R and *SYSC* 7.1.5R to *SYSC* 7.1.7R, indicating in particular whether the appropriate remedial measures have been taken in the event of any deficiencies; and

(2) the *supervisory function*, if any, must receive on a regular basis written reports on the same matters.

[**Note:** *MiFID implementing Directive* Article 9(2) and Article 9(3)]

4.3.3 G The *supervisory function* does not include a general meeting of the shareholders of a *common platform firm*, or equivalent bodies, but could involve, for example, a separate supervisory board within a two-tier board structure or the establishment of a non-executive committee of a single-tier board structure.

5.1 Employees, agents and other relevant persons

Skills, knowledge and expertise

5.1.1 R A *common platform firm* must employ personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them.

[**Note:** *MiFID implementing Directive* Article 5(1)(d)]

5.1.2 G A *firm's* systems and controls should enable it to satisfy itself of the suitability of anyone who acts for it. This includes assessing an individual's honesty and competence. This assessment should normally be made at the point of recruitment. An individual's honesty need not normally be revisited unless something happens to make a fresh look appropriate.

5.1.3 G Any assessment of an individual's suitability should take into account the level of responsibility that the individual will assume within the *firm*. The nature of this assessment will generally differ depending upon whether it takes place at the start of the individual's recruitment, at the end of the probationary period (if there is one) or subsequently.

5.1.4 G The *FSA*'s requirements on *firms* with respect to the competence of individuals are in the Training and Competence sourcebook (*TC*).

5.1.5 G The requirements on *firms* with respect to *approved persons* are in Part V of the *Act* (Performance of regulated activities) and *SUP* 10.

Segregation of functions

5.1.6 R A *common platform firm* must ensure that the performance of multiple functions by its *relevant persons* does not and is not likely to prevent those persons from discharging any particular functions soundly, honestly and professionally.

[**Note:** *MiFID implementing Directive* Article 5(1)(g)]

5.1.7 R The *senior personnel* of a *common platform firm* must define arrangements concerning the segregation of duties within the *firm* and the prevention of conflicts of interest.

[**Note:** *BCD* Annex V paragraph 1]

5.1.8 G The effective segregation of duties is an important element in the *internal controls* of a *firm* in the *prudential context*. In particular, it helps to ensure that no one individual is completely free to commit a *firm*'s assets or incur liabilities on its behalf. Segregation can also help to ensure that a *firm's governing body* receives objective and accurate information on financial performance, the risks faced by the *firm* and the adequacy of its systems.

5.1.9 G A *common platform firm* should normally ensure that no single individual has unrestricted authority to do all of the following:

(1) initiate a transaction;

(2) bind the *firm*;

(3) make payments; and

(4) account for it.

5.1.10 G Where a *common platform firm* is unable to ensure the complete segregation of duties (for example, because it has a limited number of staff), it should ensure that there are adequate compensating controls in place (for example, frequent review of an area by relevant *senior managers*).

5.1.11 G Where a *common platform firm* outsources its internal audit function, it should take reasonable steps to ensure that every individual involved in the performance of this service is independent from the individuals who perform its external audit. This should not prevent services from being undertaken by a *firm's* external auditors provided that:

(1) the work is carried out under the supervision and management of the *firm's* own internal staff; and

(2) potential conflicts of interest between the provision of external audit services and the provision of internal audit are properly managed.

Awareness of procedures

5.1.12 R A *MiFID investment firm* must ensure that its *relevant persons* are aware of the procedures which must be followed for the proper discharge of their responsibilities.

[**Note:** *MiFID implementing Directive* Article 5(1)(b)]

General

5.1.13 R The systems, internal control mechanisms and arrangements established by a *firm* in accordance with this chapter must take into account the nature, scale and complexity of its business and the nature and range of *investment services and activities* undertaken in the course of that business.

[**Note**: *MiFID implementing Directive* Article 5(1) final paragraph]

5.1.14 R A *common platform firm* must monitor and, on a regular basis, evaluate the adequacy and effectiveness of its systems, internal control mechanisms and arrangements established in accordance with this chapter, and take appropriate measures to address any deficiencies.

[**Note**: *MiFID implementing Directive* Article 5(5)]

6.1 Compliance (including internal audit)

6.1.1 R A *common platform firm* must establish, implement and maintain adequate policies and procedures sufficient to ensure compliance of the *firm* including its managers, employees and *appointed representatives* with its obligations under the *regulatory system*.

[**Note:** *MiFID* Article 13(2)]

6.1.2 R A *common platform firm* must, taking in to account the nature, scale and complexity of its business, and the nature and range of *investment services and activities* undertaken in the course of that business, establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the *firm* to comply with its obligations under the *regulatory system*, as well as associated risks, and put in place adequate measures and procedures designed to minimise such risks and to enable the *FSA* to exercise its powers effectively under the *regulatory system* and to enable any other *MiFID competent authority* to exercise its powers effectively under *MiFID*.

[**Note:** *MiFID implementing Directive* Article 6(1)]

6.1.3 R A *common platform firm* must maintain a permanent and effective compliance function which operates independently and which has the following responsibilities:

(1) to monitor and, on a regular basis, to assess the adequacy and effectiveness of the measures and procedures put in place in accordance with *SYSC* 6.1.2R, and the actions taken to address any deficiencies in the *firm*'s compliance with its obligations;

(2) to advise and assist the *relevant persons* responsible for carrying out *regulated activities* to comply with the *firm's* obligations under the *regulatory system*.

[**Note**: *MiFID implementing Directive* Article 6(2)]

6.1.4 R In order to enable the compliance function to discharge its responsibilities properly and independently, a *common platform firm* must ensure that the following conditions are satisfied:

(1) the compliance function must have the necessary authority, resources, expertise and access to all relevant information;

(2) a compliance officer must be appointed and must be responsible for the compliance function and for any reporting as to compliance required by *SYSC* 4.3.2R;

(3) the *relevant persons* involved in the compliance functions must not be

involved in the performance of services or activities they monitor;

(4) the method of determining the remuneration of the *relevant persons* involved in the compliance function must not compromise their objectivity and must not be likely to do so.

[**Note:** *MiFID implementing Directive* Article 6(3) (first paragraph)]

6.1.5 R A *common platform firm* need not comply with *SYSC* 6.1.4R(3) or *SYSC* 6.1.4R(4) if it is able to demonstrate that in view of the nature, scale and complexity of its business, and the nature and range of *investment services and activities*, the requirements under those *rules* are not proportionate and that its compliance function continues to be effective.

[**Note:** *MiFID implementing Directive* Article 6(3) second paragraph)]

6.2 Internal audit

6.2.1 R A *common platform firm* must, where appropriate and proportionate in view of the nature, scale and complexity of its business and the nature and range of *investment services and activities* undertaken in the course of that business, establish and maintain an internal audit function which is separate and independent from the other functions and activities of the *firm* and which has the following responsibilities:

(1) to establish, implement and maintain an audit plan to examine and evaluate the adequacy and effectiveness of the *firm's* systems, internal control mechanisms and arrangements;

(2) to issue recommendations based on the result of work carried out in accordance with (1);

(3) to verify compliance with those recommendations;

(4) to report in relation to internal audit matters in accordance with *SYSC* 4.3.2R.

[**Note:** *MiFID implementing Directive* Article 8]

6.3 Financial crime

6.3.1 R A *common platform firm* must ensure the policies and procedures established under *SYSC* 6.1.1R include systems and controls that:

(1) enable it to identify, assess, monitor and manage *money laundering* risk; and

(2) are comprehensive and proportionate to the nature, scale and complexity of its activities.

6.3.2 G "*Money laundering* risk" is the risk that a *firm* may be used to further *money laundering*. Failure by a *firm* to manage this risk effectively will increase the

risk to society of crime and terrorism.

6.3.3 R A *common platform firm* must carry out regular assessment of the adequacy of these systems and controls to ensure that it continues to comply with *SYSC* 6.3.1R.

6.3.4 G A *common platform firm* may also have separate obligations to comply with relevant legal requirements, including the Terrorism Act 2000, the Proceeds of Crime Act 2002 and the *Money Laundering Regulations*. *SYSC* 6.1.1R and *SYSC* 6.3.1R to *SYSC* 6.3.10G are not relevant for the purposes of regulation 3(3) of the *Money Laundering Regulations*, section 330(8) of the Proceeds of Crime Act 2002 or section 21A(6) of the Terrorism Act 2000.

6.3.5 G The *FSA*, when considering whether a breach of its *rules* on systems and controls against *money laundering* has occurred, will have regard to whether a *common platform firm* has followed relevant provisions in the guidance for the *United Kingdom* financial sector issued by the Joint Money Laundering Steering Group.

6.3.6 G In identifying its *money laundering* risk and in establishing the nature of these systems and controls, a *common platform firm* should consider a range of factors, including:

(1) its customer, product and activity profiles;

(2) its distribution channels;

(3) the complexity and volume of its transactions;

(4) its processes and systems; and

(5) its operating environment.

6.3.7 G A *common platform firm* should ensure that the systems and controls include:

(1) appropriate training for its employees in relation to *money laundering*;

(2) appropriate provision of information to its *governing body* and senior management, including a report at least annually by that *firm's money laundering reporting officer* (*MLRO*) on the operation and effectiveness of those systems and controls;

(3) appropriate documentation of its risk management policies and risk profile in relation to *money laundering*, including documentation of its application of those policies (see *SYSC* 9);

(4) appropriate measures to ensure that *money laundering* risk is taken into account in its day-to-day operation, including in relation to:

(a) the development of new products;

(b) the taking-on of new customers; and

(c) changes in its business profile; and

(5) appropriate measures to ensure that procedures for identification of new customers do not unreasonably deny access to its services to potential customers who cannot reasonably be expected to produce detailed evidence of identity.

6.3.8 R A *common platform firm* must allocate to a *director* or *senior manager* (who may also be the *money laundering reporting officer*) overall responsibility within the *firm* for the establishment and maintenance of effective anti-*money laundering* systems and controls.

The money laundering reporting officer

6.3.9 R A *common platform firm* must:

(1) appoint an individual as *MLRO*, with responsibility for oversight of its compliance with the *FSA's rules* on systems and controls against *money laundering*; and

(2) ensure that its *MLRO* has a level of authority and independence within the *firm* and access to resources and information sufficient to enable him to carry out that responsibility.

6.3.10 G The job of the *MLRO* within a *firm* is to act as the focal point for all activity within the *firm* relating to anti-*money laundering*. The *FSA* expects that a *firm's MLRO* will be based in the *United Kingdom*.

7.1 Risk control

7.1.1 G *SYSC* 4.1.1R requires a *common platform firm* to have effective processes to identify, manage, monitor and report the risks it is or might be exposed to.

7.1.2 R A *common platform firm* must establish, implement and maintain adequate risk management policies and procedures, including effective procedures for risk assessment, which identify the risks relating to the *firm's* activities, processes and systems, and where appropriate, set the level of risk tolerated by the *firm*.

[**Note**: *MiFID implementing Directive* Article 7(1)(a) and *MiFID* Article 13(5) second paragraph]

7.1.3 R A *common platform firm* must adopt effective arrangements, processes and mechanisms to manage the risk relating to the *firm's* activities, processes and systems, in light of that level of risk tolerance.

[**Note**: *MiFID implementing Directive* Article 7(1)(b)]

7.1.4 R The *senior personnel* of a *common platform firm* must approve and periodically review the strategies and policies for taking up, managing, monitoring and mitigating the risks the *firm* is or might be exposed to, including those posed by the macroeconomic environment in which it operates in relation to the status of the business cycle.

[**Note**: *BCD* Annex V paragraph 2]

7.1.5 R A *common platform firm* must monitor the following:

(1) the adequacy and effectiveness of the *firm's* risk management policies and procedures;

(2) the level of compliance by the *firm* and its *relevant persons* with the arrangements, processes and mechanisms adopted in accordance with *SYSC* 7.1.3R;

(3) the adequacy and effectiveness of measures taken to address any deficiencies in those arrangements and procedures, including failures by the *relevant persons* to comply with such arrangements or follow such procedures.

[**Note**: *MiFID implementing Directive* Article 7(1)(c)]

7.1.6 R A *common platform firm* must, where appropriate and proportionate in view of the nature, scale and complexity of its business and the nature and range of the *investment services and activities* undertaken in the course of that business, establish and maintain a risk management function that operates independently and carries out the following tasks:

(1) implementation of the policies and procedures referred to in *SYSC* 7.1.2R to *SYSC* 7.1.5R; and

(2) provision of reports and advice to *senior personnel* in accordance with *SYSC* 4.3.2R.

[**Note**: *MiFID implementing Directive* Article 7(2) first paragraph]

7.1.7 R Where a *common platform firm* is not required under *SYSC* 7.1.6R to maintain a risk management function that functions independently, it must nevertheless be able to demonstrate that the policies and procedures which it has adopted in accordance with *SYSC* 7.1.2R to *SYSC* 7.1.5R satisfy the requirements of those *rules* and are consistently effective.

[**Note**: *MiFID implementing Directive* Article 7(2) second paragraph]

7.1.8 G *SYSC* 4.1.3R requires a *BIPRU firm* to ensure that its internal control mechanisms and administrative and accounting procedures permit the verification of its compliance with *rules* adopted in accordance with the *CAD* at all times. In complying with this obligation, a *BIPRU firm* should document the organisation and responsibilities of its risk management function and it should document its risk management framework setting out how the risks in the business are identified, measured, monitored and controlled.

Credit and counterparty risk

7.1.9 R A *BIPRU firm* must base credit-granting on sound and well-defined criteria and clearly establish the process for approving, amending, renewing, and re-financing credits.

[**Note**: *BCD* Annex V paragraph 3]

7.1.10 R A *BIPRU firm* must operate through effective systems the ongoing administration and monitoring of its various credit risk-bearing portfolios and exposures, including for identifying and managing problem credits and for making adequate value adjustments and provisions.

[**Note**: *BCD* Annex V paragraph 4]

7.1.11 R A *BIPRU firm* must adequately diversify credit portfolios given its target market and overall credit strategy.

[**Note**: *BCD* Annex V paragraph 5]

7.1.12 G The documentation maintained by a *BIPRU firm* under *SYSC* 4.1.3R should include its policy for credit risk, including its risk appetite and provisioning policy and should describe how it measures, monitors and controls that risk. This should include descriptions of the systems used to ensure that the policy is correctly implemented.

Residual risk

7.1.13 R A *BIPRU firm* must address and control by means of written policies and procedures the risk that recognised credit risk mitigation techniques used by it prove less effective than expected.

[**Note**: *BCD* Annex V paragraph 6]

Market risk

7.1.14 R A *BIPRU firm* must implement policies and processes for the measurement and management of all material sources and effects of market risks.

[**Note**: *BCD* Annex V paragraph 9a]

Operational risk

7.1.15 R A *BIPRU firm* must implement policies and processes to evaluate and manage the exposure to operational risk, including to low-frequency high severity events. Without prejudice to the definition of *operational risk*, *BIPRU firms* must articulate what constitutes operational risk for the purposes of those policies and procedures.

[**Note**: *BCD* Annex V paragraph 11]

Liquidity risk[6]

7.1.16 R A *BIPRU firm* must ensure that policies and processes exist for the measurement and management of its net funding position and requirements on an ongoing and forward-looking basis. Alternative scenarios must be considered and the assumptions underpinning decisions concerning the net funding position must be reviewed regularly.

[**Note:** *BCD* Annex V paragraph 13]

7.1.17 R A *BIPRU firm* must ensure that it has contingency plans to deal with liquidity crises in place.

[**Note:** *BCD* Annex V paragraph 14]

[6] BCD Annex V paragraphs 13 and 14 will be implemented on 1 January 2007 in SYSC 11 (Liquidity risk), which will be consulted on later this year.

8.1 Outsourcing

8.1.1 R A *common platform firm* must:

(1) when relying on a third party for the performance of operational functions which are critical for the performance of *regulated activities*, *listed activities* or *ancillary services* (in this chapter "relevant services and activities") on a continuous and satisfactory basis, ensure that it takes reasonable steps to avoid undue additional operational risk;

(2) not undertake the o*utsourcing* of important operational functions in such a way as to impair:

(a) materially the quality of its internal control; and

(b) the ability of the *FSA* to monitor the *firm's* compliance with all obligations under the *regulatory system* and, if different, of a *MiFID competent authority* to monitor the *firm's* compliance with all obligations under *MiFID*.

[**Note:** *MiFID* Article 13(5) first paragraph]

8.1.2 G The application of *SYSC* 8.1 to relevant services and activities (see *SYSC* 8.1.1R(1)) is limited by *SYSC* 1.3 (Application of SYSC 4 to SYSC 10).

8.1.3 G *SYSC* 4.1.1R requires a *common platform firm* to have effective processes to identify, manage, monitor and report risks and internal control mechanisms. Except in relation to those functions described in *SYSC* 8.1.5R, where a *firm* relies on a third party for the performance of operational functions which are not critical or important for the performance of relevant services and activities (see *SYSC* 8.1.1R(1)) on a continuous and satisfactory basis, it should take into account, in a manner that is proportionate given the nature, scale and complexity of the *outsourcing*, the *rules* in this chapter in complying with that requirement.

8.1.4 R For the purposes of this chapter an operational function is regarded as critical or important if a defect or failure in its performance would materially impair the continuing compliance of a *common platform firm* with the conditions and obligations of its *authorisation* or its other obligations under the *regulatory system*, or its financial performance, or the soundness or the continuity of its relevant services and activities (see *SYSC* 8.1.1R(1)).

[**Note:** *MiFID implementing Directive* Article 13(1)]

8.1.5 R Without prejudice to the status of any other function, the following functions will not be considered as critical or important for the purposes of this chapter:

(1) the provision to the *firm* of advisory services, and other services which do not form part of the relevant services and activities (see SYSC 8.1.1R(1)) of the *firm*, including the provision of legal advice to the *firm*, the training of personnel of the *firm*, billing services and the security of the *firm's* premises and personnel;

(2) the purchase of standardised services, including market information services and the provision of price feeds.

[**Note:** *MiFID implementing Directive* Article 13(2)]

8.1.6 R If a *common platform firm outsources* critical or important operational functions or any other relevant services and activities (see *SYSC* 8.1.1R(1)), it remains fully responsible for discharging all of its obligations under the *regulatory system* and must comply, in particular, with the following conditions:

(1) the *outsourcing* must not result in the delegation by *senior personnel* of their responsibility;

(2) the relationship and obligations of the *firm* towards its *clients* under the *regulatory system* must not be altered;

(3) the conditions with which the *firm* must comply in order to be *authorised*, and to remain so, must not be undermined;

(4) none of the other conditions subject to which the *firm's authorisation* was granted must be removed or modified.

[**Note:** *MiFID implementing Directive* Article 13(3)]

8.1.7 R A *common platform firm* must exercise due skill and care and diligence when entering into, managing or terminating any arrangement for the *outsourcing* to a service provider of critical or important operational functions or of any relevant services and activities (see *SYSC* 8.1.1R(1)).

[**Note:** *MiFID implementing Directive* Article 14(1) first paragraph]

8.1.8 R A *common platform firm* must in particular take the necessary steps to ensure that the following conditions are satisfied:

(1) the service provider must have the ability, capacity, and any *authorisation* required by law to perform the *outsourced* functions, services or activities reliably and professionally;

(2) the service provider must carry out the *outsourced* services effectively, and to this end the *firm* must establish methods for assessing the standard of performance of the service provider;

(3) the service provider must properly supervise the carrying out of the *outsourced* functions, and adequately manage the risks associated

with the *outsourcing*;

(4) appropriate action must be taken if it appears that the service provider may not be carrying out the functions effectively and in compliance with applicable laws and regulatory requirements;

(5) the *firm* must retain the necessary expertise to supervise the *outsourced* functions effectively and manage the risks associated with the *outsourcing*;

(6) the service provider must disclose to the *firm* any development that may have an impact on its ability to carry out the *outsourced* functions effectively and compliance with applicable laws and regulatory requirements;

(7) the *firm* must be able to terminate the arrangement for the *outsourcing* where necessary without detriment to the continuity and quality of its provision of services to *clients*;

(8) the service provider must co-operate with the *FSA* and any other relevant *MiFID competent authority* in connection with the *outsourced* activities;

(9) the *firm*, it auditors, the *FSA* and any other relevant *MiFID competent authority* must have effective access to data related to the *outsourced* activities, as well as to the business premises of the service provider; and the *FSA* or and any other relevant *MiFID competent authority* must be able to exercise those rights of access;

(10) the service provider must protect any confidential information belonging to the *firm* or relating to its *clients*;

(11) where applicable, the *firm* and the service provider must establish, implement and maintain a contingency plan for disaster recovery and periodic testing of backup facilities.

[**Note:** *MiFID implementing Directive* Article 14(1) second paragraph]

8.1.9 R A *common platform firm* must ensure that the respective rights and obligations of the *firm* and of the service provider are clearly allocated and set out in a written agreement.

[**Note:** *MiFID implementing Directive* Article 14(2)]

8.1.10 R Where a *common platform firm* and the service provider are members of the same *group*, the *firm* may, for the purpose of complying with *SYSC* 8.1.7R to *SYSC* 8.1.11R [and the FSA implementing measures for *MiFID implementing Directive* Article 15], take into account the extent to which they *control* the service provider or have the ability to influence its actions, and the extent to which the service provider is included in the consolidated

supervision of the *group*.

[**Note:** *MiFID implementing Directive* Article 14(3)]

8.1.11 R A *common platform firm* must make available on request to the *FSA* and any other relevant *MiFID competent authority* all information necessary to enable the *FSA* and any other relevant *MiFID competent authority* to supervise the compliance of the performance of the *outsourced* activities with the requirements of the *regulatory system*.

[**Note:** *MiFID implementing Directive* Article 14(4)]

8.1.12 G As *SUP* 15.3.8G explains, a *common platform firm* should notify the *FSA* when it intends to rely on a third party for the performance of operational functions which are critical or important for the performance of relevant services and activities (see *SYSC* 8.1.1R(1)) on a continuous and satisfactory basis.

[**Note:** *MiFID implementing Directive* Recital 18]

8.1.13 R [*MiFID implementing Directive* Article 15 will be consulted on later this year.]

Annex 4

To be inserted after *SYSC* 9[7]

10.1 Conflicts of interest

Application

10.1.1 R This section applies to a *common platform firm* which provides services to its *clients* in the course of carrying on *regulated activities* or *ancillary activities*.

Identifying conflicts

10.1.2 R A *common platform firm* must take all reasonable steps to identify conflicts of interest between:

(1) the *firm*, including its managers, employees and *appointed representatives*, or any person directly or indirectly linked to them by *control*, and a *client* of the *firm*; or

(2) one *client* of the *firm* and another *client*;

that arise in the course of the *firm* providing any service referred to in *SYSC* 10.1.1R.

[**Note:** *MiFID* Article 18(1)]

Types of conflicts

10.1.3 R For the purposes of identifying the types of conflict of interest that arise in the course of providing a service and whose existence may adversely affect the interests of a *client*, a *common platform firm* must take into account, as a minimum, whether the *firm* or a *relevant person*, or a person directly or indirectly linked by *control* to the *firm*:

(1) is likely to make a financial gain, or avoid a financial loss, to the expense of the *client*;

(2) has an interest in the outcome of a service provided to the *client* or of a transaction carried out on behalf of the *client*, which is distinct from the *client*'s interest in that outcome;

(3) has a financial or other incentive to favour the interest of another *client* or group of *clients* over the interests of the *client*;

(4) carries on the same business as the *client*; or

(5) receives or will receive from a person other than the *client* an inducement in relation to a service provided to the *client*, in the form of monies, goods or services, other than the standard commission or

[7] SYSC 9 (Record-keeping) will be consulted on later this year.

fee for that service.

[**Note:** *MiFID implementing Directive* Article 21]

10.1.4 G The circumstances which should be treated as giving rise to a conflict of interest cover cases where there is a conflict between the interests of the *firm* or certain persons connected to the *firm* and the duty the *firm* owes to a *client*; or between the differing interests of two or more of its *clients*, to whom the *firm* owes in each case a duty. It is not enough that the *firm* stands to gain a benefit if there is not also a disadvantage to a *client*, or that one *client* to whom the *firm* owes a duty stands to make a gain or avoid a loss without there being a concomitant loss to another such *client*.

[**Note:** *MiFID implementing Directive* Recital 20]

Requirements only apply in respect of services

10.1.5 G Conflicts of interest are regulated under this section only where a service referred to in *SYSC* 10.1.1R is provided by a *common platform firm*. The status of the *client* to whom the service is provided (as either a retail client, professional client or eligible counterparty) is irrelevant for this purpose.

[**Note:** *MiFID implementing Directive* Recital 21]

Managing conflicts

10.1.6 R A *common platform firm* must maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps to prevent conflicts of interest as defined in *SYSC* 10.1.2R from adversely affecting the interest of *clients*.

[**Note:** *MiFID* Article 13(3)]

Conflicts policy

10.1.7 R (1) A *common platform firm* must establish, implement and maintain an effective conflicts of interest policy set out in writing and appropriate to the size and organisation of the *firm* and the nature, scale and complexity of its business.

(2) Where the *common platform firm* is a member of a group, the policy must also take into account any circumstances of which the *firm* is or should be aware, which may give rise to a conflict of interest arising as a result of the structure and business activities of other members of the group.

[**Note:** *MiFID implementing Directive* Article 22(1)]

Contents of conflicts policy

10.1.8 R (1) The conflicts of interest policy established under *SYSC* 10.1.7R must

include the following content:

(a) it must identify, with reference to the specific services and activities carried out by or on behalf of the *common platform firm*, the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of one or more *clients*; and

(b) it must specify procedures to be followed and measures to be adopted in order to manage such conflicts.

(2) The procedures and measures provided for in paragraph (1)(b) must:

(a) be designed to ensure that *relevant person*s engaged in different business activities involving a conflict of interest of the kind specified in paragraph (1)(a) carry on those activities at a level of independence appropriate to the size and activities of the *common platform firm*, and to the degree of risk entailed to *clients*; and

(b) for those purposes include such of the following as are necessary and appropriate for the *common platform firm* to ensure the requisite level of independence:

(i) effective procedures to prevent or control the exchange of information between *relevant persons* engaged in activities involving a risk of a conflict of interest where the exchange of that information may harm the interests of one or more *clients*;

(ii) the separate supervision of *relevant persons* whose principal functions involve carrying out activities on behalf of, or providing services to, *clients* whose interests may conflict, or who otherwise represent different interests that may conflict, including those of the *firm*;

(iii) the removal of any direct link between the remuneration of *relevant person*s principally engaged in one activity and the remuneration of, or revenues generated by, different *relevant person*s principally engaged in another activity, where a conflict of interest may arise in relation to those activities;

(iv) measures to prevent or limit any person from exercising inappropriate influence over the way in which a *relevant person* carries out services or activities;

(v) measures to prevent or control the simultaneous or sequential involvement of a *relevant person* in

separate services or activities where such involvement may impair the proper management of conflicts of interest.

(3) If the adoption or the practice of one or more of those measures and procedures does not ensure the requisite level of independence, a *common platform firm* must adopt such alternative or additional measures and procedures as are necessary and appropriate for those purposes.

[**Note:** *MiFID implementing Directive* Article 22(2) and (3)]

10.1.9 G In drawing up a conflicts of interest policy which identifies circumstances which constitute or may give rise to a conflict of interest, the *common platform firm* should pay special attention to the activities of investment research and advice, proprietary trading, portfolio management and corporate finance business, including underwriting or selling in an offering of securities and advising on mergers and acquisitions. In particular, such special attention is appropriate where the *firm* or a person directly or indirectly linked by *control* to the *firm* performs a combination of two or more of those activities.

[**Note:** *MiFID implementing Directive* Recital 22]

Disclosure of conflicts

10.1.10 R (1) If arrangements made by a *common platform firm* under *SYSC* 10.1.6R to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to the interests of a *client* will be prevented, the *firm* must clearly disclose the general nature and/or sources of conflicts of interest to the *client* before undertaking business for the *client*.

(2) The disclosure must:

(a) be made in a *durable medium*; and

(b) include sufficient detail, taking into account the nature of the *client*, to enable that *client* to take an informed decision with respect to the service in the context of which the conflict of interest arises.

[**Note:** *MiFID* Article 18(2) and *MiFID implementing Directive* Article 22(4) and (5)]

10.1.11 G While disclosure of specific conflicts of interest is required by *SYSC* 10.1.10R, an over-reliance on disclosure without adequate consideration as to how conflicts may appropriately be managed is undesirable. The purpose of such disclosure should be to give the *client* an opportunity to decide whether to continue his commercial relationship with the *firm*, in respect of the relevant services or wholly.

[**Note:** *MiFID implementing Directive* Recital 23]

Records of services or activities giving rise to conflicts

10.1.12 R A *common platform firm* must keep and regularly update a record of the kinds of service or activity carried out by or on behalf of the *firm* in which a conflict of interest entailing a material risk of damage to the interests of one or more *clients* has arisen or, in the case of an ongoing service or activity, may arise.

[**Note:** *MiFID implementing Directive* Article 23]

Corporate finance

10.1.13 G This section is relevant to the management of a *securities* offering by a *common platform firm.*

10.1.14 G A *common platform firm* will wish to note that when carrying on a mandate to manage an offering of *securities*, the *firm's* duty for that business is to its corporate finance *client* (in many cases, the corporate issuer or seller of the relevant *securities*), but that its responsibilities to provide services to its investment *clients* are unchanged.

10.1.15 G Measures that a *common platform firm* might wish to consider in drawing up its conflicts of interest policy in relation to the management of an offering of *securities* include:

(1) at an early stage agreeing with its corporate finance *client* relevant aspects of the offering process such as the process the *firm* proposes to follow in order to determine what recommendations it will make about allocations for the offering; how the target investor group will be identified; how recommendations on allocation and pricing will be prepared; and whether the *firm* might place *securities* with its investment *clients* or with its own proprietary book, or with an associate, and how conflicts arising might be managed; and

(2) agreeing allocation and pricing objectives with the corporate finance *client*; inviting the corporate finance *client* to participate actively in the allocation process; making the initial recommendation for allocation to *retail clients* of the *firm* as a single block and not on a named basis; having internal arrangements under which senior personnel responsible for providing services to *retail clients* make the initial allocation recommendations for allocation to *retail clients* of the *firm*; and disclosing to the *issuer* details of the allocations actually made.

[**Note:** The provisions in *SYSC* 10.1 also implement *BCD* Article 22 and *BCD* Annex V paragraph 1]

10.2 Chinese Walls

Application

10.2.1 R This section applies to a *common platform firm*.

Control of information

10.2.2 R (1) When a *common platform firm* establishes and maintains a *Chinese wall* (that is, an arrangement that requires information held by a *person* in the course of carrying on one part of the business to be withheld from, or not to be used for, *persons* with or for whom it acts in the course of carrying on another part of its business) it may:

(a) withhold or not use the information held; and

(b) for that purpose, permit *persons* employed in the first part of its business to withhold the information held from those employed in that other part of the business;

but only to the extent that the business of one of those parts involves the carrying on of *regulated activities* or *ancillary activities*.

(2) Information may also be withheld or not used by a *common platform firm* when this is required by an established arrangement maintained between different parts of the business (of any kind) in the same *group*. This provision does not affect any requirement to transmit or use information that may arise apart from the *rules* in *COB*.

(3) For the purpose of this *rule*, "maintains" includes taking reasonable steps to ensure that the arrangements remain effective and are adequately monitored, and must be interpreted accordingly.

(4) For the purposes of section 118A(5)(a) of the *Act*, behaviour conforming with paragraph (1) does not amount to market abuse.

Attribution of knowledge

10.2.3 R When any of the *rules* of *COB* or *CASS* apply to a *common platform firm* that acts with knowledge, the *firm* will not be taken to act with knowledge for the purposes of that *rule* if none of the relevant individuals involved on behalf of the *firm* acts with that knowledge as a result of arrangements established under *SYSC* 10.2.2R.

10.2.4 G When a *common platform firm* manages a conflict of interest using the arrangements in *SYSC* 10.2.2R which take the form of a *Chinese wall*, individuals on the other side of the wall will not be regarded as being in possession of knowledge denied to them as a result of the *Chinese wall*.

Annex C

Transferred and Amended text to be inserted into the Senior Management Arrangements, Systems and Controls Handbook

In this annex, the place where the text is being inserted is indicated and the text is not underlined.

To be inserted after *SYSC* 11[8]

12.1 Group risk systems and controls requirement

Application

12.1.1 R Subject to *SYSC* 12.1.2R to *SYSC* 12.1.4R, *SYSC* 12.1 applies to each of the following which is a member of a *group*:

(1) a *firm* that falls into any one or more of the following categories:

(a) a *regulated entity*;

(b) an *ELMI*;

(c) an *insurer*;

(d) a *BIPRU firm*;

(e) a non-*BIPRU firm* that is a *parent financial holding company* in a *Member State* and is a member of a *UK consolidation group*; and

(f) a *firm* subject to the *rules* in *IPRU(INV)* Chapter 14.

(2) a *UCITS firm*, but only if its *group* contains a *firm* falling into (1); and

(3) the *Society*.

12.1.2 R Except as set out in *SYSC* 12.1.4R, *SYSC* 12.1 applies with respect to different types of *group* as follows:

(1) *SYSC* 12.1.8R and *SYSC* 12.1.10R apply with respect to all *groups*, including *FSA regulated EEA financial conglomerates*, other *financial conglomerates* and *groups* dealt with in *SYSC* 12.1.13R to *SYSC* 12.1.16R;

(2) the additional requirements set out in *SYSC* 12.1.11R and *SYSC* 12.1.12R only apply with respect to *FSA regulated EEA financial conglomerates*; and

(3) the additional requirements set out in *SYSC* 12.1.13R to *SYSC*

[8] SYSC 11 (Liquidity risk) will be consulted on later this year.

12.1.16R only apply with respect to *groups* of the kind dealt with by whichever of those *rules* apply.

12.1.3 R *SYSC* 12.1 does not apply to:

(1) an *incoming EEA firm*; or

(2) an *incoming Treaty firm*; or

(3) a *UCITS qualifier*; or

(4) an *ICVC*.

12.1.4 R (1) This *rule* applies in respect of the following *rules*:

(a) *SYSC* 12.1.8R(2);

(b) *SYSC* 12.1.10R(1), so far as it relates to *SYSC* 12.1.8R(2);

(c) *SYSC* 12.1.10R(2); and

(d) *SYSC* 12.1.11R to *SYSC* 12.1.15R.

(2) The *rules* referred to in (1):

(a) only apply with respect to a *financial conglomerate* if it an *FSA regulated EEA financial conglomerate*;

(b) (so far as they apply with respect to a *group* that is not a *financial conglomerate*) do not apply with respect to a *group* for which a *competent authority* in another *EEA state* is lead regulator;

(c) (so far as they apply with respect to a *financial conglomerate*) do not apply to a *firm* with respect to a *financial conglomerate* of which it is a member if the interest of the *financial conglomerate* in that *firm* is no more than a *participation*;

(d) (so far as they apply with respect to other *groups*) do not apply to a *firm* with respect to a *group* of which it is a member if the only relationship of the kind set out in paragraph (3) of the definition of *group* between it and the other members of the *group* is nothing more than a *participation*; and

(e) do not apply with respect to a *third-country group*.

12.1.5 G For the purpose of *SYSC* 12.1, a *group* is defined in the *Glossary*, and includes the whole of a *firm's* group, including financial and non-financial undertakings. It also covers undertakings with other links to *group* members if their omission from the scope of *group* risk systems and controls would be misleading. The scope of the *group* systems and controls requirements may therefore differ from the scope of the quantitative requirements for *groups*.

Purpose

12.1.6 G The purpose of this chapter is to set out how the systems and control requirements imposed by *SYSC* (Senior Management Arrangements, Systems and Controls) apply where a *firm* is part of a *group*. If a *firm* is a member of a *group*, it should be able to assess the potential impact of risks arising from other parts of its *group* as well as from its own activities.

12.1.7 G *SYSC* 12.1 implements Articles 73(3) (Supervision on a consolidated basis of credit institutions) and 138 (Intra-group transactions with mixed activity holding companies) of the *Banking Consolidation Directive*, Article 9 of the *Financial Groups Directive* (Internal control mechanisms and risk management processes) and Article 8 of the *Insurance Groups Directive* (Intra-group transactions).

General rules

12.1.8 R A *firm* must:

(1) have adequate, sound and appropriate risk management processes and internal control mechanisms for the purpose of assessing and managing its own exposure to *group* risk, including sound administrative and accounting procedures; and

(2) ensure that its *group* has adequate, sound and appropriate risk management processes and internal control mechanisms at the level of the *group*, including sound administrative and accounting procedures.

12.1.9 G For the purposes of *SYSC* 12.1.8R, the question of whether the risk management processes and internal control mechanisms are adequate, sound and appropriate should be judged in the light of the nature, scale and complexity of the *group's* business.

12.1.10 R The internal control mechanisms referred to in *SYSC* 12.1.8R must include:

(1) mechanisms that are adequate for the purpose of producing any data and information which would be relevant for the purpose of monitoring compliance with any prudential requirements (including any reporting requirements and any requirements relating to capital adequacy, solvency, systems and controls and large exposures):

(a) to which the *firm* is subject with respect to its membership of a *group*; or

(b) that apply to or with respect to that *group* or part of it; and

(2) mechanisms that are adequate to monitor funding within the *group*.

Financial conglomerates

12.1.11 R Where *SYSC* 12.1 applies with respect to a *financial conglomerate*, the risk management processes referred to in *SYSC* 12.1.8R(2) must include:

(1) sound governance and management processes, which must include the approval and periodic review by the appropriate managing bodies within the *financial conglomerate* of the strategies and policies of the *financial conglomerate* in respect of all the risks assumed by the *financial conglomerate*, such review and approval being carried out at the level of the *financial conglomerate*;

(2) adequate capital adequacy policies at the level of the *financial conglomerate*, one of the purposes of which must be to anticipate the impact of the business strategy of the *financial conglomerate* on its risk profile and on the capital adequacy requirements to which it and its members are subject;

(3) adequate procedures for the purpose of ensuring that the risk monitoring systems of the *financial conglomerate* and its members are well integrated into their organisation; and

(4) adequate procedures for the purpose of ensuring that the systems and controls of the members of the *financial conglomerate* are consistent and that the risks can be measured, monitored and controlled at the level of the *financial conglomerate*.

12.1.12 R Where *SYSC* 12.1 applies with respect to a *financial conglomerate*, the internal control mechanisms referred to in *SYSC* 12.1.8R(2) must include:

(1) mechanisms that are adequate to identify and measure all material risks incurred by members of the *financial conglomerate* and appropriately relate capital in the *financial conglomerate* to risks; and

(2) sound reporting and accounting procedures for the purpose of identifying, measuring, monitoring and controlling *intra-group transactions and risk concentrations*.

BIPRU firms and other firms to which BIPRU 8 applies

12.1.13 R If this *rule* applies under *SYSC* 12.1.14R to a *firm*, the *firm* must:

(1) comply with *SYSC* 12.1.8R(2) in relation to any *UK consolidation group* or *non-EEA sub-group* of which it is a member, as well as in relation to its *group*; and

(2) ensure that the risk management processes and internal control mechanisms at the level of any *UK consolidation group* or *non-EEA*

sub-group of which it is a member comply with the obligations set out in the following provisions on a consolidated (or sub-consolidated) basis:

(a) *SYSC* 3.2.23R and *SYSC* 3.2.24R;

(b) *SYSC* 3.2.26R;

(c) *SYSC* 3.2.28R to [*SYSC* 3.2.35R];

(d) [rules in *SYSC* 11 implementing *BCD* Annex V paragraphs 13 and 14[9]];

(e) *BIPRU* 2.3.6R;

(f) *BIPRU* 9.1.7R and *BIPRU* 9.12.21R;

(g) *BIPRU* 10.12.1R.

[**Note:** *BCD* Article 73(3)]

12.1.14 R *SYSC* 12.1.13R applies to a *firm* that is:

(1) an *ELMI*;

(2) a *BIPRU firm*; or

(3) a non-*BIPRU firm* that is a *parent financial holding company* in a *Member State* and is a member of a *UK consolidation group*.

12.1.15 R In the case of a *firm* that:

(1) is an *ELMI* or a *BIPRU firm*; and

(2) has a *mixed-activity holding company* as a *parent undertaking*;

the risk management processes and internal control mechanisms referred to in *SYSC* 12.1.8R must include sound reporting and accounting procedures and other mechanisms that are adequate to identify, measure, monitor and control transactions between the *firm's parent undertaking mixed-activity holding company* and any of the *mixed-activity holding company's subsidiary undertakings*.

Insurance undertakings

12.1.16 R In the case of an *insurer* that has a *mixed-activity insurance holding company* as a *parent undertaking*, the risk management processes and internal control mechanisms referred to in *SYSC* 12.1.8R must include sound reporting and accounting procedures and other mechanisms that are adequate to identify, measure, monitor and control transactions between the *firm's parent*

[9] BCD Annex V paragraphs 13 and 14 will be implemented on 1 January 2007 in SYSC 11 (Liquidity risk), which will be consulted on later this year.

undertaking mixed-activity insurance holding company and any of the *mixed-activity insurance holding company's subsidiary undertakings*.

12.1.17 G *SYSC* 12.1.16R cannot apply to a *building society* as it cannot have a *mixed-activity holding company* as a *parent undertaking*. *SYSC* 12.1.16R cannot apply to a *friendly society* as it cannot have a *mixed-activity insurance holding company* as a *parent undertaking*.

Nature and extent of requirements and allocation of responsibilities within the group

12.1.18 G Assessment of the adequacy of a *group's* systems and controls required by *SYSC* 12.1 will form part of the *FSA's* risk management process.

12.1.19 G The nature and extent of the systems and controls necessary under *SYSC* 12.1.8R(1) to address *group* risk will vary according to the materiality of those risks to the *firm* and the position of the *firm* within the *group*.

12.1.20 G In some cases the management of the systems and controls used to address the risks described in *SYSC* 12.1.8R(1) may be organised on a *group*-wide basis. If the *firm* is not carrying out those functions itself, it should delegate them to the *group* members that are carrying them out. However, this does not relieve the *firm* of responsibility for complying with its obligations under *SYSC* 12.1.8R(1). A *firm* cannot absolve itself of such a responsibility by claiming that any breach of that *rule* is caused by the actions of another member of the *group* to whom the *firm* has delegated tasks. The risk management arrangements are still those of the *firm*, even though personnel elsewhere in the *firm's group* are carrying out these functions on its behalf.

12.1.21 G *SYSC* 12.1.8R(1) deals with the systems and controls that a *firm* should have in respect of the exposure it has to the rest of the *group*. On the other hand, the purpose of *SYSC* 12.1.8R(2) and the *rules* in *SYSC* 12.1 that amplify it is to require *groups* to have adequate systems and controls. However a *group* is not a single legal entity on which obligations can be imposed. Therefore the obligations have to be placed on individual *firms*. The purpose of imposing the obligations on each *firm* in the *group* is to make sure that the *FSA* can take supervisory action against any *firm* in a *group* whose systems and controls do not meet the standards in *SYSC* 12.1. Thus responsibility for compliance with the *rules* for *group* systems and controls is a joint one.

12.1.22 G If both a *firm* and its *parent undertaking* are subject to *SYSC* 12.1.8R(2), the *FSA* would not expect systems and controls to be duplicated. In this case, the *firm* should assess whether and to what extent it can rely on its parent's *group* risk systems and controls.

Annex D

Transferred text to be inserted into the Senior Management Arrangements, Systems and Controls Handbook

In this annex, the place where the text is being inserted is indicated and the text is not underlined.

To be inserted after *SYSC* 12

13.1 Operational Risk: Systems and Controls

13.1 Application

13.1.1 G *SYSC* 13 applies to an *insurer* unless it is:

(1) a *non-directive friendly society*; or

(2) an *incoming EEA firm*; or

(3) an *incoming Treaty firm*.

13.1.2 G *SYSC* 13 applies to:

(1) an *EEA-deposit insurer*; and

(2) a *Swiss general insurer*;

only in respect of the activities of the *firm* carried on from a *branch* in the *United Kingdom*.

13.2 Purpose

13.2.1 G *SYSC* 13 provides *guidance* on how to interpret *SYSC* 3.1.1R and *SYSC* 3.2.6R, which deal with the establishment and maintenance of systems and controls, in relation to the management of operational risk. Operational risk has been described by the Basel Committee on Banking Supervision as "the risk of loss, resulting from inadequate or failed internal processes, people and systems, or from external events". This chapter covers systems and controls for managing risks concerning any of a *firm's* operations, such as its IT systems and *outsourcing* arrangements. It does not cover systems and controls for managing credit, market, liquidity and insurance risk.

13.2.2 G Operational risk is a concept that can have a different application for different *firms*. A *firm* should assess the appropriateness of the *guidance* in this chapter in the light of the scale, nature and complexity of its activities as well as its obligations as set out in *Principle* 3, to organise and control its affairs responsibly and effectively.

13.2.3 G A *firm* should take steps to understand the types of operational risk that are relevant to its particular circumstances, and the operational losses to which

they expose the *firm*. This should include considering the potential sources of operational risk addressed in this chapter: people; processes and systems; external events.

13.2.4 G Operational risk can affect, amongst other things, a *firm's* solvency, or lead to unfair treatment of consumers or lead to financial crime. A *firm* should consider all operational risk events that may affect these matters in establishing and maintaining its systems and controls.

13.3 Other related Handbook sections

13.3.1 G The following is a non-exhaustive list of *rules* and *guidance* in the *Handbook* that are relevant to a *firm's* management of operational risk:

(1) *SYSC* 14 and *INSPRU* 5.1 contain specific *rules* and *guidance* for the establishment and maintenance of operational risk systems and controls in a *prudential context*.

(2) *COB* contains *rules* and *guidance* that can relate to the management of operational risk; for example, *COB* 2 (Rules which apply to all firms conducting designated investment business), *COB* 3 (Financial promotion), *COB* 5 (Advising and selling), *COB* 7 (Dealing and managing) and *COB* 9 (Client assets).

13.4 Requirements to notify the FSA

13.4.1 G Under *Principle* 11 and *SUP* 15.3.1R, a *firm* must notify the *FSA* immediately of any operational risk matter of which the *FSA* would reasonably expect notice. *SUP* 15.3.8G provides *guidance* on the occurrences that this requirement covers, which include a significant failure in systems and controls and a significant operational loss.

13.4.2 G Regarding operational risk, matters of which the *FSA* would expect notice under *Principle* 11 include:

(1) any significant operational exposures that a *firm* has identified;

(2) the *firm's* invocation of a business continuity plan; and

(3) any other significant change to a *firm's* organisation, infrastructure or business operating environment.

13.5 Risk management terms

13.5.1 G In this chapter, the following interpretations of risk management terms apply:

(1) a *firm's* risk culture encompasses the general awareness, attitude and behaviour of its *employees* and *appointed representatives* to risk and the management of risk within the organisation;

(2) operational exposure means the degree of operational risk faced by a *firm* and is usually expressed in terms of the likelihood and impact of a particular type of operational loss occurring (for example, fraud, damage to physical assets);

(3) a *firm's* operational risk profile describes the types of operational risks that it faces, including those operational risks within a *firm* that may have an adverse impact upon the quality of service afforded to its *clients*, and its exposure to these risks.

13.6 People

13.6.1 G A *firm* should consult *SYSC* 3.2.2G to *SYSC* 3.2.5G for *guidance* on reporting lines and delegation of functions within a *firm* and *SYSC* 3.2.13G to *SYSC* 3.2.14G for *guidance* on the suitability of *employees* and *appointed representatives*. This section provides additional *guidance* on management of *employees* and other human resources in the context of operational risk.

13.6.2 G A *firm* should establish and maintain appropriate systems and controls for the management of operational risks that can arise from *employee*s. In doing so, a *firm* should have regard to:

(1) its operational risk culture, and any variations in this or its human resource management practices, across its operations (including, for example, the extent to which the compliance culture is extended to in-house IT staff);

(2) whether the way *employees* are remunerated exposes the *firm* to the risk that it will not be able to meet its regulatory obligations (see *SYSC* 3.2.18G). For example, a *firm* should consider how well remuneration and performance indicators reflect the *firm's* tolerance for operational risk, and the adequacy of these indicators for measuring performance;

(3) whether inadequate or inappropriate training of *client*-facing services exposes *clients* to risk of loss or unfair treatment including by not enabling effective communication with the *firm*;

(4) the extent of its compliance with applicable regulatory and other requirements that relate to the welfare and conduct of *employees*;

(5) its arrangements for the continuity of operations in the event of *employee* unavailability or loss;

(6) the relationship between indicators of 'people risk' (such as overtime, sickness, and *employee* turnover levels) and exposure to operational losses; and

(7) the relevance of all the above to *employees* of a third party supplier who are involved in performing an *outsourcing* arrangement. As necessary, a *firm* should review and consider the adequacy of the

staffing arrangements and policies of a service provider.

Employee responsibilities

13.6.3 G A *firm* should ensure that all *employees* are capable of performing, and aware of, their operational risk management responsibilities, including by establishing and maintaining:

(1) appropriate segregation of *employees*' duties and appropriate supervision of *employees* in the performance of their responsibilities (see *SYSC* 3.2.5G);

(2) appropriate recruitment and subsequent processes to review the fitness and propriety of *employees* (see *SYSC* 3.2.13G and *SYSC* 3.2.14G);

(3) clear policy statements and appropriate systems and procedures manuals that are effectively communicated to *employees* and available for *employees* to refer to as required. These should cover, for example, compliance, IT security and health and safety issues;

(4) training processes that enable *employees* to attain and maintain appropriate competence; and

(5) appropriate and properly enforced disciplinary and employment termination policies and procedures.

13.6.4 G A *firm* should have regard to *SYSC* 13.6.3G in relation to *approved persons*, people occupying positions of high personal trust (for example, security administration, payment and settlement functions); and people occupying positions requiring significant technical competence (for example, *derivatives* trading and technical security administration). A *firm* should also consider the *rules* and *guidance* for *approved persons* in other parts of the *Handbook* (including *APER* and *SUP*) and the *rules* and *guidance* on *senior manager* responsibilities in *SYSC* 2.1 (Apportionment of Responsibilities).

13.7 Processes and systems

13.7.1 G A *firm* should establish and maintain appropriate systems and controls for managing operational risks that can arise from inadequacies or failures in its processes and systems (and, as appropriate, the systems and processes of third party suppliers, agents and others). In doing so a *firm* should have regard to:

(1) the importance and complexity of processes and systems used in the end-to-end operating cycle for products and activities (for example, the level of integration of systems);

(2) controls that will help it to prevent system and process failures or identify them to permit prompt rectification (including pre-approval or reconciliation processes);

(3) whether the design and use of its processes and systems allow it to comply adequately with regulatory and other requirements;

(4) its arrangements for the continuity of operations in the event that a significant process or system becomes unavailable or is destroyed; and

(5) the importance of monitoring indicators of process or system risk (including reconciliation exceptions, compensation payments for *client* losses and documentation errors) and experience of operational losses and exposures.

Internal documentation

13.7.2 G Internal documentation may enhance understanding and aid continuity of operations, so a *firm* should ensure the adequacy of its internal documentation of processes and systems (including how documentation is developed, maintained and distributed) in managing operational risk.

External documentation

13.7.3 G A *firm* may use external documentation (including contracts, transaction statements or advertising brochures) to define or clarify terms and conditions for its products or activities, its business strategy (for example, including through press statements), or its brand. Inappropriate or inaccurate information in external documents can lead to significant operational exposure.

13.7.4 G A *firm* should ensure the adequacy of its processes and systems to review external documentation prior to issue (including review by its compliance, legal and marketing departments or by appropriately qualified external advisers). In doing so, a *firm* should have regard to:

(1) compliance with applicable regulatory and other requirements (such as *COB* 3 (Financial promotion));

(2) the extent to which its documentation uses standard terms (that are widely recognised, and have been tested in the courts) or non-standard terms (whose meaning may not yet be settled or whose effectiveness may be uncertain);

(3) the manner in which its documentation is issued; and

(4) the extent to which confirmation of acceptance is required (including by *customer* signature or counterparty confirmation).

IT systems

13.7.5 G IT systems include the computer systems and infrastructure required for the automation of processes, such as application and operating system software; network infrastructure; and desktop, server, and mainframe hardware.

Automation may reduce a *firm's* exposure to some 'people risks' (including by reducing human errors or controlling access rights to enable segregation of duties), but will increase its dependency on the reliability of its IT systems.

13.7.6 G A *firm* should establish and maintain appropriate systems and controls for the management of its IT system risks, having regard to:

(1) its organisation and reporting structure for technology operations (including the adequacy of senior management oversight);

(2) the extent to which technology requirements are addressed in its business strategy;

(3) the appropriateness of its systems acquisition, development and maintenance activities (including the allocation of responsibilities between IT development and operational areas, processes for embedding security requirements into systems); and

(4) the appropriateness of its activities supporting the operation of IT systems (including the allocation of responsibilities between business and technology areas).

Information security

13.7.7 G Failures in processing information (whether physical, electronic or known by *employees* but not recorded) or of the security of the systems that maintain it can lead to significant operational losses. A *firm* should establish and maintain appropriate systems and controls to manage its information security risks. In doing so, a *firm* should have regard to:

(1) confidentiality: information should be accessible only to *persons* or systems with appropriate authority, which may require firewalls within a system, as well as entry restrictions;

(2) integrity: safeguarding the accuracy and completeness of information and its processing;

(3) availability and authentication: ensuring that appropriately authorised *persons* or systems have access to the information when required and that their identity is verified;

(4) non-repudiation and accountability: ensuring that the *person* or system that processed the information cannot deny their actions.

13.7.8 G A *firm* should ensure the adequacy of the systems and controls used to protect the processing and security of its information, and should have regard to established security standards such as ISO17799 (Information Security Management).

Geographic location

13.7.9 G Operating processes and systems at separate geographic locations may alter a *firm's* operational risk profile (including by allowing alternative sites for the continuity of operations). A *firm* should understand the effect of any differences in processes and systems at each of its locations, particularly if they are in different countries, having regard to:

(1) the business operating environment of each country (for example, the likelihood and impact of political disruptions or cultural differences on the provision of services);

(2) relevant local regulatory and other requirements regarding data protection and transfer;

(3) the extent to which local regulatory and other requirements may restrict its ability to meet regulatory obligations in the *United Kingdom* (for example, access to information by the *FSA* and local restrictions on internal or external audit); and

(4) the timeliness of information flows to and from its headquarters and whether the level of delegated authority and the risk management structures of the overseas operation are compatible with the *firm's* head office arrangements.

13.8 External events and other changes

13.8.1 G The exposure of a *firm* to operational risk may increase during times of significant change to its organisation, infrastructure and business operating environment (for example, following a corporate restructure or changes in regulatory requirements). Before, during, and after expected changes, a *firm* should assess and monitor their effect on its risk profile, including with regard to:

(1) untrained or de-motivated *employees* or a significant loss of *employees* during the period of change, or subsequently;

(2) inadequate human resources or inexperienced *employees* carrying out routine business activities owing to the prioritisation of resources to the programme or project;

(3) process or system instability and poor management information due to failures in integration or increased demand; and

(4) inadequate or inappropriate processes following business re-engineering.

13.8.2 G A *firm* should establish and maintain appropriate systems and controls for the management of the risks involved in expected changes, such as by ensuring:

(1) the adequacy of its organisation and reporting structure for managing the change (including the adequacy of senior management oversight);

(2) the adequacy of the management processes and systems for managing the change (including planning, approval, implementation and review processes); and

(3) the adequacy of its strategy for communicating changes in systems and controls to its *employees*.

Unexpected changes and business continuity management

13.8.3 G *SYSC* 3.2.19G provides high level *guidance* on business continuity. This section provides additional *guidance* on managing business continuity in the context of operational risk.

13.8.4 G The high level requirement for appropriate systems and controls at *SYSC* 3.1.1R applies at all times, including when a business continuity plan is invoked. However, the *FSA* recognises that, in an emergency, a *firm* may be unable to comply with a particular *rule* and the conditions for relief are outlined in *GEN* 1.3 (Emergency).

13.8.5 G A *firm* should consider the likelihood and impact of a disruption to the continuity of its operations from unexpected events. This should include assessing the disruptions to which it is particularly susceptible (and the likely timescale of those disruptions) including through:

(1) loss or failure of internal and external resources (such as people, systems and other assets);

(2) the loss or corruption of its information; and

(3) external events (such as vandalism, war and "acts of God").

13.8.6 G A *firm* should implement appropriate arrangements to maintain the continuity of its operations. A *firm* should act to reduce both the likelihood of a disruption (including by succession planning, systems resilience and dual processing); and the impact of a disruption (including by contingency arrangements and insurance).

13.8.7 G A *firm* should document its strategy for maintaining continuity of its operations, and its plans for communicating and regularly testing the adequacy and effectiveness of this strategy. A *firm* should establish:

(1) formal business continuity plans that outline arrangements to reduce the impact of a short, medium or long-term disruption, including:

(a) resource requirements such as people, systems and other assets, and arrangements for obtaining these resources;

(b) the recovery priorities for the *firm's* operations; and

(c) communication arrangements for internal and external concerned parties (including the *FSA*, *clients* and the press);

(2) escalation and invocation plans that outline the processes for implementing the business continuity plans, together with relevant contact information;

(3) processes to validate the integrity of information affected by the disruption;

(4) processes to review and update (1) to (3) following changes to the *firm's* operations or risk profile (including changes identified through testing).

13.8.8 G The use of an alternative site for recovery of operations is common practice in business continuity management. A *firm* that uses an alternative site should assess the appropriateness of the site, particularly for location, speed of recovery and adequacy of resources. Where a site is shared, a *firm* should evaluate the risk of multiple calls on shared resources and adjust its plans accordingly.

13.9 Outsourcing

13.9.1 G As *SYSC* 3.2.4G explains, a *firm* cannot contract out its regulatory obligations and should take reasonable care to supervise the discharge of outsourced functions. This section provides additional *guidance* on managing *outsourcing* arrangements (and will be relevant, to some extent, to other forms of third party dependency) in relation to operational risk. *Outsourcing* may affect a *firm's* exposure to operational risk through significant changes to, and reduced control over, people, processes and systems used in outsourced activities.

13.9.2 G *Firms* should take particular care to manage *material outsourcing* arrangements and, as *SUP* 15.3.8G(1)(e) explains, a *firm* should notify the *FSA* when it intends to enter into a *material outsourcing* arrangement.

13.9.3 G A *firm* should not assume that because a service provider is either a regulated *firm* or an intra-group entity an *outsourcing* arrangement with that provider will, in itself, necessarily imply a reduction in operational risk.

13.9.4 G Before entering into, or significantly changing, an *outsourcing* arrangement, a *firm* should:

(1) analyse how the arrangement will fit with its organisation and reporting structure; business strategy; overall risk profile; and ability to meet its regulatory obligations;

(2) consider whether the agreements establishing the arrangement will allow it to monitor and control its operational risk exposure relating

to the *outsourcing*;

(3) conduct appropriate due diligence of the service provider's financial stability and expertise;

(4) consider how it will ensure a smooth transition of its operations from its current arrangements to a new or changed *outsourcing* arrangement (including what will happen on the termination of the contract); and

(5) consider any concentration risk implications such as the business continuity implications that may arise if a single service provider is used by several *firms*.

13.9.5 G In negotiating its contract with a service provider, a *firm* should have regard to:

(1) reporting or notification requirements it may wish to impose on the service provider;

(2) whether sufficient access will be available to its internal auditors, external auditors or *actuaries* (see section 341 of the *Act*) and to the *FSA* (see *SUP* 2.3.5R (Access to premises) and *SUP* 2.3.7R (Suppliers under material outsourcing arrangements);

(3) information ownership rights, confidentiality agreements and *Chinese walls* to protect *client* and other information (including arrangements at the termination of the contract);

(4) the adequacy of any guarantees and indemnities;

(5) the extent to which the service provider must comply with the *firm's* policies and procedures (covering, for example, information security);

(6) the extent to which a service provider will provide business continuity for outsourced operations, and whether exclusive access to its resources is agreed;

(7) the need for continued availability of software following difficulty at a third party supplier;

(8) the processes for making changes to the *outsourcing* arrangement (for example, changes in processing volumes, activities and other contractual terms) and the conditions under which the *firm* or service provider can choose to change or terminate the *outsourcing* arrangement, such as where there is:

(a) a change of ownership or *control* (including insolvency or receivership) of the service provider or *firm*; or

(b) significant change in the business operations (including sub-contracting) of the service provider or *firm*; or

(c) inadequate provision of services that may lead to the *firm* being unable to meet its regulatory obligations.

13.9.6 G In implementing a relationship management framework, and drafting the service level agreement with the service provider, a *firm* should have regard to:

(1) the identification of qualitative and quantitative performance targets to assess the adequacy of service provision, to both the *firm* and its *clients*, where appropriate;

(2) the evaluation of performance through service delivery reports and periodic self certification or independent review by internal or external auditors; and

(3) remedial action and escalation processes for dealing with inadequate performance.

13.9.7 G In some circumstances, a *firm* may find it beneficial to use externally validated reports commissioned by the service provider, to seek comfort as to the adequacy and effectiveness of its systems and controls. The use of such reports does not absolve the *firm* of responsibility to maintain other oversight. In addition, the *firm* should not normally have to forfeit its right to access, for itself or its agents, to the service provider's premises.

13.9.8 G A *firm* should ensure that it has appropriate contingency arrangements to allow business continuity in the event of a significant loss of services from the service provider. Particular issues to consider include a significant loss of resources at, or financial failure of, the service provider, and unexpected termination of the *outsourcing* arrangement.

13.10 Insurance

13.10.1 G Whilst a *firm* may take out insurance with the aim of reducing the monetary impact of operational risk events, non-monetary impacts may remain (including impact on the *firm's* reputation). A *firm* should not assume that insurance alone can replace robust systems and controls.

13.10.2 G When considering utilising insurance, a *firm* should consider:

(1) the time taken for the *insurer* to pay claims (including the potential time taken in disputing cover) and the *firm's* funding of operations whilst awaiting payment of claims;

(2) the financial strength of the *insurer*, which may determine its ability to pay claims, particularly where large or numerous small claims are made at the same time; and

(3) the effect of any limiting conditions and exclusion clauses that may restrict cover to a small number of specific operational losses and may exclude larger or hard to quantify indirect losses (such as lost business or reputational costs).

14.1 Prudential risk management and associated systems and controls

Application

14.1.1 R *SYSC* 14.1 applies to an *insurer* unless it is:

(1) a *non-directive friendly society*; or

(2) an *incoming EEA firm*; or

(3) an *incoming Treaty firm*.

14.1.2 R *SYSC* 14.1 applies to:

(1) an *EEA-deposit insurer*; and

(2) a *Swiss general insurer*;

only in respect of the activities of the *firm* carried on from a *branch* in the *United Kingdom*.

Purpose

14.1.3 G *SYSC* 14.1 sets out some *rules* and *guidance* on the establishment and maintenance of systems and controls for the management of a *firm's* prudential risks. A *firm's* prudential risks are those that can reduce the adequacy of its financial resources, and as a result may adversely affect confidence in the financial system or prejudice *consumers*. Some key prudential risks are credit, market, liquidity, operational, insurance and group risk.

14.1.4 G The purpose of *SYSC* 14.1 is to serve the *FSA's regulatory objectives* of consumer protection and market confidence. In particular, this section aims to reduce the risk that a *firm* may pose a threat to these *regulatory objectives*, either because it is not prudently managed, or because it has inadequate systems to permit appropriate senior management oversight and control of its business.

14.1.5 G Both adequate financial resources and adequate systems and controls are necessary for the effective management of prudential risks. A *firm* may hold financial resources to help alleviate the financial consequences of minor weaknesses in its systems and controls (to reflect possible impairments in the accuracy or timing of its identification, measurement, monitoring and control of certain risks, for example). However, financial resources cannot adequately compensate for significant weaknesses in a *firm's* systems and controls that could fundamentally undermine its ability to control its affairs effectively.

How to interpret SYSC 14.1

14.1.6 G *SYSC* 14.1 is designed to amplify *Principle* 3 (Management and control) which requires that a *firm* take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems. *SYSC* 14.1 is also designed to be complementary to *SYSC* 2, *SYSC* 3 and *SYSC* 13 in that it contains some additional *rules* and *guidance* on senior management arrangements and associated systems and controls for *firms* that could have a significant impact on the *FSA's* objectives in a *prudential context*.

14.1.7 G In addition to supporting *PRIN* and *SYSC* 2, *SYSC* 3 and *SYSC* 13, *SYSC* 14.1 lays the foundations for the more specific *rules* and *guidance* on the management of credit, market, liquidity, operational, insurance and group risks that are in *SYSC* 11 [*PRU* 5.1][10], *SYSC* 12, *SYSC* 15, *SYSC* 16 and *INSPRU* 5.1. Many of the elements raised here in general terms are expanded upon in these sections.

14.1.8 G Appropriate systems and controls for the management of prudential risk will vary from *firm* to *firm*. Therefore, most of the material in *SYSC* 14.1 is *guidance*. In interpreting this *guidance*, a *firm* should have regard to its own particular circumstances. Following from *SYSC* 3.1.2 G, this should include considering the nature, scale and complexity of its business, which may be influenced by factors such as:

(1) the diversity of its operations, including geographical diversity;

(2) the volume and size of its transactions; and

(3) the degree of risk associated with each area of its operation.

14.1.9 G The *guidance* contained within this section is not designed to be exhaustive. When establishing and maintaining its systems and controls a *firm* should have regard not only to other parts of the *Handbook*, but also to material that is issued by other industry or regulatory bodies.

The role of systems and controls in a prudential context

14.1.10 G In a *prudential context*, a *firm's* systems and controls should provide its senior management with an adequate means of managing the *firm*. As such, they should be designed and maintained to ensure that senior management is able to make and implement integrated business planning and risk management decisions on the basis of accurate information about the risks that the *firm* faces and the financial resources that it has.

The prudential responsibilities of senior management and the apportionment of those responsibilities

14.1.11 G Ultimate responsibility for the management of prudential risks rests with a *firm's governing body* and relevant *senior managers*, and in particular with

[10] SYSC 11 (Liquidity risk) will be consulted on later this year.

those individuals that undertake the *firm's governing functions* and the *apportionment and oversight function*. In particular, these responsibilities should include:

(1) overseeing the establishment of an appropriate business plan and risk management strategy;

(2) overseeing the development of appropriate systems for the management of prudential risks;

(3) establishing adequate *internal controls*; and

(4) ensuring that the *firm* maintains adequate financial resources.

The delegation of responsibilities within the firm

14.1.12 G Although authority for the management of a *firm's* prudential risks is likely to be delegated, to some degree, to individuals at all levels of the organisation, overall responsibility for this activity should not be delegated from its *governing body* and relevant *senior managers*.

14.1.13 G Where delegation does occur, a *firm* should ensure that appropriate systems and controls are in place to allow its *governing body* and relevant *senior managers* to participate in and control its prudential risk management activities. The *governing body* and relevant *senior managers* should approve and periodically review these systems and controls to ensure that delegated duties are being performed correctly.

Firms subject to risk management on a group basis

14.1.14 G Some *firms* organise the management of their prudential risks on a stand-alone basis. In some cases, however, the management of a *firm's* prudential risks may be entirely or largely subsumed within a whole *group* or *sub-group* basis.

(1) The latter arrangement may still comply with the *FSA's* prudential policy on systems and controls if the *firm's governing body* formally delegates the functions that are to be carried out in this way to the *persons* or bodies that are to carry them out. Before doing so, however, the *firm's governing body* should have explicitly considered the arrangement and decided that it is appropriate and that it enables the *firm* to meet the *FSA's* prudential policy on systems and controls. The *firm* should notify the *FSA* if the management of its prudential risks is to be carried out in this way.

(2) Where the management of a *firm's* prudential risks is largely, but not entirely, subsumed within a whole *group* or *sub-group* basis, the *firm* should ensure that any prudential issues that are specific to the *firm* are:

(a) identified and adequately covered by those to whom it has delegated certain prudential risk management tasks; or

(b) dealt with by the *firm* itself.

14.1.15 G Any delegation of the management of prudential risks to another part of a *firm's group* does not relieve it of responsibility for complying with the *FSA's* prudential policy on systems and controls. A *firm* cannot absolve itself of such a responsibility by claiming that any breach of the *FSA's* prudential policy on systems and controls is effected by the actions of a third party *firm* to whom the *firm* has delegated tasks. The risk management arrangements are still those of the *firm*, even though personnel elsewhere in the *firm's group* are carrying out these functions on its behalf. Thus any references in *GENPRU*, *INSPRU* or *SYSC* to what a *firm*, its personnel and its management should and should not do still apply, and do not need any adjustment to cover the situation in which risk management functions are carried out on a *group*-wide basis.

14.1.16 G Where it is stated in *GENPRU*, *INSPRU* or *SYSC* that a particular task in relation to a *firm*'s systems and controls should be carried out by a *firm's governing body* this task should not be delegated to another part of its *group*. Furthermore, even where the management of a *firm*'s prudential risks is delegated as described in *SYSC* 14.1.14G, responsibility for its effectiveness and for ensuring that it remains appropriate remains with the *firm's governing body*. The *firm's governing body* should therefore keep any delegation under review to ensure that delegated duties are being performed correctly.

Business planning and risk management

14.1.17 G Business planning and risk management are closely related activities. In particular, the forward-looking assessment of a *firm's* financial resources needs, and of how business plans may affect the risks that it faces, are important elements of prudential risk management. A *firm's* business planning should also involve the creation of specific risk policies which will normally outline a *firm's* strategy and objectives for, as appropriate, the management of its market, credit, liquidity, operational, insurance and group risks and the processes that it intends to adopt to achieve these objectives. *SYSC* 14.1.18R to *SYSC* 14.1.25G set out some *rules* and *guidance* relating to business planning and risk management in a *prudential context* (see also *SYSC* 3.2.17G, which states that a *firm* should plan its business appropriately).

14.1.18 R A *firm* must take reasonable steps to ensure the establishment and maintenance of a business plan and appropriate systems for the management of prudential risk.

14.1.19 R When establishing and maintaining its business plan and prudential risk management systems, a *firm* must document:

(1) an explanation of its overall business strategy, including its business objectives;

(2) a description of, as applicable, its policies towards market, credit (including provisioning), liquidity, operational, insurance and group risk (that is, its risk policies), including its appetite or tolerance for these risks and how it identifies, measures or assesses, monitors and controls these risks;

(3) the systems and controls that it intends to use in order to ensure that its business plan and risk policies are implemented correctly;

(4) a description of how the *firm* accounts for assets and liabilities, including the circumstances under which items are netted, included or excluded from the *firm's* balance sheet and the methods and assumptions for valuation;

(5) appropriate financial *projections* and the results of its stress testing and scenario analysis (see *GENPRU* 1.2 (Adequacy of financial resources); and

(6) details of, and the justification for, the methods and assumptions used in financial *projections* and stress testing and scenario analysis.

14.1.20 G The prudential risk management systems referred to in *SYSC* 14.1.18R and *SYSC* 14.1.19R are the means by which a *firm* is able to:

(1) identify the prudential risks that are inherent in its business plan, operating environment and objectives, and determine its appetite or tolerance for these risks;

(2) measure or assess its prudential risks;

(3) monitor its prudential risks; and

(4) control or mitigate its prudential risks.

SYSC 11.[ ] [*PRU* 5.1.78E][11] is an *evidential provision* relating to *SYSC* 14.1.18R concerning risk management systems in respect of *liquidity risk* arising from substantial exposures in foreign currencies.

14.1.21 G A *firm* should consider the relationship between its business plan, risk policies and the financial resources that it has available (or can readily access), recognising that decisions made in respect of one element may have consequences for the other two.

14.1.22 G A *firm's* business plan and risk management systems should be:

(1) effectively communicated so that all *employees* and contractors understand and adhere to the procedures related to their own

[11] SYSC 11 (Liquidity risk) will be consulted on later this year.

responsibilities;

(2) regularly updated and revised, in particular when there is significant new information or when actual practice or performance differs materially from the documented strategy, policy or systems.

14.1.23 G The level of detail in a *firm's* business plan and its approach to the design of its risk management systems should be appropriate to the scale and complexity of its operations, and the nature and degree of risk that it faces.

14.1.24 G A *firm's* business plan and systems documentation should be accessible to the *firm's* management in line with their respective responsibilities and, upon request, to the *FSA*.

14.1.25 G *SYSC* 14.1.19R(5) requires a *firm* to *document* its financial projections and the results of its stress testing and scenario analysis. Such financial projections, stress tests and scenario analysis should be used by a *firm's governing body* and relevant *senior managers* when deciding upon how much risk the *firm* is willing to accept in pursuit of its business objectives and how risk limits should be set. Further *rules* and *guidance* on stress testing and scenario analysis are outlined in *GENPRU* 1.2 (Adequacy of financial resources) and *SYSC* 11[*PRU* 5.1][12] (Liquidity risk systems and controls).

Internal controls: introduction

14.1.26 G *Internal controls* should provide a *firm* with reasonable assurance that it will not be hindered in achieving its objectives, or in the orderly and legitimate conduct of its business, by events that may reasonably be foreseen. More specifically in a *prudential context, internal controls* should be concerned with ensuring that a *firm's* business plan and risk management systems are operating as expected and are being implemented as intended. The following *rule* (*SYSC* 14.1.27R) reflects the importance of *internal controls* in a *prudential context*.

14.1.27 R A *firm* must take reasonable steps to establish and maintain adequate *internal controls*.

14.1.28 G The precise role and organisation of *internal controls* can vary from *firm* to *firm*. However, a *firm's internal controls* should normally be concerned with assisting its *governing body* and relevant *senior managers* to participate in ensuring that it meets the following objectives:

(1) safeguarding both the assets of the *firm* and its *customers*, as well as identifying and managing liabilities;

(2) maintaining the efficiency and effectiveness of its operations;

[12] SYSC 11 (Liquidity risk) will be consulted on later this year.

(3) ensuring the reliability and completeness of all accounting, financial and management information; and

(4) ensuring compliance with its internal policies and procedures as well as all applicable laws and regulations.

14.1.29 G When determining the adequacy of its *internal controls*, a *firm* should consider both the potential risks that might hinder the achievement of the objectives listed in *SYSC* 14.1.28G, and the extent to which it needs to control these risks. More specifically, this should normally include consideration of:

(1) the appropriateness of its reporting and communication lines (see *SYSC* 3.2.2G);

(2) how the delegation or contracting of functions or activities to *employees*, *appointed representatives* or other third parties (for example *outsourcing*) is to be monitored and controlled (see *SYSC* 3.2.3G to *SYSC* 3.2.4G, *SYSC* 14.1.12G to *SYSC* 14.1.16G and *SYSC* 14.1.33G; additional guidance on the management of outsourcing arrangements is also provided in *SYSC* 13.9);

(3) the risk that a *firm's employees* or contractors might accidentally or deliberately breach a *firm's* policies and procedures (see *SYSC* 13.6.3G);

(4) the need for adequate segregation of duties (see *SYSC* 3.2.5G and *SYSC* 14.1.30G to *SYSC* 14.1.33G;

(5) the establishment and control of risk management committees (see *SYSC* 14.1.34G to *SYSC* 14.1.37G);

(6) the need for risk assessment and the establishment of a risk assessment function (see *SYSC* 3.2.10G and *SYSC* 14.1.38G to *SYSC* 14.1.41G;

(7) the need for internal audit and the establishment of an internal audit function and audit committee (see *SYSC* 3.2.15G to *SYSC* 3.2.16G and *SYSC* 14.1.42G to *SYSC* 14.1.45G).

Internal controls: segregation of duties

14.1.30 G The effective segregation of duties is an important internal control in the *prudential context*. In particular, it helps to ensure that no one individual is completely free to commit a *firm's* assets or incur liabilities on its behalf. Segregation can also help to ensure that a *firm's governing body* receives objective and accurate information on financial performance, the risks faced by the *firm* and the adequacy of its systems. In this regard, a *firm* should ensure that there is adequate segregation of duties between *employees* involved in:

(1) taking on or controlling risk (which could involve risk mitigation);

(2) risk assessment (which includes the identification and analysis of risk); and

(3) internal audit.

14.1.31 G In addition, a *firm* should normally ensure that no single individual has unrestricted authority to do all of the following:

(1) initiate a transaction;

(2) bind the *firm*;

(3) make payments; and

(4) account for it.

14.1.32 G Where a *firm* is unable to ensure the complete segregation of duties (for example, because it has a limited number of staff), it should ensure that there are adequate compensating controls in place (for example, frequent review of an area by relevant *senior managers*).

14.1.33 G Where a *firm* outsources a *controlled function*, such as *internal audit*, it should take reasonable steps to ensure that every individual involved in the performance of this service is independent from the individuals who perform its external audit. This should not prevent services from being undertaken by a *firm's* external auditors provided that:

(1) the work is carried out under the supervision and management of the *firm's* own internal staff; and

(2) potential conflicts of interest between the provision of external audit services and the provision of *controlled functions* are properly managed.

Internal controls: risk management committees

14.1.34 G In many *firms*, especially if there are multiple business lines, it is common for the *governing body* to delegate some tasks related to risk control and management to committees such as asset and liability committees (ALCO), credit risk committees and market risk committees.

14.1.35 G Where a *firm* decides to create one or more risk management committee(s), adequate *internal controls* should be put in place to ensure that these committees are effective and that their actions are consistent with the objectives outlined in *SYSC* 14.1.28G. This should normally include consideration of the following:

(1) setting clear terms of reference, including membership, reporting lines and responsibilities of each committee;

(2) setting limits on their authority;

(3) agreeing routine reporting and non-routine reporting escalation procedures;

(4) agreeing the minimum frequency of committee meetings; and

(5) reviewing the performance of these risk management committees.

14.1.36 G The decision to delegate risk management tasks, along with the terms of reference of the committees and their performance, should be reviewed periodically by the *firm's governing body* and revised as appropriate.

14.1.37 G The effective use of risk management committees can help to enhance a *firm's internal controls*. In establishing and maintaining its risk management committees, a *firm* should consider:

(1) their membership, which should normally include relevant *senior managers* (such as the head of group risk, head of legal, and the heads of market, credit, liquidity and operational risk, etc.), business line managers, risk management personnel and other appropriately skilled people, for example, actuaries, lawyers, accountants, IT specialists, etc.;

(2) using these committees to:

(i) inform the decisions made by a *firm's governing body* regarding its appetite or tolerance for risk taking;

(ii) highlight risk management issues that may require attention by the *governing body*;

(iii) consider risk at the firm-wide level and, within delegated limits, to determine the allocation of risk limits and financial resources across business lines;

(iv) consider how exposures may be unwound, hedged, or otherwise mitigated, as appropriate.

Internal controls: risk assessment

14.1.38 G Risk assessment is the process through which a *firm* identifies and analyses (using both qualitative and quantitative methodologies) the risks that it faces. A *firm's* risk assessment activities should normally include consideration of:

(1) its total exposure to risk at the firm-wide level (that is, its exposure across business lines and risk categories);

(2) capital allocation and the need to calculate risk weighted returns for different business lines;

(3) the potential correlations that can exist between the risks in different business lines; this should also include looking for risks to which a *firm's* business plan is particularly sensitive, such as interest rate risk, or multiple dealings with the same *counterparty*;

(4) the use of stress tests and scenario analysis;

(5) whether there are risks inherent in the *firm's* business that are not being addressed adequately;

(6) the risk adjusted return that the *firm* is achieving; and

(7) the adequacy and timeliness of management information on market, credit, insurance, liquidity, operational and group risks from the business lines, including risk limit utilisation.

14.1.39 G In accordance with *SYSC* 3.2.10G a *firm* should consider whether it needs to set up a separate *risk assessment function* (or functions) that is responsible for assessing the risks that the *firm* faces and advising its *governing body* and *senior managers* on them.

14.1.40 G Where a *firm* does decide that it needs a separate *risk assessment function*, the *employees* or contractors that carry out this function should not normally be involved in risk taking activities such as business line management (see *SYSC* 14.1.30G to *SYSC* 14.1.33G on the segregation of duties).

14.1.41 G A summary of the results of the analysis undertaken by a *firm's risk assessment function* (including, where necessary, an explanation of any assumptions that were adopted) should normally be reported to relevant *senior managers* as well as to the *firm's governing body*.

Internal audit

14.1.42 G A *firm* should ensure that it has appropriate mechanisms in place to assess and monitor the appropriateness and effectiveness of its systems and controls. This should normally include consideration of:

(1) adherence to and effectiveness of, as appropriate, its market, credit, liquidity, operational, insurance, and group risk policies;

(2) whether departures and variances from its documented systems and controls and risk policies have been adequately documented and appropriately reported, including whether appropriate pre-clearance authorisation has been sought for material departures and variances;

(3) adherence to and effectiveness of its accounting policies, and whether accounting records are complete and accurate;

(4) adherence to and effectiveness of its management reporting arrangements, including the timeliness of reporting, and whether information is comprehensive and accurate; and

(5) adherence to *FSA rules* and regulatory prudential standards.

14.1.43 G In accordance with *SYSC* 3.2.15G and *SYSC* 3.2.16G, a *firm* should consider whether it needs to set up a dedicated *internal audit function*.

14.1.44 G Where a *firm* decides to set up an *internal audit function*, this function should provide independent assurance to its *governing body*, audit committee or an appropriate *senior manager* of the integrity and effectiveness of its systems and controls.

14.1.45 G In forming its judgements, the *person* performing the *internal audit function* should test the practical operation of a *firm's* systems and controls as well as its accounting and risk policies. This should include examining the adequacy of supporting records.

Management information

14.1.46 G Many individuals, at various levels of a *firm*, need management information relating to their activities. However, *SYSC* 14.1.47G to *SYSC* 14.1.50G concentrates on the management information that should be available to those at the highest level of a *firm*, that is, the *firm's governing body* and relevant *senior managers*. In so doing *SYSC* 14.1.47G to *SYSC* 14.1.50G amplify *SYSC* 3.2.11G and *SYSC* 3.2.12G (which outline the *FSA's* high level policy on senior management information) by providing some additional *guidance* on the management information that should be available in a *prudential context*.

14.1.47 G The role of management information should be to help a *firm's governing body* and *senior managers* to understand risk at a firm-wide level. In so doing, it should help them to:

(1) determine whether a *firm* is prudently managed with adequate financial resources;

(2) make the decisions that fall within their ambit (for example, the high level business plans, strategy and risk tolerances of the *firm*); and

(3) oversee the execution of tasks for which they are responsible.

14.1.48 G A *firm* should consider what information needs to be made available to its *governing body* and *senior managers*. Some possible examples include:

(1) firm-wide information such as the overall profitability and value of a *firm* and its total exposure to risk;

(2) reports from committees to which the *governing body* has delegated risk management tasks, if applicable;

(3) reports from a *firm's internal audit* and *risk assessment functions*, if applicable, including exception reports, where risk limits and policies have been breached or systems circumvented;

(4) financial projections under expected and abnormal (that is, stressed) conditions;

(5) reconciliation of actual profit and loss to previous financial projections and an analysis of any significant variances;

(6) matters which require a decision from the *governing body* or *senior managers*, for example a significant variation to a business plan, amendments to risk limits, the creation of a new business line, etc;

(7) compliance with *FSA rules* and regulatory prudential standards;

(8) risk weighted returns; and

(9) liquidity and funding requirements.

14.1.49 G The management information that is provided to a *firm's governing body* and *senior managers* should have the following characteristics:

(1) it should be timely, its frequency being determined by factors such as:

(a) the volatility of the business in which the *firm* is engaged (that is, the speed at which its risks can change);

(b) any time constraints on when action needs to be taken; and

(c) the level of risk that the *firm* is exposed to, compared to its available financial resources and tolerance for risk;

(2) it should be reliable, having regard to the fact that it may be necessary to sacrifice a degree of accuracy for timeliness; and

(3) it should be presented in a manner that highlights any relevant issues on which those undertaking *governing functions* should focus particular attention.

14.1.50 G The production of management and other information may require the collation of data from a variety of separate manual and automated systems. In such cases, responsibility for the integrity of the information may be spread amongst a number of operational areas. A *firm* should ensure that it has appropriate processes to validate the integrity of its information.

Record keeping

14.1.51 G *SYSC* 3.2.20R requires a *firm* to take reasonable care to make and retain adequate records. The following policy on record keeping supplements *SYSC* 3.2.20R by providing some additional *rules* and *guidance* on record keeping in a *prudential context*. The purpose of this policy is to:

(1) facilitate the prudential supervision of a *firm* by ensuring that adequate information is available regarding its past/current financial

situation and business activities (which includes the design and implementation of systems and controls); and

(2) help the *FSA* to satisfy itself that a *firm* is operating in a prudent manner and is not prejudicing the interests of its *customers* or market confidence.

14.1.52 G In addition to the record keeping requirements in *GENPRU*, *INSPRU* and *SYSC*, a *firm* should remember that it may be obliged, under other applicable laws or regulations, to keep similar or additional records.

14.1.53 R (1) A *firm* must make and regularly update accounting and other records that are sufficient to enable the *firm* to demonstrate to the *FSA*:

(a) that the *firm* is financially sound and has appropriate systems and controls;

(b) the *firm's* financial position and exposure to risk (to a reasonable degree of accuracy); and

(c) the *firm's* compliance with the *rules* in *GENPRU*, *INSPRU* and *SYSC*.

(2) The records in (1) must be retained for a minimum of three years, or longer as appropriate.

14.1.54 G A *firm* should be able to make available the records described in *SYSC* 14.1.53 R within a reasonable timeframe when requested to do so by the *FSA*.

14.1.55 G The *FSA* recognises that not all records are specific to a particular point in time. As such, while it may be appropriate to update some records on a daily or continuous basis, for example expenditure and details of certain transactions, it may not be appropriate to update other records as regularly as this, for example those relating to its business plan and risk policies. A *firm* should decide how regularly it should update particular records.

14.1.56 G A *firm* should decide which records it needs to hold, noting that compliance with *SYSC* 14.1.53R does not require it to hold records on every single aspect of its activities. Some specific *guidance* on the types of records that a *firm* should hold is set out in each of the risk specific sections on systems and controls (see *SYSC* 11 [*PRU* 5.1][13], *SYSC* 12, *SYSC* 14.1.65, *SYSC* 15 to *SYSC* 17 and *INSPRU* 5.1).

14.1.57 G In deciding which records to hold, a *firm* should also take into account that failure to keep adequate records could make it harder for it to satisfy the *FSA* that it is compliant with the *rules* in *GENPRU*, *INSPRU* or *SYSC*, and to defend any enforcement action taken against it.

[13] SYSC 11 (Liquidity risk) will be consulted on later this year.

14.1.58 G A *firm* should keep the records required in *GENPRU*, *INSPRU* and *SYSC* in an appropriate format and language (in terms of format this could include holding them on paper or in electronic or some other form). However, whatever format or language a *firm* chooses, *SYSC* 3.2.20R requires that records be capable of being reproduced on paper and in English (except where they relate to business carried on from an establishment situated in a country where English is not an official language).

14.1.59 G In accordance with *SYSC* 3.2.20R, a *firm* should retain the records that it needs to comply with *SYSC* 14.1.53R for as long as they are relevant for the purposes for which they were made.

14.1.60 R A *firm* must keep the *records* required in *SYSC* 14.1.53R in the *United Kingdom*, except where:

(1) they relate to business carried on from an establishment in a country or territory that is outside the *United Kingdom*; and

(2) they are kept in that country or territory.

14.1.61 R When a *firm* keeps the records required in *SYSC* 14.1.53R outside the *United Kingdom*, it must periodically send an adequate summary of those records to the *United Kingdom*.

14.1.62 G Where a *firm* outsources the storage of some or all of its records to a third party service provider, it should ensure that these records are readily accessible and can be reproduced within a reasonable time period. The *firm* should also ensure that these records are stored in compliance with the *rules* and *guidance* on record keeping in *GENPRU*, *INSPRU* or *SYSC*. Additional *guidance* on the management of *outsourcing* agreements is provided in *SYSC* 13.

14.1.63 G A *firm* may rely on records that have been produced by a third party (for example, another *group* company or an external agent, such as an outsource service provider). However where the *firm* does so it should ensure that these records are readily accessible and can be reproduced within a reasonable time period. The *firm* should also ensure that these records comply with the *rules* and *guidance* on record keeping in *GENPRU*, *INSPRU* or *SYSC*.

14.1.64 G In accordance with *SYSC* 3.2.21G, a *firm* should have adequate systems and controls for maintaining the security of its records so that they are reasonably safeguarded against loss, unauthorised access, alteration or destruction.

Operational Risk

14.1.65 G As well as covering other types of risk, the *rules* and *guidance* set out in this chapter deal with a *firm's* approach to operational risk. In particular:

(1) *SYSC* 14.1.18R requires a *firm* to take reasonable steps to ensure that the risk management systems put in place to identify, assess, monitor and control operational risk are adequate for that purpose;

(2) *SYSC* 14.1.19R(2) requires a *firm* to document its policy for operational risk, including its risk appetite and how it identifies, assesses, monitors and controls that risk; and

(3) *SYSC* 14.1.27R requires a *firm* to take reasonable steps to establish and maintain adequate *internal controls* to enable it to assess and monitor the effectiveness and implementation of its business plan and prudential risk management systems.

15.1 Credit risk management systems and controls

Application

15.1.1 G *SYSC* 15.1 applies to an *insurer* unless it is:

(1) a *non-directive friendly society*; or

(2) an *incoming EEA firm*; or

(3) an *incoming Treaty firm*.

15.1.2 G *SYSC* 15.1 applies to:

(1) an *EEA-deposit insurer*; and

(2) a *Swiss general insurer*;

only in respect of the activities of the *firm* carried on from a *branch* in the *United Kingdom*.

Purpose

15.1.3 G This section provides *guidance* on how to interpret *SYSC* 14 insofar as it relates to the management of credit risk.

15.1.4 G Credit risk is incurred whenever a *firm* is exposed to loss if another party fails to perform its financial obligations to the *firm*, including failing to perform them in a timely manner. It arises from both on and off balance sheet items. For contracts for traded *financial instruments*, for example the purchase and sale of *securities* or *over the counter derivatives*, risks may arise if the *firm's counterparty* does not honour its side of the contract. This constitutes counterparty risk, which can be considered a subset of credit risk. Another risk is issuer risk, which could potentially result in a *firm* losing the full price of a market instrument since default by the issuer could result in the value of its bonds or stocks falling to nil. In insurance *firms*, credit risk can arise from *premium* debtors, where cover under *contracts of insurance* may either commence before premiums become due or continue after their non-payment. Credit risk can also arise if a *reinsurer* fails to fulfil its financial obligation to repay a *firm* upon submission of a *claim*.

15.1.5 G Credit risk concerns the *FSA* in a *prudential context* because inadequate systems and controls for credit risk management can create a threat to the *regulatory objectives* of market confidence and consumer protection by:

(1) the erosion of a *firm's* capital due to excessive credit losses thereby threatening its viability as a going concern;

(2) an inability of a *firm* to meet its own obligations to depositors, *policyholders* or other market *counterparties* due to its capital

erosion.

15.1.6 G Appropriate systems and controls for the management of credit risk will vary with the scale, nature and complexity of the *firm's* activities. Therefore the material in this section is *guidance*. A *firm* should assess the appropriateness of any particular item of *guidance* in the light of the scale, nature and complexity of its activities as well as its obligations as set out in *Principle* 3 to organise and control its affairs responsibly and effectively.

Requirements

15.1.7 G High level requirements for prudential systems and controls, including those for credit risk, are set out in *SYSC* 14. In particular:

(1) *SYSC* 14.1.19R(2) requires a *firm* to document its policy for credit risk, including its risk appetite and how it identifies, measures, monitors and controls that risk;

(2) *SYSC* 14.1.19R(2) requires a *firm* to document its provisioning policy. Documentation should describe the systems and controls that it intends to use to ensure that the policy is correctly implemented;

(3) *SYSC* 14.1.18R requires it to establish and maintain risk management systems to identify, measure, monitor and control credit risk (in accordance with its credit risk policy), and to take reasonable steps to ensure that its systems are adequate for that purpose;

(4) in line with *SYSC* 14.1.11G, the ultimate responsibility for the management of credit risk should rest with a *firm's governing body*. Where delegation of authority occurs the *governing body* and relevant *senior managers* should approve and periodically review systems and controls to ensure that delegated duties are being performed correctly.

Credit risk policy

15.1.8 G *SYSC* 14.1.18R requires a *firm* to establish, maintain and document a business plan and risk policies. They should provide a clear indication of the amount and nature of credit risk that the *firm* wishes to incur. In particular, they should cover for credit risk:

(1) how, with particular reference to its activities, the *firm* defines and measures credit risk;

(2) the *firm's* business aims in incurring credit risk including:

(a) identifying the types and sources of credit risk to which the *firm* wishes to be exposed (and the limits on that exposure) and those to which the *firm* wishes not to be exposed (and how that is to be achieved, for example how exposure is to be avoided or mitigated);

(b) specifying the level of diversification required by the *firm* and the *firm's* tolerance for risk concentrations (and the limits on those exposures and concentrations); and

(c) drawing the distinction between activities where credit risk is taken in order to achieve a return (for example, lending) and activities where credit exposure arises as a consequence of pursuing some other objective (for example, the purchase of a *derivative* in order to mitigate *market risk*);

(3) how credit risk is assessed both when credit is granted or incurred and subsequently, including how the adequacy of any security and other risk mitigation techniques is assessed;

(4) the detailed limit structure for credit risk which should:

(a) address all key risk factors, including intra-*group* exposures and indirect exposures (for example, exposures held by *related* and *subsidiary undertakings*);

(b) be commensurate with the volume and complexity of activity;

(c) be consistent with the *firm's* business aims, historical performance, and its risk appetite;

(5) procedures for:

(a) approving new or additional exposures to *counterparties*;

(b) approving new products and activities that give rise to credit risk;

(c) regular risk position and performance reporting;

(d) limit exception reporting and approval; and

(e) identifying and dealing with the problem exposures caused by the failure or downgrading of a *counterparty*;

(6) the methods and assumptions used for the stress testing and scenario analysis required by *GENPRU* 1.2 (Adequacy of financial resources)], including how these methods and assumptions are selected and tested;

(7) the allocation of responsibilities for implementing the credit risk policy and for monitoring adherence to, and the effectiveness of, the policy.

Counterparty assessment

15.1.9 G The *firm* should make a suitable assessment of the risk profile of the *counterparty*. The factors to be considered will vary according to both the type of credit and the *counterparty* being considered. This may include:

(1) the purpose of the credit, the duration of the agreement and the source of repayment;

(2) an assessment and continuous monitoring of the credit quality of the *counterparty*;

(3) an assessment of the *claims* payment record where the *counterparty* is a *reinsurer*;

(4) an assessment of the nature and amount of risk attached to the *counterparty* in the context of the industrial sector or geographical region or country in which it operates, as well as the potential impact on the *counterparty* of political, economic and market changes; and

(5) the proposed terms and conditions attached to the granting of credit, including ongoing provision of information by the *counterparty*, covenants attached to the facility as well as the adequacy and enforceability of *collateral*, security and guarantees.

15.1.10 G It is important that sound and legally enforceable documentation is in place for each agreement that gives rise to credit risk as this may be called upon in the event of a default or dispute. A *firm* should therefore consider whether it is appropriate for an independent legal opinion to be sought on documentation used by the *firm*. Documentation should normally be in place before the *firm* enters into a contractual obligation or releases funds.

15.1.11 G Where *premium* payments are made via *brokers* or *intermediaries*, the *firm* should describe how it monitors and controls its exposure to those *brokers* and *intermediaries*. In particular, the policy should identify whether the risk of default by the *broker* or *intermediary* is borne by the *firm* or the *policyholder*.

15.1.12 G Any variation from the usual credit policy should be documented.

15.1.13 G A *firm* involved in loan syndications or consortia should not rely on other parties' assessment of the credit risks involved. It will remain responsible for forming its own judgement on the appropriateness of the credit risk thereby incurred with reference to its stated credit risk policy. Similarly a *firm* remains responsible for assessing the credit risk associated with any insurance or *reinsurance* placed on its behalf by other parties.

15.1.14 G Where a credit scoring approach or other *counterparty* assessment process is used, the *firm* should periodically assess the particular approach taken in the light of past and expected future *counterparty* performance and ensure that any statistical process is adjusted accordingly to ensure that the business

written complies with the *firm's* risk appetite.

15.1.15 G In assessing its contingent exposure to a *counterparty*, the *firm* should identify the amount which would be due from the *counterparty* if the value, index or other factor upon which that amount depends were to change.

Credit risk measurement

15.1.16 G A *firm* should measure its credit risk using a robust and consistent methodology which should be described in its credit risk policy; the appropriate method of measurement will depend upon the nature of the credit product provided. The *firm* should consider whether the measurement methodologies should be backtested and the frequency of such backtesting.

15.1.17 G A *firm* should also be able to measure its credit exposure across its entire portfolio or within particular categories such as exposures to particular industries, economic sectors or geographical areas.

15.1.18 G Where a *firm* is a member of a *group* that is subject to consolidated reporting, the *group* should be able to monitor credit exposures on a consolidated basis. See *SYSC* 12, *INSPRU* 6.1 and *GENPRU* 3.

15.1.19 G A *firm* should have the capability to measure its credit exposure to individual *counterparties* on at least a daily basis.

Risk monitoring

15.1.20 G A *firm* should implement an effective system for monitoring its credit risk which should be described in its credit risk policy.

15.1.21 G A *firm* should have a system of management reporting which provides clear, concise, timely and accurate credit risk reports to relevant functions within the *firm*. The reports could cover exceptions to the *firm's* credit risk policy, non-performing exposures and changes to the level of credit risk within the *firm's* credit portfolio. A *firm* should have procedures for taking appropriate action according to the information within the management reports, such as a review of *counterparty* limits, or of the overall credit policy.

15.1.22 G Individual credit facilities and overall limits should be periodically reviewed in order to check their appropriateness for both the current circumstances of the *counterparty* and the *firm's* current internal and external economic environment. The frequency of review should be appropriate to the nature of the facility.

15.1.23 G A *firm* should utilise appropriate stress testing and scenario analysis of credit exposures to examine the potential effects of economic or industry downturns, market events, changes in interest rates, changes in foreign exchange rates, changes in liquidity conditions and changes in levels of insurance losses where relevant.

Problem exposures

15.1.24 G A *firm* should have systematic processes for the timely identification, management and monitoring of problem exposures. These processes should be described in the credit risk policy.

15.1.25 G A *firm* should have adequate procedures for recovering exposures in arrears or that have had provisions made against them. A *firm* should allocate responsibility, either internally or externally, for its arrears management and recovery.

Provisioning

15.1.26 G *SYSC* 14.1.19R(2) requires a *firm* to document its provisioning policy. A *firm's* provisioning policy can be maintained either as a separate document or as part of its credit risk policy.

15.1.27 G At intervals that are appropriate to the nature, scale and complexity of its activities a *firm* should review and update its provisioning policy and associated systems.

15.1.28 G In line with *SYSC* 15.1.6G, the *FSA* recognises that the frequency with which a *firm* reviews its provisioning policy once it has been established will vary from *firm* to *firm.* However, the *FSA* expects a *firm* to review at least annually whether its policy remains appropriate for the business it undertakes and the economic environment in which it operates.

15.1.29 G In line with *SYSC* 14.1.12G, the provisioning policy referred to in *SYSC* 15.1.26G must be approved by the *firm's governing body* or another appropriate body to which the *firm's governing body* has delegated this responsibility.

15.1.30 G In line with *SYSC* 14.1.24G, the *FSA* may request a *firm* to provide it with a copy of its current provisioning policy.

15.1.31 G Provisions may be general (against the whole of a given portfolio), specific (against particular exposures identified as bad or doubtful) or both. The *FSA* expects contingent liabilities (for example guarantees) and anticipated losses to be recognised in accordance with accepted accounting standards at the relevant time, such as those embodied in the Financial Reporting Standards issued by the Accounting Standards Board.

Risk mitigation

15.1.32 G A *firm* may choose to use various credit risk mitigation techniques including the taking of *collateral*, the use of letters of credit or guarantees, or *counterparty netting* agreements to manage and control their *counterparty* exposures. The use of such techniques does not obviate the need for thorough credit analysis and procedures. The reliance placed by a *firm* on *risk* mitigation should be described in the credit risk policy.

15.1.33 G A *firm* should consider the legal and financial ability of a guarantor to fulfil the guarantee if called upon to do so.

15.1.34 G A *firm* should monitor the validity and enforceability of its *collateral* arrangements.

15.1.35 G The *firm* should analyse carefully the protection afforded by risk mitigants such as netting agreements or credit *derivatives,* to ensure that any residual risk is identified, measured, monitored and controlled.

Record keeping

15.1.36 G Prudential records made under *SYSC* 14.1.53R should include appropriate records of:

(1) credit exposures, including aggregations of credit exposures, as appropriate, by:

(a) groups of connected *counterparties*;

(b) types of *counterparty* as defined, for example, by the nature or geographical location of the *counterparty*;

(2) credit decisions, including details of the decision and the facts or circumstances upon which it was made; and

(3) information relevant to assessing current *counterparty* and risk quality.

15.1.37 G Credit records should be retained as long as they are needed for the purpose described in *SYSC* 15.1.36G (subject to the minimum three year retention period). In particular, a *firm* should consider whether it is appropriate to retain information regarding *counterparty* history such as a record of credit events as well as a record indicating how credit decisions were taken.

16.1 Market risk management systems and controls

Application

16.1.1 G *SYSC* 16.1 applies to an *insurer* unless it is:

(1) a *non-directive friendly society*; or

(2) an *incoming EEA firm*; or

(3) an *incoming Treaty firm*.

16.1.2 G *SYSC* 16.1 applies to:

(1) an *EEA-deposit insurer*; and

(2) a *Swiss general insurer*;

only in respect of the activities of the *firm* carried on from a *branch* in the *United Kingdom*.

16.1.3 G *Firms* should also see *GENPRU* 1.2 (*GENPRU* 1.2.64G to *GENPRU* 1.2.78G) and *INSPRU* 3.1.

Purpose

16.1.4 G (1) The purpose of this section is to amplify *SYSC* 14 insofar as it relates to *market risk*.

(2) *Market risk* includes equity, interest rate, foreign exchange (FX), commodity risk and interest rate risk on *long-term insurance contracts*. The price of *financial instruments* may also be influenced by other risks such as *spread risk*, *basis risk*, correlation, *specific risk* and *volatility risk*.

(3) This section does not deal with the risk management of *market risk* in a *group* context. A *firm* that is a member of a *group* should also read *SYSC* 12 (Group risk systems and controls) which outlines the *FSA's* requirements for the risk management of *market risk* within a *group*.

(4) Appropriate systems and controls for the management of *market risk* will vary with the scale, nature and complexity of the *firm's* activities. Therefore the material in this section is *guidance*. A *firm* should assess the appropriateness of any particular item of *guidance* in the light of the scale, nature and complexity of its activities as well as its obligations as set out in *Principle* 3 to organise and control its affairs responsibly and effectively.

Requirements

16.1.5 G High level requirements for prudential systems and controls, including those for *market risk*, are set out in *SYSC* 14. In particular:

(1) *SYSC* 14.1.19R(2) requires a *firm* to document its policy for *market risk*, including its risk appetite and how it identifies, measures, monitors and controls that risk;

(2) *SYSC* 14.1.19R(4) requires a *firm* to document its asset and liability recognition policy. Documentation should describe the systems and controls that it intends to use to comply with the policy;

(3) *SYSC* 14.1.19R requires a *firm* to establish and maintain risk management systems to identify, measure, monitor and control *market risk* (in accordance with its *market risk* policy), and to take reasonable steps to establish systems adequate for that purpose;

(4) In line with *SYSC* 14.1.11G, the ultimate responsibility for the management of *market risk* should rest with a *firm's governing body*. Where delegation of authority occurs the *governing body* and relevant *senior managers* should approve and adequately review systems and controls to check that delegated duties are being performed correctly.

Market risk policy

16.1.6 G *SYSC* 14 requires a *firm* to establish, maintain and document a business plan and risk policies. They should provide a clear indication of the amount and nature of *market risk* that the *firm* wishes to incur. In particular, they should cover for *market risk*:

(1) how, with particular reference to its activities, the *firm* defines and measures *market risk*;

(2) the *firm's* business aims in incurring *market risk* including:

(a) identifying the types and sources of *market risk* to which the *firm* wishes to be exposed (and the limits on that exposure) and those to which the *firm* wishes not to be exposed (and how that is to be achieved, for example how exposure is to be avoided or mitigated); and

(b) specifying the level of diversification required by the *firm* and the *firm's* tolerance for risk concentrations (and the limits on those exposures and concentrations).

16.1.7 G The *market risk* policy of a *firm* should be endorsed by the *firm's governing body* and implemented by its senior management, who should take adequate steps to disseminate the policy and train the relevant staff such that they can effectively implement the policy.

16.1.8 G The *market risk* policy of a *firm* should enforce the risk management and control principles and include detailed information on:

(1) the *financial instruments*, commodities, assets and liabilities (and mismatches between assets and liabilities) that a *firm* is exposed to and the limits on those exposures;

(2) the *firm's* investment strategy as applicable between each insurance fund;

(3) activities that are intended to hedge or mitigate *market risk* including mismatches caused by for example differences in the assets and liabilities and maturity mismatches; and

(4) the methods and assumptions used for measuring linear, non-linear and geared *market risk* including the rationale for selection, ongoing validation and testing. Methods might include stress testing and scenario analysis, asset/liability analysis, correlation analysis, Value-at-Risk (VaR) and *options* such as delta, gamma, vega, rho and theta. Exposure to non-linear or geared *market risk* is typically through the use of *derivatives*.

Risk identification

16.1.9 G A *firm* should have in place appropriate risk reporting systems that enable it to identify the types and amount of *market risk* to which it is, and potentially could be, exposed. The information that systems should capture may include but is not limited to:

(1) position information which may include a description of individual *financial instruments* and their cash flows; and

(2) market data which may consist of raw time series of market rates, index levels and prices and derived time series of benchmark yield curves, spreads, implied volatilities, historical volatilities and correlations.

Risk measurement

16.1.10 G Having identified the *market risk* that the *firm* is exposed to on at least a daily basis, a *firm* should be able to measure and manage that *market risk* on a consistent basis. This may be achieved by:

(1) regularly stress testing all or parts of the *firm's* portfolio to estimate potential economic losses in a range of market conditions including abnormal markets. Corporate level stress test results should be discussed regularly by risk monitors, senior management and risk takers, and should guide the *firm's market risk* appetite (for example, stress tests may lead to discussions on how best to unwind or hedge a position), and influence the internal capital allocation process;

(2) measuring the *firm's* exposure to particular categories of *market risk* (for example, equity, interest rate, foreign exchange and commodities) as well as across its entire portfolio of *market risks*;

(3) analysing the impact that new transactions or businesses may have on its *market risk* position on an on-going basis; and

(4) regularly backtesting realised results against internal model generated *market risk* measures in order to evaluate and assess its accuracy. For example, a *firm* should keep a database of daily risk measures such as VaR and *options* such as delta, gamma, vega, rho and theta, and use these to back test predicted profit and loss against actual profit and loss for all trading desks and business units, and monitor the number of exceptions from agreed confidence bands.

Valuation

16.1.11 G A *firm* should take reasonable steps to establish systems and control procedures such that the *firm* complies with the requirements of *GENPRU* 1.3 (Valuation).

16.1.12 G The systems and controls referred to in *SYSC* 16.1.11G should include the following:

(1) the department responsible for the validation of the value of assets and liabilities should be independent of the business trading area, and should be adequately resourced by suitably qualified staff. The department should report to a suitably qualified individual, independent from the business trading area, who has sufficient authority to enforce the systems and controls policies and any alterations to valuation treatments where necessary;

(2) all valuations should be checked and validated at appropriate intervals. Where a *firm* has chosen not to validate all valuations on a daily basis this should be agreed by senior management;

(3) a *firm* should establish a review procedure to check that the valuation procedures are followed and are producing valuations in compliance with the requirements in this section. The review should be undertaken by suitably qualified staff independent of the business trading area, on a regular and ad hoc basis. In particular, this review procedure should include:

(a) the quality and appropriateness of the price sources used;

(b) valuation reserves held; and

(c) the valuation methodology employed for each product and consistent adherence to that methodology;

(4) where a valuation is disputed and the dispute cannot be resolved in a timely manner it should be reported to senior management. It should

continue to be reported to senior management until agreement is reached;

(5) where a *firm* is marking positions to market it should take reasonable steps to establish a price source that is reliable and appropriate to enable compliance with the provisions in this section on an ongoing basis;

(6) a *firm* should document its policies and procedures relating to the entire valuation process. In particular, the following should be documented:

(a) the valuation methodologies employed for all product categories;

(b) details of the price sources used for each product;

(c) the procedures to be followed where a valuation is disputed;

(d) the valuation adjustment and reserving policies;

(e) the level at which a difference between a valuation assigned to an asset or liability and the valuation used for validation purposes will be reported on an exceptions basis and investigated;

(f) where a *firm* is using its own internal estimate to produce a valuation, it should document in detail the process followed in order to produce the valuation; and

(g) the review procedures established by a *firm* in relation to the requirements of this section should be adequately documented and include the rationale for the policy;

(7) a *firm* should maintain records which demonstrate:

(a) senior management's approval of the policies and procedures established; and

(b) management sign-off of the reviews undertaken in accordance with *SYSC* 16.1.11G.

Risk monitoring

16.1.13 G Risk monitoring is the operational process by which a *firm* monitors compliance with defined policies and procedures of the *market risk* policy. The *firm's* risk monitoring system should be independent of the *employees* who are responsible for exposing the *firm* to *market risk*.

16.1.14 G The *market risk* policy of a *firm* may require the production of *market risk* reports at various levels within the *firm*. These reports should provide sufficiently accurate *market risk* data to relevant functions within the *firm*,

and should be timely enough to allow any appropriate remedial action to be proposed and taken, for example:

(1) at a *firm* wide level, a *market risk* report may include information:

(a) summarising and commenting on the total *market risk* that a *firm* is exposed to and *market risk* concentrations by business unit, asset class and country;

(b) on VaR reports against risk limits by business unit, asset class and country;

(c) commenting on significant risk concentrations and market developments; and

(d) on *market risk* in particular legal entities and geographical regions;

(2) at the business unit level, a *market risk* report may include information summarising *market risk* by currency, trading desk, maturity or duration band, or by instrument type;

(3) at the trading desk level, a *market risk* report may include detailed information summarising *market risk* by individual trader, instrument, position, currency, or maturity or duration band; and

(4) all risk data should be readily reconcilable back to the prime books of entry with a fully documented audit trail.

16.1.15 G Risk monitoring may also include information on:

(1) the procedures for taking appropriate action in response to the information within the *market risk* reports;

(2) ensuring that there are controls and procedures for identifying and reporting trades and positions booked at off-market rates;

(3) the process for new product approvals;

(4) the process for dealing with situations (authorised and unauthorised) where particular *market risk* exposures exceed predetermined risk limits and criteria; and

(5) the periodic review of the risk monitoring process in order to check its suitability for both current market conditions and the *firm's* overall risk appetite.

16.1.16 G Risk monitoring should be subject to periodic independent review by suitably qualified staff.

Risk control

16.1.17 G Risk control is the independent monitoring, assessment and supervision of business units within the defined policies and procedures of the *market risk* policy. This may be achieved by:

(1) setting an appropriate *market risk* limit structure to control the *firm's* exposure to *market risk*; for example, by setting out a detailed *market risk* limit structure at the corporate level, the business unit level and the trading desk level which addresses all the key *market risk* factors and is commensurate with the volume and complexity of activity that the *firm* undertakes;

(2) setting limits on risks such as price or rate risk, as well as those factors arising from *options* such as delta, gamma, vega, rho and theta;

(3) setting limits on net and gross positions, *market risk* concentrations, the maximum allowable loss (also called "stop-loss"), VaR, potential risks arising from stress testing and scenario analysis, gap analysis, correlation, liquidity and volatility; and

(4) considering whether it is appropriate to set intermediate (early warning) thresholds that alert management when limits are being approached, triggering review and action where appropriate.

Record keeping

16.1.18 G High level requirements for record keeping are set out in *SYSC* 14.

16.1.19 G In relation to *market risk*, a *firm* should retain appropriate prudential records of:

(1) off and on market trades in *financial instruments*;

(2) the nature and amounts of off and on balance sheet exposures, including the aggregation of exposures;

(3) trades in *financial instruments* and other assets and liabilities; and

(4) methods and assumptions used in stress testing and scenario analysis and in VaR models.

16.1.20 G A *firm* should keep a data history to enable it to perform back testing of methods and assumptions used for stress testing and scenario analysis and for VaR models.

17.1 Insurance risk systems and controls

Application

17.1.1 G *SYSC* 17.1 applies to an *insurer* unless it is:

(1) a *non-directive friendly society*; or

(2) an *incoming EEA firm;* or

(3) an *incoming Treaty firm*.

17.1.2 G *SYSC* 17.1 applies to:

(1) an *EEA-deposit insurer*; and

(2) a *Swiss general insurer*;

only in respect of the activities of the *firm* carried on from a *branch* in the *United Kingdom*.

Purpose

17.1.3 G This section provides *guidance* on how to interpret *SYSC* 14 (Prudential risk management and associated systems and controls) in so far as it relates to the management of insurance risk. Insurance risk refers to fluctuations in the timing, frequency and severity of insured events, relative to the expectations of the *firm* at the time of underwriting. Insurance risk can also refer to fluctuations in the timing and amount of *claim* settlements. For *general insurance business* some specific examples of insurance risk include variations in the amount or frequency of *claims* or the unexpected occurrence of multiple *claims* arising from a single cause. For *long-term insurance business* examples include variations in the mortality and persistency rates of *policyholders*, or the possibility that guarantees could acquire a value that adversely affects the finances of a *firm* and its ability to treat its *policyholders* fairly consistent with the *firm's* obligations under *Principle* 6. More generally, insurance risk includes the potential for expense overruns relative to pricing or provisioning assumptions.

17.1.4 G Insurance risk concerns the *FSA* in a *prudential context* because inadequate systems and controls for its management can create a threat to the *regulatory objectives* of market confidence and consumer protection. Inadequately managed insurance risk may result in:

(1) the inability of a *firm* to meet its contractual insurance liabilities as they fall due; and

(2) the inability of a *firm* to treat its *policyholders* fairly consistent with the *firm's* obligations under *Principle* 6 (for example, in relation to bonus payments).

17.1.5 G *Guidance* on the application of this section to a *firm* that is a member of a *group* is provided in *SYSC* 12 (Group risk systems and controls).

17.1.6 G The *guidance* contained within this section should be read in conjunction with the rest of *SYSC.*

17.1.7 G Appropriate systems and controls for the management of insurance risk will vary with the scale, nature and complexity of a *firm's* activities. Therefore, the material in this section is *guidance*. A *firm* should assess the appropriateness of any particular item of *guidance* in the light of the scale, nature and complexity of its activities as well as its obligations, as set out in *Principle* 3, to organise and control its affairs responsibly and effectively.

General requirements

17.1.8 G High level *rules* and *guidance* for prudential systems and controls for insurance risk are set out in *SYSC* 14. In particular:

(1) *SYSC* 14.1.18R requires a *firm* to take reasonable steps to establish and maintain a business plan and appropriate risk management systems;

(2) *SYSC* 14.1.19R(2) requires a *firm* to document its policy for insurance risk, including its risk appetite and how it identifies, measures, monitors and controls that risk; and

(3) *SYSC* 14.1.27R requires a *firm* to take reasonable steps to establish and maintain adequate *internal controls* to enable it to assess and monitor the effectiveness and implementation of its business plan and prudential risk management systems.

Insurance risk policy

17.1.9 G A *firm's* insurance risk policy should outline its objectives in carrying out *insurance business*, its appetite for insurance risk and its policies for identifying, measuring, monitoring and controlling insurance risk. The insurance risk policy should cover any activities that are associated with the creation or management of insurance risk. For example, underwriting, *claims* management and settlement, assessing *technical provisions* in the balance sheet, risk mitigation and risk transfer, record keeping and management reporting. Specific matters that should normally be in a *firm's* insurance risk policy include:

(1) a statement of the *firm's* willingness and capacity to accept insurance risk;

(2) the classes and characteristics of *insurance business* that the *firm* is prepared to accept;

(3) the underwriting criteria that the *firm* intends to adopt, including how these can influence its rating and pricing decisions;

(4) its approach to limiting significant aggregations of insurance risk, for example, by setting limits on the amount of business that can be underwritten in one region or with one *policyholder*;

(5) where relevant, the *firm's* approach to pricing *long-term insurance contracts*, including the determination of the appropriate level of any reviewable *premiums*;

(6) the *firm's* policy for identifying, monitoring and managing risk when it has delegated underwriting authority to another party (additional *guidance* on the management of *outsourcing* arrangements is provided in *SYSC* 13.9);

(7) the *firm's* approach to managing its expense levels, including acquisition costs, recurring costs, and one-off costs, taking account of the margins available in both the prices for products and in the *technical provisions* in the balance sheet;

(8) the *firm's* approach to the exercise of any discretion (e.g. on charges or the level of benefits payable) that is available in its *long-term insurance contracts*, in the context also of the legal and regulatory constraints existing on the application of this discretion;

(9) the *firm's* approach to the inclusion of options within new *long-term insurance contracts* and to the possible exercise by *policyholders* of options on existing contracts;

(10) the *firm's* approach to managing persistency risk;

(11) the *firm's* approach to managing risks arising from timing differences in taxation or from changes in tax laws;

(12) the *firm's* approach to the use of *reinsurance* or the use of some other means of risk transfer;

(13) how the *firm* intends to assess the effectiveness of its risk transfer arrangements and manage the residual or transformed risks (for example, how it intends to handle disputes over contract wordings, potential payout delays and *counterparty* performance risks);

(14) a summary of the data and information to be collected and reported on underwriting, *claims* and risk control (including internal accounting records), management reporting requirements and external data for risk assessment purposes;

(15) the risk measurement and analysis techniques to be used for setting underwriting *premiums, technical p*rovisions in the balance sheet, and assessing capital requirements; and

(16) the *firm's* approach to stress testing and scenario analysis, as required by *GENPRU* 1.2 (Adequacy of financial resources), including the methods adopted, any assumptions made and the use that is to be

made of the results.

17.1.10 G Further, more detailed, *guidance* is given in *SYSC* 17.1.11G to *SYSC* 17.1.37G on the identification, measurement, monitoring and control (including the use of *reinsurance* and other forms of risk transfer) of insurance risk. A *firm* should consider what additional material to that set out above should be included in its insurance risk policy on each of these for its various activities.

Risk identification

17.1.11 G A *firm* should seek to identify the causes of fluctuations in the occurrence, amount and timing of its insurance liabilities. A *firm* should also seek to identify aggregations of risk that may give rise to large single or multiple *claims*.

17.1.12 G The identification of insurance risk should normally include:

(1) in connection with the *firm's* business plan:

(a) processes for identifying the types of insurance risks that may be associated with a new product and for comparing the risk types that are present in different classes of business (in order to identify possible aggregations in particular insurance risks); and

(b) processes for identifying business environment changes (for example landmark legal rulings) and for collecting internal and external data to test and modify business plans;

(2) at the point of sale, processes for identifying the underwriting risks associated with a particular *policyholder* or a group of *policyholders* (for example, processes for identifying potential *claims* for mis-selling and for collecting information on the *claims* histories of *policyholders*, including whether they have made any potentially false or inaccurate claims, to identify possible adverse selection or moral hazard problems);

(3) after the point of sale, processes for identifying potential and emerging *claims* for the purposes of *claims* management and *claims* provisioning; this could include:

(a) identifying possible judicial rulings;

(b) keeping up to date with developments in market practice; and

(c) collecting information on industry wide initiatives and settlements.

17.1.13 G A *firm* should also identify potential pricing risks, where the liabilities or costs arising from the sale of a product may not be as expected.

Risk measurement

17.1.14 G A *firm* should have in place appropriate systems for collecting the data it needs to measure insurance risk. At a minimum this data should be capable of allowing a *firm* to evaluate the types of *claims* experienced, *claims* frequency and severity, expense levels, persistency levels and, where relevant, potential changes in the value of guarantees and options in *long-term insurance contracts*.

17.1.15 G A *firm* should ensure that the data it collects and the measurement methodologies that it uses are sufficient to enable it to evaluate, as appropriate:

(1) its exposure to insurance risk at all relevant levels, for example, by contract, *policyholder*, product line or insurance class;

(2) its exposure to insurance risk across different geographical areas and time horizons;

(3) its total, *firm*-wide, exposure to insurance risk and any other risks that may arise out of the *contracts of insurance* that it issues;

(4) how changes in the volume of business (for example via changes in *premium* levels or the number of new contracts that are underwritten) may influence its exposure to insurance risk;

(5) how changes in *policy* terms may influence its exposure to insurance risk; and

(6) the effects of specific loss scenarios on the insurance liabilities of the *firm*.

17.1.16 G A *firm* should hold data in a manner that allows for it to be used in a flexible way. For example, data should be sufficiently detailed and disaggregated so that contract details may be aggregated in different combinations to assess different risks.

17.1.17 G A *firm* should be able to justify its choice of measurement methodologies. This justification should normally be documented.

17.1.18 G A *firm* should periodically review the appropriateness of the measurement methodologies that it uses. This could, for example, include back testing (that is, by comparing actual versus expected results) and updating for changes in market practice.

17.1.19 G A *firm* should ensure that it has access to the necessary skills and resources that it needs to measure insurance risk using its chosen methodology.

17.1.20 G When measuring its insurance risks, a *firm* should consider how emerging experience could be used to update its underwriting process, in particular in relation to contract terms and pricing and also its assessment of the *technical*

provisions in the balance sheet.

17.1.21 G A *firm* should have the capability to measure its exposure to insurance risk on a regular basis. In deciding on the frequency of measurement, a *firm* should consider:

(1) the time it takes to acquire and process all necessary data;

(2) the speed at which exposures could change; and

(3) that it may need to measure its exposure to certain types of insurance risk on a daily basis (for example, weather catastrophes).

Risk monitoring

17.1.22 G A *firm* should provide regular and timely information on its insurance risks to the appropriate level of management. This could include providing reports on the following:

(1) a statement of the *firm's* profits or losses for each class of business that it underwrites (with an associated analysis of how these have arisen for any *long-term insurance contracts*), including a variance analysis detailing any deviations from budget or changes in the key performance indicators that are used to assess the success of its business plan for insurance;

(2) the *firm's* exposure to insurance risk at all relevant levels (see *SYSC* 17.1.15G(1)), as well as across different geographical areas and time zones (see *SYSC* 17.1.15G(2)), also senior management should be kept informed of the *firm's* total exposure to insurance risk (see *SYSC* 17.1.15G(3));

(3) an analysis of any internal or external trends that could influence the *firm's* exposure to insurance risk in the future (e.g. new weather patterns, socio-demographic changes, expense overruns etc);

(4) any new or emerging developments in *claims* experience (e.g. changes in the type of *claims*, average *claim* amounts or the number of similar *claims*);

(5) the results of any stress testing or scenario analyses;

(6) the amount and details of new business written and the amount of business that has lapsed or been cancelled;

(7) identified fraudulent *claims*;

(8) a watch list, detailing, for example, material/catastrophic events that could give rise to significant numbers of new *claims* or very large *claims*, contested *claims*, client complaints, legal and other developments;

(9) the performance of any *reinsurance*/risk transfer arrangements; and

(10) progress reports on matters that have previously been referred under escalation procedures (see *SYSC* 17.1.23G).

17.1.23 G A *firm* should establish and maintain procedures for the escalation of appropriate matters to the relevant level of management. Such matters may include:

(1) any significant new exposures to insurance risk, including for example any landmark rulings in the courts;

(2) a significant increase in the size or number of *claims*;

(3) any breaches of the limits set out in *SYSC* 17.1.27G and *SYSC* 17.1.28G, in particular senior management should be informed where any maximum limits have been breached (see *SYSC* 17.1.29G); and

(4) any unauthorised deviations from its insurance risk policy (including those by a *broker*, *appointed representative* or other delegated authority).

17.1.24 G A *firm* should regularly monitor the effectiveness of its analysis techniques for setting provisions for *claims* on *general insurance contracts*.

17.1.25 G A *firm* should have appropriate procedures in place to allow managers to monitor the application (and hence the effect) of its *reinsurance* programme. This would include, for a general *insurer*, procedures for monitoring how its *reinsurance* programme affects the gross provisions that it makes for outstanding *claims* (including *claims* that are incurred but not reported).

Risk control

17.1.26 G A *firm* should take appropriate action to ensure that it is not exposed to insurance risk in excess of its risk appetite. In so doing, the *firm* should be both reactive, responding to actual increases in exposure, and proactive, responding to potential future increases. Being proactive should involve close co-ordination between the processes of risk control, risk identification and risk measurement, as potential future exposures need to be identified and understood before effective action can be taken to control them.

17.1.27 G A *firm* should consider setting limits for its exposure to insurance risk, which trigger action to be taken to control exposure. Periodically these limits should be amended in the light of new information (e.g. on the expected number or size of *claims*). For example, limits could be set for:

(1) the *firm's* aggregate exposure to a single source of insurance risk or for events that may be the result of a number of different sources;

(2) the *firm's* exposure to specific geographic areas or any other groupings of risks whose outcomes may be positively correlated;

(3) the number of fraudulent *claims*;

(4) the number of very large *claims* that could arise;

(5) the number of unauthorised deviations from its insurance risk policy;

(6) the amount of insurance risk than can be transferred to a particular *reinsurer*;

(7) the level of expenses incurred in respect of each relevant business area; and

(8) the level of persistency by product line or distribution channel.

17.1.28 G A *firm* should also consider setting individual underwriting limits for all *employees* and agents that have the authority to underwrite insurance risk. This could include both monetary limits and limits on the types of risk that they can underwrite. Where individual underwriting limits are set, the *firm* should ensure that they are adhered to.

17.1.29 G In addition to setting some 'normal' limits for insurance risk, a *firm* should consider setting some maximum limits, beyond which immediate, emergency action should be taken. These maximum limits could be determined through stress testing and scenario analysis.

17.1.30 G A *firm* should pay close attention to the wording of its *policy* documentation to ensure that these wordings do not expose it to more, or higher, *claims* than it is expecting. In so doing, the *firm* should consider:

(1) whether it has adequate in-house legal resources;

(2) the need for periodic independent legal review of *policy* documentation;

(3) the use of standardised documentation and referral procedures for variation of terms;

(4) reviewing the documentation used by other insurance companies;

(5) revising documentation for new *policies* in the light of past experience; and

(6) the operation of law in the jurisdiction of the *policyholder*.

17.1.31 G A *firm* should ensure that it has appropriate systems and controls for assessing the validity of *claims*. This could involve consideration of the evidence that will be required from *policyholders* and how this evidence is to be tested as well as procedures to determine when experts such as loss

adjusters, lawyers or accountants should be used.

17.1.32 G Particular care should be taken to ensure that a *firm* has appropriate systems and controls to deal with large *claims* or large groups of *claims* that could significantly deplete its financial resources. This should include systems to ensure that senior management (that is, the *governing body* and relevant *senior managers*) is involved in the processing of such *claims* from the outset.

17.1.33 G A *firm* should consider how it intends to use *reinsurance* or some other form of insurance risk transfer agreement to help to control its exposure to insurance risk. Additional *guidance* on the use of *reinsurance*/risk transfer is provided below.

Reinsurance and other forms of risk transfer

17.1.34 G Before entering into or significantly changing a *reinsurance* agreement, or any other form of insurance risk transfer agreement, a *firm* should:

(1) analyse how the proposed *reinsurance*/risk transfer agreement will affect its exposure to insurance risk, its underwriting strategy and its ability to meet its regulatory obligations;

(2) ensure there are adequate legal checking procedures in respect of the draft agreement;

(3) conduct an appropriate due diligence of the *reinsurer's* financial stability (that is, solvency) and expertise; and

(4) understand the nature and limits of the agreement (particular attention should be given to the wording of contracts to ensure that all of the required risks are covered, that the level of available cover is appropriate, and that all the terms, conditions and warranties are unambiguous and understood).

17.1.35 G In managing its *reinsurance* agreements, or any other form of insurance risk transfer agreement, a *firm* should have in place appropriate systems that allow it to maintain its desired level of cover. This could involve systems for:

(1) monitoring the risks that are covered (that is, the scope of cover) by these agreements and the level of available cover;

(2) keeping underwriting staff informed of any changes in the scope or level of cover;

(3) properly co-ordinating all *reinsurance*/risk transfer activities so that, in aggregate, the desired level and scope of cover is maintained;

(4) ensuring that the *firm* does not become overly reliant on any one *reinsurer* or other risk transfer provider;

(5) conducting regular stress testing and scenario analysis to assess the resilience of its *reinsurance* and risk transfer programmes to catastrophic events that may give rise to large and or numerous *claims*.

17.1.36 G In making a claim on a *reinsurance* contract (that is, its *reinsurance* recoveries) or some other risk transfer contract a *firm* should ensure:

(1) that it is able to identify and recover any money that it is due in a timely manner; and

(2) that it makes adequate financial provision for the risk that it is unable to recover any money that it expected to be due, as a result of either a dispute with or a default by the *reinsurer*/risk transfer provider. Additional *guidance* on credit risk in *reinsurance*/risk transfer contracts is provided in *INSPRU* 2.1 (Credit risk in insurance)].

17.1.37 G Where the planned level or scope of cover from a *reinsurance*/risk transfer contract is not obtained, a *firm* should consider revising its underwriting strategy.

Record keeping

17.1.38 G The *FSA's* high level *rules* and *guidance* for record keeping are outlined in *SYSC* 3.2.20R (Records). Additional *rules* and *guidance* in relation to the *prudential context* are set out in *SYSC* 14.1.51G to *SYSC* 14.1.64G. In complying with these *rules* and *guidance*, a *firm* should retain an appropriate record of its insurance risk management activities. This may, for example, include records of:

(1) each new risk that is underwritten (noting that these records may be held by agents or cedants, rather than directly by the *firm* provided that the *firm* has adequate access to those records);

(2) any material aggregation of exposure to risk from a single source, or of the same kind or to the same potential catastrophe or event;

(3) each notified *claim* including the amounts notified and paid, precautionary notices and any re-opened *claims*;

(4) *policy* and contractual documents and any relevant representations made to *policyholders*;

(5) other events or circumstances relevant to determining the risks and commitments that arise out of *contracts of insurance* (including discretionary benefits and charges under any *long-term insurance contracts*);

(6) the formal wordings of *reinsurance* contracts; and

(7) any other relevant information on the *firm's reinsurance* or other risk-transfer arrangements, including the extent to which they:

(a) have been exhausted by recoveries on paid *claims*; and

(b) will be exhausted by recoveries on reported *claims* and, to the extent known, on incurred but not reported *claims*.

17.1.39 G A *firm* should retain its underwriting and *claims* histories for as long as they may be needed to inform pricing or provisioning decisions.

18.1 Application and purpose

Application

18.1.1 G This chapter is relevant to every *firm* to the extent that the Public Interest Disclosure Act 1998 ("PIDA") applies to it.

Purpose

18.1.2 G (1) The purposes of this chapter are:

(a) to remind *firms* of the provisions of PIDA; and

(b) to encourage *firms* to consider adopting and communicating to workers appropriate internal procedures for handling workers' concerns as part of an effective risk management system.

(2) In this chapter "worker" includes, but is not limited to, an individual who has entered into a contract of employment.

18.1.3 G The *guidance* in this chapter concerns the effect of PIDA in the context of the relationship between *firms* and the *FSA*. It is not comprehensive guidance on PIDA itself.

18.2 Practical measures

Effect of Public Interest Disclosure Act 1998

18.2.1 G (1) Under PIDA, any clause or term in an agreement between a worker and his employer is void in so far as it purports to preclude the worker from making a protected disclosure (that is, "blow the whistle").

(2) In accordance with section 1 of PIDA:

(a) a protected disclosure is a qualifying disclosure which meets the relevant requirements set out in that section;

(b) a qualifying disclosure is a disclosure, made in good faith, of information which, in the reasonable belief of the worker making the disclosure, tends to show that one or more of the following (a "failure") has been, is being, or is likely to be, committed:

(i) a criminal offence; or

(ii) a failure to comply with any legal obligation; or

(iii) a miscarriage of justice; or

(iv) the putting of the health and safety of an individual in danger; or

(v) damage to the environment; or

(vi) deliberate concealment relating to any of (i) to (v);

it is immaterial whether the relevant failure occurred, occurs or would occur in the *United Kingdom* or elsewhere, and whether the law applying to it is that of the *United Kingdom* or of any other country or territory.

Internal procedures

18.2.2 G (1) *Firms* are encouraged to consider adopting (and encouraged to invite their *appointed representatives* to consider adopting) appropriate internal procedures which will encourage workers with concerns to blow the whistle internally about matters which are relevant to the functions of the *FSA*.

(2) Smaller *firms* may choose not to have as extensive procedures in place as larger *firms*. For example, smaller *firms* may not need written procedures. The following is a list of things that larger and smaller *firms* may want to do.

(a) For larger *firms*, appropriate internal procedures may include:

(i) a clear statement that the *firm* takes failures seriously (see *SYSC* 18.2.1G(2)(b));

(ii) an indication of what is regarded as a failure;

(iii) respect for the confidentiality of workers who raise concerns, if they wish this;

(iv) an assurance that, where a protected disclosure has been made, the *firm* will take all reasonable steps to ensure that no *person* under its control engages in victimisation;

(v) the opportunity to raise concerns outside the line management structure, such as with the Compliance Director, Internal Auditor or Company Secretary;

(vi) penalties for making false and malicious allegations;

(vii) an indication of the proper way in which concerns may be raised outside the *firm* if necessary (see (3));

(viii) providing access to an external body such as an independent charity for advice;

(ix) making whistleblowing procedures accessible to staff of key contractors; and

(x) written procedures.

(b) For smaller *firms*, appropriate internal procedures may include:

(i) telling workers that the *firm* takes failures seriously (see *SYSC* 18.2.1G(2)(b)) and explaining how wrongdoing affects the organisation;

(ii) telling workers what conduct is regarded as failure;

(iii) telling workers who raise concerns that their confidentiality will be respected, if they wish this;

(iv) making it clear that concerned workers will be supported and protected from reprisals;

(v) nominating a senior officer as an alternative route to line management and telling workers how they can contact that individual in confidence;

(vi) making it clear that false and malicious allegations will be penalised by the *firm*;

(vii) telling workers how they can properly blow the whistle outside the *firm* if necessary (see (3));

(viii) providing access to an external body for advice such as an independent charity for advice; and

(ix) encouraging managers to be open to concerns.

(3) (a) *Firms* should also consider telling workers (through the *firm's* internal procedures, or by means of an information sheet available from the *FSA's* website, or by some other means) that they can blow the whistle to the *FSA*, as the regulator prescribed in respect of financial services and markets matters under PIDA.

(b) The *FSA* will give priority to live concerns or matters of recent history, and will emphasise that the worker's first port of call should ordinarily be the *firm* (see Frequently Asked Questions on www.fsa.gov.uk/whistle/).

(c) For the *FSA's* treatment of confidential information, see *SUP* 2.2.4G.

Link to fitness and propriety

18.2.3 G The *FSA* would regard as a serious matter any evidence that a *firm* had acted to the detriment of a worker because he had made a protected disclosure (see *SYSC* 18.2.1G(2)) about matters which are relevant to the functions of the *FSA*. Such evidence could call into question the fitness and propriety of the *firm* or relevant members of its staff, and could therefore, if relevant, affect the *firm's* continuing satisfaction of *threshold condition* 5 (Suitability) or, for an *approved person*, his status as such.

Annex E

Amendments to the Handbook coming into force on 1 November 2007

In this Annex, underlining indicates new text and striking through indicates deleted text. In this annex where an entire section is being deleted, the place where the change will be made is indicated and the text will not be struck through.

Amend SYSC 1.1 as follows

1.1 Application of SYSC 2 and SYSC 3

….

1.1.1 R Who?

SYSC 2 and *SYSC* 3 apply to every *firm* except that:

…

(6) ~~*SYSC* 3.2.23R to *SYSC* 3.2.37R apply only to a *BIPRU firm*~~ for a *common platform firm, SYSC* 3 does not apply.

…

~~1.3.1A G From 1 January 2007 until 1 November 2007, the application of *SYSC* 4 to *SYSC* 10 is limited by *SYSC* TP 1.~~

…

Amend SYSC 3 as follows

…

3.1.1A R [Deleted]

…

3.2.23R to 3.2.37R [Deleted]

Amend SYSC 12 as follows

…

12.1.13 R If this *rule* applies under *SYSC* 12.1.14R to a *firm*, the *firm* must:

(1) …; and

(2) ensure that the risk management processes and internal control mechanisms at the level of any *UK consolidation group* or *non-EEA sub-group* of which it is a member comply with the obligations set out in the following provisions on a consolidated (or sub-consolidated)

basis:

(a) ~~*SYSC* 3.2.23R and *SYSC* 3.2.24R~~ *SYSC* 4.1.1R and *SYSC* 4.1.2R;

(b) ~~*SYSC* 3.2.26R~~ *SYSC* 4.1.8R;

(c) ~~*SYSC* 3.2.28R to [*SYSC* 3.2.35R]~~ *SYSC* 5.1.7R;

(d) ~~[rules in *SYSC* 11 implementing *BCD* Annex V paragraphs 13 and 14]~~ *SYSC* 7;

(e) ~~*BIPRU* 2.3.6R~~ [rules in *SYSC* 11 implementing *BCD* Annex V paragraphs 13 and 14][14];

(f) ~~*BIPRU* 9.1.7R *and BIPRU* 9.12.21R~~ *BIPRU* 2.3.6R;

(g) ~~*BIPRU* 10.12.1R~~ *BIPRU* 9.1.7R and *BIPRU* 9.12.21R;

(h) *BIPRU* 10.12.1R.

[14] BCD Annex V paragraphs 13 and 14 will be implemented on 1 January 2007 in SYSC 11 (Liquidity risk), which will be consulted on later this year.

Annex F

Amendments to the Glossary of Definitions

In this Annex, underlining indicates new text and striking through indicates deleted text.

Part 1 – New definitions

To be inserted alphabetically at the appropriate points in the existing glossary. These definitions are still under consideration and the following indicative drafting has been set out for the purposes of this CP only. Where square brackets appear around a defined term, that term will be defined in the glossary when the provisions come into effect, but the definition does not appear here.

ancillary service (in accordance with Article 4 (1)(3) of *MiFID*) any of the services listed in Section B of Annex I to *MiFID*, that is:

(1) safekeeping and administration of *financial instruments* for the account of clients, including custodianship and related services such as cash/collateral management;

(2) granting credits or loans to an investor to allow him to carry out a transaction in one or more *financial instruments*, where the firm granting the credit or loan is involved in the transaction;

(3) advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to mergers and the purchase of undertakings;

(4) foreign exchange services where these are connected to the provision of *investment services*;

(5) *investment research* and financial analysis or other forms of general recommendation relating to transactions in *financial instruments*;

(6) services related to underwriting; and

(7) *investment services and activities* as well as ancillary services of the type included under Section A or B of Annex 1 related to the underlying of the derivatives included under Section C – 5, 6, 7 and 10, that is:

(a) options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other

termination event);

(b) options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a *regulated market* and/or an [*MTF*];

(c) options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in (ii) and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls;

(d) options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in (i) to (iii), which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a *regulated market* or an [*MTF*], are cleared and settled through recognised clearing houses or are subject to regular margin calls;

where these are connected to the provision of *investment services* or ancillary services.

CAD the *Capital Adequacy Directive*.

CRD The European Parliament and Council Directive Re-casting Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions (No. 200[] / [ ]/EC).

common platform firm a *firm* that is:

(a) a *BIPRU firm*;

	(b) an *exempt CAD firm*; or (c) a *MiFID investment firm* which falls within the definition of "local firm" in Article 3.1P of the *Banking Consolidation Directive*.
eligible counterparty	(in accordance with article 24 of *MiFID*) a *client* that is categorised as an eligible counterparty in accordance with the client categorisation *rules* in *COB* [*COB x*].
investment services and activities	(in accordance with article 4(1)(2) of *MiFID*) any of the services and activities listed in Section A of Annex 1 to *MiFID* relating to any of the *financial instruments* listed in Section C of Annex 1 to *MiFID*, that is: (a) reception and transmission of orders in relation to one or more *financial instruments*; (b) execution of orders on behalf of clients; (c) [*dealing on own account*]; (d) [*portfolio management*]; (e) [*investment advice*]; (f) underwriting of *financial instruments* and/or placing of *financial instruments* on a firm commitment basis; (g) placing of *financial instruments* without a firm commitment basis; and (h) operation of [*multilateral trading facilities*].
MiFID	The European Parliament and Council Directive on markets in financial instruments (No. 2004/39/EC).
MiFID competent authority	an authority, designated by the *United Kingdom* or the relevant *EEA State* in accordance with Article 48 of *MiFID*.
MiFID implementing Directive	Commission directive [x] implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms, and defined terms for the purposes of that Directive.
MiFID implementing Regulation	Commission Regulation [x] implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the

	purposes of that Directive.
MiFID investment firm	an [*investment firm*] that has a registered office (or, if it has no registered office, its head office) in an *EEA State*: (a) excluding a *person* to whom *MiFID* does not apply as a result of Articles 2 or 3 of *MiFID*; but (b) including, subject to (a), a *BCD credit institution* when providing one or more *investment services* and/or carrying on performing investment activities.
professional client	(in accordance with Article 4(1)(12) of *MiFID*) a *client* that is categorised as a professional client in accordance with the client categorisation *rules* in *COB* (*COB* x).
retail client	(in accordance with Article 4(1)(12) of *MiFID*) a *client* that is categorised as a retail client in accordance with the client categorisation *rules* in *COB (COB x).*
senior personnel	(in relation to a *common platform firm*) those *persons* who effectively direct the business of the *firm,* which could include a *firm's governing body* and other *persons* who effectively direct the business of the *firm*.
supervisory function	(in accordance with Article 9(4) of MiFID) any function within a *common platform firm* that is responsible for the supervision of its *senior personnel.*

Annex 4

Part 2 – GENPRU/BIPRU definitions

Some of the definitions used in the draft handbook text have been defined or amended by the glossary attached to the BIPRU CP. These are listed below and it is intended that these will be inserted alphabetically at the appropriate points in the existing glossary when the *CRD* comes into force on 1 January 2007.

Banking Consolidation Directive	the ~~Council~~ Directive of the European Parliament and Council of [ ] ~~20 March~~ 200~~0~~6 relating to the taking up and pursuit of the business of credit institutions (No ~~2000~~/~~12~~/EC.
BIPRU	the Prudential sourcebook for *banks*, *building societies* and *investment firms*.
BIPRU firm	has the meaning set out *BIPRU* 1.1.4 (Application and purpose), which is in summary a *firm* that is: (a) a *building society*; or (b) a *bank*; or (c) a *full scope BIPRU investment firm*; or (d) a *BIPRU limited licence firm*; or (e) a *BIPRU limited activity firm*.
Capital Adequacy Directive	the ~~Council~~ Directive of the European Parliament and Council of ~~15 March 1993~~ [ ] 2006 on capital adequacy of investment firms and credit institutions (No ~~93~~/~~6~~/~~E~~EC).
credit institution	~~(as defined~~ in accordance with articles ~~14~~(1) and 107 of the *BCD*): (1) an *undertaking* whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account; or (2) an electronic money institution within the meaning of the *E-Money Directive*; but so that: (3) ~~excluding~~ an institution within (2) that does not have the right to benefit from the mutual recognition arrangements under *BCD* is excluded; and (4) for the purposes of *BIPRU* 10 (Concentration risk requirements) it means:

	(a) a credit institution as defined by (1) – (3) that has been authorised in an *EEA State*; or (b) any private or public *undertaking* which meets the definition in (1) – (3) and which has been authorised in a country outside the *EEA*. (see also *BCD credit institution*, *full credit institution*, *full BCD credit institution* and *Zone A credit institution*.)
exempt CAD firm	~~(in accordance with Article 2(2) of the *Capital Adequacy Directive* (Definitions)) a firm that satisfies the following conditions:~~ has the meaning set out *BIPRU* 1.1.16R (Types of investment firm: exempt CAD firm) which is in summary an *investment firm* that satisfies certain specified conditions. ~~(a) it is an *ISD investment firm;*~~ ~~(b) it is not an *insurer*, a *bank*, a *building society* or an *ELMI*;~~ ~~(c) its *permission* is subject to a *limitation* or *requirement* preventing it from holding *client money* or *clients' assets* and for that reason it may not at any time place itself in debit with its *clients*; and~~ ~~(d) the only *core investment service* for which it has permission is receiving and transmitting on behalf of investors orders in relation to one or more of the instruments listed in Section B of the Annex to the *ISD*.~~
UK Consolidation Group	has the meaning in *BIPRU* 8.2.1R (Scope - UK consolidation groups), which is in summary a *consolidation group* that is identified as a *UK consolidation group* in accordance with the decision tree in *BIPRU* 8 Ann 1R.
non-EEA sub-group	(in accordance with *BIPRU* 8.2.XR (Scope – Non-EEA sub-groups) a group of *undertakings* identified as a *non-EEA sub-group* in *BIPRU* 8.2.4R to *BIPRU* 8.2.8R (Scope – Non-EEA sub-groups).
operational risk	(in accordance with Article 4(22) of the *Banking Consolidation Directive*) the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk.

participation	(for the purposes of *ELM*, ~~and *PRU* 8 (Group Risk)~~ for the purposes of *BIPRU*, *GENPRU* and *INSPRU* as they apply on a consolidated basis and for the purposes of the definition of *capital resources* of a *BIPRU firm*):
	(a) …

Annex 4

Part 3 – Existing definitions

Necessarily some existing definitions in the glossary will have to change. These definitions are still under consideration and the following indicative drafting has been set out for the purposes of this CP only.

client	(1)	(except in: *ML*; ~~in~~ *PROF*; *SYSC* 10; and in relation to a *regulated mortgage contract*) any *person* with or for whom a *firm* conducts or intends to conduct *designated investment business* or any other *regulated activity*; and:
		…
	(3A)	(in *SYSC* 10) any *person* to whom a *common platform firm* provides, or intends to provide, a service in the course of carrying on a *regulated activity* for that *person*, but does not include:
		(a) a trust beneficiary:
		(b) a *corporate finance contact*; or
		(c) a *venture capital contact*.
	(4)	(in relation to a *regulated mortgage contract*, except in *ML*, ~~and~~ *PROF* and *SYSC 10*) the individual or trustee who is the borrower or potential borrower under that contract.
control	(1)	(in relation to the acquisition, increase or reduction of control of a *firm*) the relationship between a *person* and the *firm* or other *undertaking* of which the *person* is a *controller*.
	(2)	(for a *common platform firm* and in accordance with Article 4(1)(30) of *MiFID*) control as defined in Article 1 of Directive 83/349/EEC.
durable medium	(1)	paper; or
	(2)	(in accordance with Article 2(f) of the *Distance Marketing Directive*, ~~and~~ Article 2(12) of the *Insurance Mediation Directive* and article 2(2) of the *MiFID implementing Directive*) any instrument which enables the recipient to store information in a way accessible for future reference for a period of time adequate for the purposes of the information and which allows the unchanged reproduction of the information stored; this includes, in particular, floppy disks, CD-ROMs, DVDs and the hard drive of the recipient's computer on which electronic mail is stored, but not Internet websites unless

they fulfil the criteria in this definition.

financial instrument [delete existing definition and replace with the following]

(as defined in Article 4(1)(17) of *MiFID*) those instruments specified in Section C of Annex I of *MiFID*, that is*:*

(a) transferable securities;

(b) money-market instruments;

(c) units in collective investment undertakings;

(d) options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash;

(e) options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event);

(f) options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a *regulated market* and/or an [*MTF*];

(g) options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in (f) and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls;

(h) derivative instruments for the transfer of credit risk;

(i) financial contracts for differences; and

(j) options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this definition,

which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an [*MTF*], are cleared and settled through recognised clearing houses or are subject to regular margin calls.

outsourcing (1) (except in *SYSC* 8) the use of a *person* to provide customised services to a *firm* other than:

(a) a member of the *firm's* governing body acting in his capacity as such; or

(b) an individual employed by a *firm* under a contract of service.

(2) (in *SYSC* 8) (in accordance with the *MiFID implementing Directive*) an arrangement of any form between a *common platform firm* and a service provider by which that service provider performs a process, a service or an activity which would otherwise be taken by the *common platform firm* itself.

regulatory system the arrangements for regulating a *firm* or other *person* in or under the *Act*, including the *threshold conditions*, the *Principles* and other *rules*, the *Statements of Principle*, codes and *guidance* and including any relevant directly applicable provisions of a Directive or Regulation such as those contained in the *MiFID implementing Directive* and the *MiFID implementing Regulation*.

relevant person (1) (in accordance with the *MiFID implementing Directive,* but not limited to situations covered by *MiFID*)(in relation to a *firm*) any of the following:

(a) a director, partner or equivalent, manager or *appointed representative* of the *firm;*

(b) a director, partner or equivalent, or manager of any *appointed representative* of the *firm*;

(c) an employee of the *firm* or of an *appointed representative* of the *firm*, as well as any other natural person whose services are placed at the disposal and under the control of the *firm* or an *appointed representative* of the *firm* and who is involved in the provisions by the *firm* of *regulated activities*;

(d) a natural person who is involved in the provision of services to the *firm* or to its *appointed representative* under an outsourcing arrangement

for the purpose of the provision by the *firm* of *regulated activities.*

(2) (in *COMP*) a *person* for *claims* against whom the *compensation scheme* provides cover, as defined in *COMP* 6.2.1R.

Perimeter Guidance (MiFID and Recast CAD Scope) Instrument 2006

Annex 5

PERIMETER GUIDANCE (MIFID AND RECAST CAD SCOPE) INSTRUMENT 2006

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of its powers under section 157(1) (Guidance) of the Financial Services and Markets Act 2000 ('the Act').

.

Commencement

B. This instrument comes into force on [ ].

Amendments to the Perimeter Guidance manual (PERG)

C. PERG is amended in accordance with the Annex. The general guidance in PERG does not form part of the Handbook.

Citation

D. This instrument may be cited as the Perimeter Guidance (MiFID and recast CAD Scope) Instrument 2006.

By order of the Board
[ ]

Annex 5

Annex

Amendments to the Perimeter Guidance manual

In this Annex, underlining indicates new text and striking through indicates deleted text, with the exception of Chapter 13 which represents new text.

1.4.2 G Table: list of general guidance to be found in *PERG.*

Chapter:	**Applicable to:**	**About:**
PERG 13: Guidance on the scope of the Markets in Financial Instruments Directive and the recast Capital Adequacy Directive	Any *UK person* who needs to know whether *MiFID* or the recast CAD as implemented in the UK apply to him.	the scope of *MiFID* and the recast CAD

INTRODUCTORY NOTE

This guidance is currently in draft form. At the time of preparation of this draft guidance, there are ongoing transposition group meetings with the Commission and other Member States. These may lead to further updating of the text in due course.

DRAFT GUIDANCE

13. Guidance on the scope of the Markets in Financial Instruments Directive and the recast Capital Adequacy Directive

13.1 Background

Q1. What is the purpose of this guidance?

These questions and answers (Q&As) are designed to help UK firms consider:

- whether they fall within the scope of the Markets in Financial Instruments Directive 2004/39/EC (MiFID) and therefore are subject to its requirements;
- how their existing *permissions* correspond to related MiFID concepts;
- whether the recast Capital Adequacy Directive (recast CAD) applies to them; and
- if so, which category of investment firm they are for the purposes of the FSA transposition of the recast CAD.

Q2. Why does it matter whether or not we fall within the scope of MiFID?

Depending on whether or not you fall within the scope of MiFID, you may be subject to:

- domestic legislation implementing MiFID (for example, FSA rules);
- directly applicable legislation made by the European Commission (the draft *MiFID implementing Regulation*); and
- domestic legislation implementing the recast CAD (see PERG 13.6).

The question is also relevant to whether you can exercise passporting rights in relation to investment services or activities - only firms to which MiFID applies can do so.

Q3. Is there anything else we should be reading?

The Q&As complement, and should be read in conjunction with, the relevant legislation and the general guidance on regulated activities, which is in chapter 2 of our Perimeter Guidance manual ("PERG"). The Q&As relating to the recast CAD should be read in conjunction with the relevant parts of our General Prudential sourcebook ("GENPRU") and the Prudential sourcebook for banks, building societies and investment firms ("BIPRU").

More generally, you should be aware that the recast CAD forms part of the Capital Requirements Directive (CRD), which also amends the Banking Consolidation Directive (BCD).

Q4. How much can we rely on these Q&As?

The answers given in these Q&As represent the FSA's views but the interpretation of financial services legislation is ultimately a matter for the courts. How the scope of MiFID and the recast CAD affect the regulatory position of any particular person will depend on individual circumstances. If you have doubts about your position after reading these Q&As, you may wish to seek legal advice. The Q&As are not a substitute for reading the relevant provisions in MiFID, the recast CAD, the draft MiFID implementing measures and HM Treasury's implementing legislation.

Moreover, although MiFID and the recast CAD set out most of the key provisions and definitions relating to scope, some provisions may be subject to further legislation by the European Commission. In addition to FSA guidance, MiFID's scope provisions may also be the subject of guidance or communications by the European Commission or the Committee of European Securities Regulators (CESR). Similarly, recast CAD provisions may be the subject of guidance or communications by the European Commission or the Committee of European Banking Supervisors (CEBS).

Q5. How does this document work?

The Q&As are divided into the following sections:

- General (PERG 13.2);
- Investment services and activities (PERG 13.3);
- Financial instruments (PERG 13.4);
- Exemptions from MiFID (PERG 13.5);
- The recast CAD (PERG 13.6); and
- Annexes 1 and 2 - flow chart and tables.

We have also included guidance in the form of flow charts to help firms decide whether MiFID and the recast CAD apply to them and permission maps indicating which regulated

activities and *specified investments* correspond to MiFID investment services, activities and financial instruments (please see Annexes 1-3 to this document).

Article and recital references are to MiFID (Level 1 measures) unless otherwise stated. References to categories of investment services and activities and financial instruments adopt the structure of Annex 1 MiFID: for example, A1 refers to "reception and transmission of orders in relation to one or more financial instruments" and C1 relates to "transferable securities".

13.2 General

Q6. We provide investment services to our clients – does MiFID apply to us?

Yes if you are:

- an "investment firm" and the exemptions in MiFID do not apply to you; or
- a "tied agent" as defined by MiFID.

If you are a non-EEA firm, for example the UK branch of a US firm, MiFID does not apply to you. See the flow charts in Annex 1 for further information and PERG 13.5 for guidance relating to exemptions. See Q.13 for guidance relating to tied agents.

Q7. We are a credit institution. How does MiFID apply to us?

If you are a credit institution, article 1.2 MiFID provides that selected MiFID provisions apply to you, including organisational and conduct of business requirements, when you are providing investment services to your clients or performing investment activities. The exemptions in articles 2 and 3 (see PERG 13.5) do not apply to credit institutions.

Q8. We are a UCITS management company that, in addition to managing unit trusts and investment companies, provides portfolio management services to third parties. How does MiFID apply to us?

If you are the management company of a *UCITS scheme* with a *permission* to manage investments including MiFID financial instruments, certain MiFID provisions apply to you if you also provide investment services to third parties (see Q.47). These include initial capital endowment, organisational and conduct of business requirements. You are a *UCITS investment firm* for the purposes of the FSA Handbook.

Q9. We provide investment services to our clients. How do we know whether we are an investment firm for the purposes of MiFID? (article 4.1(1))

If your regular occupation or business includes providing investment services to others on a professional basis, you are an investment firm and require authorisation unless you benefit from an exemption or are a tied agent (see Q. 13). Broadly speaking, this means that the investment services you provide will amount to a business in their own right.

Where you are a firm with more than one business, you can still be an investment firm. We expect that the vast majority of firms which were subject to the requirements of the Investment Services Directive (ISD) to be subject to MiFID requirements where they continue to provide the same investment services. We also expect some firms that were not subject to the ISD (for example, certain commodity dealers) to be investment firms for the purposes of MiFID and subject to MiFID requirements.

Q10. We do not provide investment services to others but we do buy and sell financial instruments (for example, shares and derivatives) on a regular basis. Are we an investment firm for the purposes of MiFID?

Yes, if you are trading in financial instruments for your own account as a regular occupation or business on a "professional basis", although you may be able to rely on one of the MiFID exemptions (see PERG 13.5), in which case MiFID does not apply. You can be an investment firm even if you are not providing investment services to others; this is a change from the position under the ISD, arising from the fact that you are also an investment firm under MiFID where you perform investment activities on a professional basis. What amounts to a "professional basis" depends on the individual circumstances.

Q11. We are a credit institution that does not provide investment services to customers but we do have a treasury function. Are we subject to MiFID?

Yes, you will be subject to MiFID if the activities of your treasury function amount to dealing on own account (see Q. 18). As you are a credit institution, articles 2 and 3 MiFID will not apply to you.

Q12. Is there any change to the "by way of business" test in domestic legislation?

There is no change to article 3 of the Financial Services and Markets Act 2000 (Carrying on Regulated Activities By Way of Business) Order 2001 as part of MiFID implementation by HM Treasury, so the domestic test for whether you are carrying on "regulated activities by way of business" and require *authorisation* remains unchanged.

Q13. How will we know whether we are a tied agent (article 4.1(25))?

A tied agent under MiFID is a similar concept to an *appointed representative* under the *Act*. A tied agent does not require authorisation for the purposes of MiFID, just as an *appointed representative* does not require *authorisation* under the *Act*. In our view, you will only be a

tied agent if your principal is an investment firm to which MiFID applies. So, if you act for a principal that is subject to an exemption in either article 2 or 3 MiFID (as implemented by HM Treasury – see PERG 13.5 below), you are not a tied agent for the purposes of MiFID although you may be an *appointed representative* for domestic purposes.

Assuming your principal is an investment firm to which MiFID applies, if you are registered as an *appointed representative* on the FSA Register and provide services including *arranging (bringing about) deals in investments* or advising in either case in relation to MiFID investments, you are generally a tied agent for the purposes of article 4.1(25). You can continue to be an *appointed representative* following MiFID implementation. In our view, it is possible for a UK representative to be a tied agent of an incoming EEA firm. However, it is not possible to provide investment services on behalf of more than one investment firm to which MiFID applies.

13.3 – Investment Services and Activities

Q14. Where do we find a list of MiFID services and activities?

In Section A of Annex 1 to the Directive. There are eight investment services and activities in Section A (A1 to A8), four of which are further defined in article 4 MiFID. These are:

- investment advice (article 4.1(4) MiFID);
- execution of orders on behalf of clients (article 4.1(5) MiFID);
- dealing on own account (article 4.1(6) MiFID); and
- portfolio management (article 4.1(9) MiFID).

A further provision relating to investment advice is contained in article 52 of the draft *MiFID implementing Directive*.

Q15. When might we be receiving and transmitting orders in relation to one or more financial instruments? (A1 & recital 20)

You only provide this service if you are both receiving and transmitting orders. This service includes arrangements that bring together two or more investors, thereby bringing about a transaction between those investors. This may be relevant, for example, to corporate finance firms. You may be providing this service even though, having brought the investors together, the actual offer or acceptance is not communicated through you.

If you enter into a transaction, you will be doing more than receiving and transmitting orders and will need to consider whether you are executing orders on behalf of clients or dealing on own account.

Q16. We are introducers who merely put clients in touch with other investment firms – are we receiving and transmitting orders?

No. If all you do is introduce clients to investment firms so that they can provide investment services to those clients, this in itself does not bring about a transaction and so will not amount to receiving and transmitting orders. But if you are a person who does more than merely introduce, for example an introducing broker, you are likely to be receiving orders on behalf of your clients and transmitting these to clearing firms and therefore may fall within the scope of MiFID.

Q17. When might we be executing orders on behalf of clients? (A2, article 4.1(5) & recital 21)

When you are acting to conclude agreements to buy or sell one or more financial instruments on behalf of clients. You will be acting to conclude an agreement if you participate in its execution (that is, enter into it) on behalf of a client, as opposed simply to arranging the relevant deal. In our view, you can execute orders either when dealing in investments as agent (by entering into an agreement in the name of your client) or by dealing in investments as principal (for example by back-to-back trading).

Q18. What is dealing on own account? (A3 & article 4.1(6))

Dealing on own account is trading against proprietary capital resulting in the conclusion of transactions in one or more financial instruments. In most cases, if you were a firm who was dealing for own account under the ISD, the FSA would expect you to be dealing on own account for the purposes of MiFID if you continue to perform the same activities.

We consider that there is a distinction between true back-to-back trading (executing orders on behalf of clients) and position-taking (dealing on own account). In our view, if a firm enters into matching back-to-back trades in order to execute a client order (true back-to-back trading), this does not amount to dealing on own account.

This contrasts with a situation where a person enters into a position for the purpose of executing an order on behalf of a client (at which time it has a market or "unmatched principal" position on its books) and subsequently hedges its exposure by taking a corresponding position in the market. A firm which does this is position-taking and therefore dealing on own account, as well as executing an order on behalf of a client. This is consistent with article 11 recast CAD, which makes it clear that the term "positions" includes positions arising from client servicing (for example, execution of orders on behalf of clients) and market making, as well as proprietary positions.

In our view, however, if you are a firm which meets all of the conditions of article 5.2 of the recast CAD (see Q.65), you will not be dealing on own account.

Q19. What is portfolio management under MiFID? (A4 & article 4.1(19))

Portfolio management is managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments. If there is only a single financial instrument in a portfolio, you may be carrying on portfolio management even if the rest of the portfolio consists of other types of assets, such as real estate. Portfolio management includes acting as a third party manager of the assets of a *collective investment scheme*, where discretion has been delegated to the manager by the operator of the scheme. However, the operation of a *collective investment scheme* (including managing its assets) is exempt under MiFID (see Q. 47). The advisory agent who keeps clients' portfolios under review and provides advice to enable the client to make investment decisions (but does not take investment decisions himself) is not carrying on portfolio management but may be providing investment advice under MiFID.

Q20. What is investment advice under MiFID? (A5 and article 4.1(4))

Investment advice means providing personal recommendations to a client, either at its request or on your own initiative, in respect of one or more transactions relating to financial instruments.

Q21. What is a "personal recommendation" for the purposes of MiFID (article 52 of the draft MiFID implementing Directive)?

A personal recommendation is one given to a person:

- in his capacity as an investor, or potential investor, or as agent for either; which is:
    - presented as suitable for him or based on a consideration of his personal circumstances; and
    - constitutes a recommendation to him to do one or more of the following:
        - buy, sell, subscribe for, exchange, redeem, hold or underwrite a particular financial instrument;
        - exercise, or not to exercise, any right conferred by a particular financial instrument to buy, sell, subscribe for, exchange, or redeem a financial instrument.

This is similar to the UK regulated activity of *advising on investments* but is narrower in scope insofar as it requires the recommendation to be of a personal nature. We do not

consider that a personal recommendation includes advice given to an issuer to issue securities.

Q22. Can you give us some other practical examples of what are not personal recommendations under MiFID?

A recommendation is not a personal recommendation if it is issued exclusively through distribution channels or to the public (article 52 of the draft *MiFID implementing Directive*) and a "distribution channel" is one through which information is, or is likely to become, publicly available because a large number of people have access to it. Advice about financial instruments in a newspaper, journal, magazine, publication, internet communication or radio or television broadcast should not amount to a personal recommendation where the giving of investment advice is not the principal purpose of the publication or broadcast (recital 67 to the draft *MiFID implementing Directive)*.

Merely providing information to clients should not itself normally amount to investment advice. Practical examples include:

- advising clients on how to fill in an application form;
- disseminating company news or announcements;
- merely explaining the risks and benefits of a particular financial instrument; and
- producing league tables showing the performance of financial instruments against published benchmarks.

However, you should bear in mind that, where a person provides only selective information to a client, for example, when comparing one financial instrument against another, or when a client has indicated those benefits that he seeks in a product, this could, depending on the circumstances, amount to an implied recommendation and hence investment advice.

Q23. Is generic advice investment advice for the purposes of MiFID (recitals 68 and 69 draft *MiFID implementing Directive*)?

No. Investment advice is limited to advice on particular financial instruments, for example "I recommend that you buy XYZ Company shares". If you only provide generic advice on financial instruments and do not provide advice on particular financial instruments, you do not require *authorisation*.

If you are an investment firm to which MiFID applies, however, the generic advice that you provide may be subject to MiFID-based requirements. For example, if you recommend to a client that it should invest in equities rather than bonds and this advice is not in fact suitable, you are likely, depending on the circumstances of the case, to contravene MiFID requirements to:

- act honestly, fairly and professionally in accordance with the best interests of your clients; and
- provide information to clients that is fair, clear and not misleading.

If you are an investment firm which provides recommendations intended for distribution channels or the public generally (that is, general recommendations), this is an ancillary service for the purposes of MiFID (B5) and, depending on the circumstances, it may constitute the UK regulated activity of *advising on investments*.

Q24. What is underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis? (A6)

A6 comprises two elements:

- the "underwriting of financial instruments"; and/or
- the "placing of financial instruments on a firm commitment basis".

Underwriting is a commitment to take up financial instruments where others do not acquire them. In our view, placing is the service of finding investors for securities on behalf of a seller and may involve a commitment to take up those securities where others do not acquire them. We associate underwriting and placing of financial instruments with situations where a company or other business vehicle wishes to raise capital for commercial purposes, and in particular with primary issues.

In our view, the "firm commitment" aspect of the placing service relates to the person arranging the placing, as opposed to the person who has agreed to purchase any instruments as part of the placing. Accordingly, placing on a firm commitment basis occurs where a firm undertakes to arrange the placing of the instruments and to purchase some or all the shares that it may not succeed in placing with third parties. In other words, the placing element of

A6 requires the same person to arrange the placing and provide a firm commitment that some or all of the instruments will be purchased.

Q25. When might placing of financial instruments without a firm commitment basis arise (A7)?

Where the person arranging the placing does not undertake to purchase those instruments he fails to place with third parties.

Q26. What is a multilateral trading facility? (A8, article 4.1(15) & recital 6)

The concept of a multilateral trading facility (MTF) draws on standards, issued by CESR, on which the FSA's previous alternative trading system (ATS) regime was based. It includes multilateral trading systems (for example, trading platforms) operated either by investment firms or by market operators which bring together multiple buyers and sellers of financial instruments. For there to be an MTF, the buying and selling of financial instruments in these systems must be governed by non-discretionary rules in a way that results in contracts. As the rules must be non-discretionary, once orders and quotes are received within the system an MTF operator has no discretion in determining how they interact. The MTF operator instead must establish rules governing how the system operates and the characteristics of the quotes and orders (for example, their price and time of receipt in the system) then determine the resulting trades.

In our view, a firm can be an MTF operator whether or not it performs any other MiFID investment service or activity listed in A1 to A7.

Q27. We are an alternative trading system operator. Do we have to re-apply to the FSA to operate a multilateral trading facility?

No. Broadly speaking, any authorised person who operates an alternative trading system prior to 1 November 2007 is automatically granted permission to operate a multilateral trading facility, unless it notifies the FSA to the contrary by 1 October 2007.

Q28. What about ancillary services (Annex 1, section B)? Do we need to be authorised if we wish to provide these services?

Yes, but only when providing these services is a *regulated activity*, for example, if you provide custody services which fall within the *regulated activity* of *safeguarding and*

administering investments. You are not an investment firm within the scope of MiFID, however, if you only perform ancillary services (regardless of whether these are *regulated activities* or not).

Q29. We are an investment firm - can we apply for passporting rights that include ancillary services?

Yes, but only if:

- you carry on the ancillary services together with one or more investment services and activities; and
- where the ancillary service is also a *regulated activity*, you have a permission enabling you to carry on those activities.

You will not be able to apply for passporting rights in respect of ancillary services only.

13.4 Financial Instruments

Q.30. Where do we find a list of MiFID financial instruments?

In Section C of Annex 1 to the Directive. There are ten different categories of financial instruments in Section C (C1 to C10). Transferable securities (C1) and money market instruments (C2) are defined in article 4. Further provisions relating to C7 and C10 are contained in articles 38 and 39 of the draft *MiFID implementing Regulation*.

Q31. What are transferable securities? (C1 & article 4.1(18))

Transferable securities refer to classes of securities negotiable on the capital markets but excluding instruments of payment. We consider that instruments are negotiable on the capital markets when they are capable of being traded on the capital markets.

Transferable securities include:

- shares in companies (whether listed or unlisted, admitted to trading or otherwise) and securities of partnerships and other entities that are equivalent to shares in companies;
- bonds and other forms of securitised debt;
- depositary receipts;
- securities giving the right to acquire or sell transferable securities (for example, warrants, options, futures and convertible bonds); and
- securitised cash-settled derivatives, including certain futures, options, swaps and other contracts for differences relating to transferable securities, currencies, interest rates or yields, commodities or other indices or measures.

Q32. What are units in collective investment undertakings (C3)?

This category of financial instrument includes units in regulated and unregulated collective investment schemes. In our view, this category also includes closed-ended corporate schemes, such as investment trust companies.

Q33. Which types of financial derivative fall within MiFID scope (C4, 8 and 9)?

The scope of financial derivatives under MiFID is wider than under the ISD and includes the following:

- derivative instruments relating to securities, currencies, interest rates or yields, or other derivative instruments, financial indices or measures, that may be settled physically or in cash (C4);
- derivative instruments for the transfer of credit risk (C8); and
- financial contracts for differences (C9).

The scope of C4, C8 and C9 does not extend to spot transactions, transactions which are not derivatives (such as commodity forwards entered into for commercial purposes) and sports spread bets.

Q34. What are derivative instruments for the transfer of credit risk (C8)?

Derivative instruments that are designed for the purposes of transferring credit risk from one person to another. They include credit default products, synthetic collateralised debt obligations, total rate of return swaps, downgrade options and credit spread products.

Q35. Which types of commodity derivative fall within MiFID scope?

Broadly speaking, the following commodity derivatives fall within the scope of MiFID:

- a derivative relating to a commodity derivative, for example, an option on a commodity future;
- cash-settled commodity derivatives (including physically settled derivatives that provide for settlement in cash at the option of one of the parties other than in the event of default or termination);
- physically settled commodity derivatives traded on a *regulated market* or MTF; and
- other commodity derivatives capable of physical settlement and not for commercial purpose, that is standardised contracts subject to clearing house or margin arrangements so long as they fall into one of the following categories:
    - instruments traded on a non-EEA trading facility that performs an analogous function to a *regulated market* or MTF;
    - instruments expressly stated to be traded on or subject to the rules of a *regulated market*, MTF or such a non-EEA trading facility that performs an analogous function; or
    - back-to-back contracts with clients or counterparties equivalent to contracts traded on a *regulated market*, MTF or such a non-EEA trading facility.

Q36. What is a commodity for the purposes of MiFID?

"Commodity" means any good of a fungible nature that is capable of being delivered, including metals and their ores and alloys, agricultural products and energy such as electricity (article 2.1 of the draft *MiFID implementing Regulation*). If a good is freely replaceable by another of a similar nature or kind for the purposes of the relevant contract (or is normally regarded as such in the market), the two goods will be fungible in nature for these purposes. Gold bars are a classic example of fungible goods. The concept of commodity should not include services or other items that are not goods, such as currencies or rights in real estate, or that are entirely intangible (recital 22 of the draft *MiFID implementing Regulation*).

Q37. Are there any other derivatives subject to MiFID regulation?

There is a miscellaneous category of derivatives in C10, which is supplemented by articles 38 and 39 of the draft *MiFID implementing Regulation*. These relate to:

- climatic variables;
- freight rates;
- inflation rates or other official economic statistics;
- telecommunications bandwidth;
- commodity storage capacity;
- transmission or transportation capacity relating to commodities, whether cable, pipeline or other means;
- an allowance, credit, permit, right or similar asset which is directly linked to the supply, distribution or consumption of energy derived from renewable resources (for example, greenhouse gas emission allowances);
- a geological, environment or other physical variable;
- any other asset or right of a fungible nature, other than a right to receive a service, that is capable of being transferred; or
- an index or measure related to the price or volume of transactions in any asset, right, service or obligation.

C10 derivatives must also meet at least one of the following criteria:

- the contract is settled in cash or may be settled in cash at the option of one or more of the parties, otherwise than by reason of default or other termination event; or

- the contract is traded in a *regulated market* or an MTF; or
- the contract is standardised, subject to clearing house or margin arrangements and falls into one or more of the categories described under the fourth bullet point in Q.34 above.

13.5 Exemptions from MiFID

Q38. Where do we find a list of MiFID exemptions?

In articles 2 and 3 of MiFID.

Q39. Could you give me an idea of the types of firm and people that might be able to rely on the exemptions?

The exemptions in article 2 MiFID are likely to be relevant to insurers, group treasurers, professional firms to which Part XX of the *Act* applies, professional investors who invest only for themselves, pension schemes, depositaries and operators of collective investment schemes, journalists and commodity producers and traders. The Treasury implementation of the exemption in article 3 MiFID is relevant to an independent financial adviser with a requirement on its permission that it cannot hold client money. In each case, it will be for firms and individuals to consider their own circumstances and consider whether they fall within the relevant exemptions.

Q40. We are an insurer. Does MiFID apply to us?

No. Insurers are exempt from MiFID (article 2.1(a)).

Q41. We are a non-financial services group company providing investment services to other companies in the same group. Are we exempt under the group exemption in article 2.1(b)?

Yes, if you provide these services exclusively for your parent company, your subsidiaries and those of your parent company. This means that providing investment services for the benefit of group companies must be the only investment service that you undertake. If you provide investment services for group companies and for other third parties (other than services involving the administration of employee share schemes), then all of your services are subject to regulation.

Q42. We also buy and sell financial instruments for ourselves. Are we still able to use the group exemption?

Yes. The group exemption applies to investment services and not investment activities. So, as long as your dealing does not involve you providing a service to third parties, you can still rely on the group exemption in respect of the services you provide solely to other group

companies. You will, of course, need to consider whether your investment activities (i.e. buying and selling instruments on your own account) are regulated and may be able to rely on article 2.1(i) MiFID (see Q.48) if you are dealing on own account. The combination of this exemption with that in article 2.1(b) MiFID could be relevant to companies performing group treasury functions.

Q43. We provide investment services as a complement to our main professional activity. Are we exempt?

Yes, you will be exempt under article 2.1(c) MiFID if you provide these services in an incidental manner in the course of your professional activity, and that activity is regulated by legal or regulatory provisions or a code of ethics that do not exclude the provision of investment services. The meaning of "incidental" is potentially subject to further Commission legislation pursuant to article 2.3 MiFID, although as at **[insert date of publication]** there was no Commission mandate to CESR to advise on this issue.

This exemption is relevant, for example, to firms belonging to *designated professional bodies*, such as accountants, actuaries and solicitors, to whom Part XX of the *Act* applies. It could also apply to certain *authorised professional firms* who provide investment services in an incidental manner in the course of their professional activity. In our view, the criteria set out in PROF 2.1.14G in relation to section 327(4) of the *Act* are also relevant to considering whether a firm can rely on the exemption in article 2.1(c) MiFID. *Authorised professional firms* may also wish to consider whether they are exempt from MiFID requirements by virtue of the domestic implementation of the article 3 optional exemption (see Q. 52-57).

The article 2.1(c) MiFID exemption may also apply to journalists and broadcasters, although in most cases the FSA would not expect either to fall within the MiFID definition of investment firm (see Q. 9 and 22).

Q44. We regularly buy and sell financial instruments ourselves but never as a service to third parties. Are there any exemptions which might apply to us?

Yes, you could fall within the article 2.1(d) MiFID exemption but not if you:

- are a market maker (please see Q.45 below); or

- deal on own account outside a regulated market or an MTF on an organised, frequent and systematic basis by providing a system accessible to third parties in order to engage in dealings with them. Trading on a non-EEA market (for example, NASDAQ) would be outside a regulated market in this context. A system for these purposes might include a trading platform, website or other mechanism that functions on the basis of a set of rules.

You cannot rely, however, on the article 2.1(d) MiFID exemption if you provide any investment services or activities other than dealing on own account. If buying and selling financial instruments is not your main business, or, as the case may be, the main business of your group, you might also fall within the exemption in article 2.1(i) MiFID (see Q. 48).

Q45. What is a market maker?

A market maker is "a person who holds himself out on the financial markets on a continuous basis as being willing to deal on own account by buying and selling financial instruments against his proprietary capital at prices defined by him" (article 4.1(8) MiFID). This is likely to be the case if you are recognised or registered as a market maker on an investment exchange. However, in our view anyone who satisfies the definition will be a market maker for the purposes of MiFID, even if they are not under an obligation to make quotes.

Q46. Is there an exemption, as there was under the ISD, relating to employee share schemes and company pension schemes?

Yes, there is an exemption in article 2(1)(e) MiFID for persons providing investment services consisting exclusively in the administration of employee-participation schemes, for example employee share schemes and company pension schemes. In our view, whilst administration for these purposes could extend to services comprising reception and transmission or execution of orders on behalf of clients or placing, it would not include investment advice in relation to employee share schemes or company pension schemes.

This exemption can also be combined with the "group exemption" in article 2.1(b) MiFID, by virtue of article 2.1(f) MiFID. In our view, it may also be combined with the exemption in article 2.1(i) MiFID if a firm is dealing on own account in financial instruments as an ancillary activity to its main business, or, as the case may be, the main business of its group, including where the main business is the administration of employee share schemes or company pension schemes.

Q47. Are we right in thinking that MiFID does not apply to collective investment undertakings and their operators?

Yes. Generally speaking, collective investment undertakings are specifically exempt, as are their depositaries and managers. The "manager" corresponds, in essence, to the operator of a collective investment scheme and not to a person who is managing the assets of the undertaking (unless that person is also the operator). In our view, the operator only benefits from the exemption in respect of any investment services or activities it may carry on as operator of a collective investment undertaking, and it falls outside the exemption to the extent that it also provides investment services or performs activities in a different capacity, for example, if it provides investment advice to, or manages the assets of, a third party.

In the case of *UCITS management companies*, some MiFID provisions will apply to those who provide portfolio management services, investment advice or safekeeping and administration services to third parties, by virtue of article 5.4 of the *UCITS Directive*. See Q. 8 above.

Q48. Who can rely on the exemption in article 2.1(i)?

You may be able to rely on the exemption if:

- you deal on own account in financial instruments (that is, any of the instruments in C1-C10); or
- provide investment services in commodity derivatives or C10 derivative contracts.

However, the exemption will only apply if what you do is ancillary to your main business or, as the case may be, the main business of your group (if you are part of a group) and that main business is neither investment services nor banking services.

In our view, a firm which is part of a non-investment or banking group and which provides investment services in commodity derivatives or C10 contracts for its own clients (and not simply those of its group), for example as a stand-alone business, is likely to fall outside the scope of the article 2.1(i) exemption.

Q49. What is an ancillary activity for these purposes?

The meaning of "ancillary" is potentially subject to further European Commission legislation pursuant to article 2.3 MiFID, but as at **[insert date of publication]** there was no European Commission mandate to CESR to advise on this issue. For an activity to be "ancillary" for these purposes, in our view, it must at least be both directly related and subordinate to the main business of the group. Where, for example, a firm buys or sells commodity derivatives for the purposes of limiting an identifiable risk of the main business, as per the risk management exclusion in article 19 of the *Regulated Activities Order*, in our view this would qualify as ancillary for these purposes. On the other hand, where a commodity producer deals on own account for speculative purposes, it is unlikely that this would be ancillary to the main business in the case of article 2.1(i) MiFID. This activity may fall, however, within the article 2.1(k) MiFID exemption (see Q. 50 below).

Q50. Our main business is producing commodities and we sell commodity derivatives. We are a member of a non-financial services group. Are we exempt from MiFID?

Yes. You will be exempt under article 2.1(k) MiFID because you are a person:

- whose main business consists of dealing on own account in commodities and/or commodity derivatives, and
- who is not part of a group whose main business is the provision of other investment services or banking services.

The question of what is your main business for the purposes of article 2.1(k) MiFID is determined on an entity basis and not on a group basis (which is different from the approach taken in article 2.1(i) MiFID). You should also note that the article 2.1(k) MiFID exemption refers to commodities and/or commodity derivatives but not C10 derivatives.

Recital 18 of the draft *MiFID implementing Regulation* indicates that the exemptions in article 2.1(i) and (k) MiFID could be expected to exclude significant numbers of commercial producers and consumers of energy and other commodities, including energy suppliers and commodity merchants.

Q51. We traded on an investment exchange as a local firm and were exempt from the ISD. Are we exempt under MiFID?

Yes. If you fell within the exemption in article 2.2(j) ISD for local firms and continue to perform the same services and activities, you should generally fall within the exemption in article 2.1(l) MiFID. If you provide investment advice, however, you will not be able to rely upon the exemption in article 2.1(l) MiFID.

Q52. Article 3 is an optional exemption. Will the exemption apply to UK firms?

Yes, the optional exemption is exercised by HM Treasury in Part 4 of the draft Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2006 (the "draft MiFID Regulations").

Q53. Which firms might fall within this exemption?

The exemption applies to persons who are receiving and transmitting orders, or giving investment advice, or both, who meet the following conditions:

- they do not hold clients' funds or securities;
- they do not provide any investment service other than reception and transmission of orders or investment advice, or both, in relation to transferable securities and units in collective investment undertakings;
- they transmit orders only to one or more of the following:
    - other MiFID investment firms;
    - credit institutions authorised under the BCD;
    - branches of third country investment firms or credit institutions complying with rules considered by the FSA to be at least as stringent as those laid down in MiFID, the BCD or the CAD;
    - collective investment undertakings or their managers (that is, operators) authorised under the law of a Member State to market units to the public;
    - investment trust companies.

Under the draft MiFID Regulations, if you meet these qualifying conditions, you will be automatically exempt from regulations made by the European Commission under MiFID.

Q54. We are (or previously were) an IFA and have a permission which covers (i) arranging (bringing about) deals in investments; (ii) making arrangements with a view to transactions; and (iii) advising on investments, in each case in relation

to securities but not derivatives. We are not permitted to hold client money or investments. Are we exempt?

The FSA expects so, assuming you do not:

- carry on activities outside your permission; or
- transmit orders to persons other than those listed above (see answer to Q.53); or
- place financial instruments without a firm commitment basis. See Q. 24-25.

We would generally not expect IFAs to be placing financial instruments without a firm commitment basis as we associate placing of financial instruments with situations where a company or other business vehicle wishes to raise capital for commercial purposes, and in particular with primary issues.

Q55. What happens if we breach any of the qualifying conditions (see Q. 53)? Do we then lose the exemption?

This depends on when you notify us of the breach. Under regulation 6 of the draft MiFID Regulations, you must notify us within six months of the breach. If you fail to do so, you automatically lose the benefit of the exemption as of nine months from the date of breach. You cannot then re-apply to be an exempt firm until a period of twelve months has elapsed from loss of exempt status (regulation 7 of the draft MiFID Regulations).

If you do notify us within six months of the date of breach, we will then decide whether you should continue to benefit from the exemption.

Q56. If we fall within the exemption does this mean that we cannot acquire passporting rights under MiFID?

No. Regulation 8 of the draft MiFID Regulations contains a mechanism enabling firms who would otherwise be exempt to opt into MiFID regulation and apply for the passport by making the appropriate notifications to the FSA (although they would then become subject to the requirements of MiFID, including certain enhanced prudential requirements – see Q.62 below).

Q57. What is the practical effect of exercising the optional exemption for those firms falling within its scope?

MiFID requirements do not apply to firms falling within the optional exemption, where this has been exercised by a firm's Member State. Firms falling within the exemption will still need to be authorised as it is a requirement of the exemption that the activities of firms are regulated at national level. It is for the FSA to determine the requirements which apply to such firms.

13.6 The recast Capital Adequacy Directive

Q58. What is the purpose of this section?

This section is designed to help UK investment firms consider:

- whether the recast CAD, as implemented in the UK, applies to them;
- if so, which category of firm they are for the purposes of the FSA's base capital resources requirements made under the recast CAD, for example whether they are a *BIPRU 50K firm*, a *BIPRU 125K firm*, a *BIPRU 730K firm*, a *UCITS investment firm*, an *exempt CAD firm* or a firm falling within the transitional regime for certain commodity brokers and dealers; and
- how the recast CAD otherwise impacts on their business, by explaining when a firm will be a *limited licence firm*, a *limited activity firm* or a *full scope BIPRU investment firm*.

This section is intended to provide a general summary of these issues and not a detailed or exhaustive explanation of the recast CAD as implemented in the UK.

Q59. Are we subject to the recast CAD?

Only investment firms subject to the requirements of MiFID are subject to the requirements of the recast CAD. This includes *UCITS investment firms* (see Q.8 above and Q.67 below).

Despite being subject to the requirements of MiFID, broadly speaking, if you are one of the following investment firms our implementation of the recast CAD will only apply to you in a limited way:

- a firm whose main business consists exclusively of providing investment services or activities in relation to commodity derivatives and/or C10 derivatives, and to whom the ISD would not have applied. If you fall into this category, you will fall within a transitional regime under which you will not be subject to the capital requirements of the recast CAD but will be subject to other requirements (see Q.61 below); or
- a firm that is only authorised to provide investment advice and/or receive and transmit orders without holding client money or securities. If you fall into this category, you will be an *exempt CAD firm* and only subject to base capital requirements under the recast CAD (see Q.62-63 below).

If you are an investment firm to which an exemption in either article 2 or article 3 MiFID applies (see PERG 13.5 and Annex 1 flow chart 2), you are not subject to the recast CAD. However, if you potentially fall within the article 3 exemption, but decide to opt into MiFID regulation, for instance to acquire passporting rights (see Q.56 above), you are subject to the recast CAD. If you do so, you are an *exempt CAD firm*.

Q60. We are an investment firm to which MiFID applies and do not fall into one of the limited categories described above. How does the recast CAD apply to us?

You are a *CAD investment firm*. Broadly speaking, you should go through an initial two stage process in considering how the recast CAD will apply to you:

- consider what kind of base capital requirements apply to you; and
- consider whether you are a *limited licence firm*, a *limited activity firm* or a *full scope BIPRU investment firm* to determine how other capital requirements of the recast CAD apply to you.

You are either a *BIPRU 50K firm* (subject to a base capital requirement of euro 50,000) (see Q.64 below), a *BIPRU 125K firm* (subject to a base capital requirement of euro 125,000) (see Q.65 below), a *BIPRU 730K firm* (subject to a base capital requirement of euro 730,000) (see Q.66 below) or a *UCITS investment firm* (see Q.67 below). Which base capital requirement applies to you depends on the scope of your *permission* and any limitations placed upon it.

If you are a *CAD investment firm*, in essence the scope of your *permission* and any limitations placed upon it also dictate whether you are a *limited licence firm*, a *limited activity firm* or a *full scope BIPRU investment firm*. Broadly speaking, the benefit of being a *limited licence firm* or a *limited activity firm* (see Qs 67-69 below) is that you are exempt from minimum own funds requirements to hold capital to cover operational risk, although you are subject to the requirements to hold own funds calculated by reference to credit risk, market risk and fixed overheads. If you are a *full scope BIPRU investment firm*, you are subject to the full range of recast CAD risk requirements (see Q.70 below). See, generally, GENPRU 2.1.16R in relation to the calculation of capital resources requirements for *limited licence firms, limited activity firms* and *full scope BIPRU investment firms*.

The question of whether you are a *limited licence firm* or a *limited activity firm* may also be relevant to capital treatment at a group level. This is outside the scope of this guidance which focuses only on the application of the recast CAD at the level of the individual firm, although you may find the decision tree at BIPRU 8 Ann 2R helpful in considering these issues.

Q61. How do we know if we are a firm to which the transitional regime for certain commodity brokers and dealers applies?

You are a firm to which the transitional regime applies if:

- you are a firm to which the ISD did not or would not have applied on 31 December 2006; and
- your main business consists exclusively of the provision of investment services or activities in relation to financial instruments set out in C5, 6, 7, 9 and 10 of Annex 1 of MiFID.

This exemption is only relevant if you are a firm to which MiFID applies, i.e. you do not fall within the exemptions in articles 2 or 3 of MiFID (see Q.59 above). Although you are exempt from the capital requirements of the recast CAD, you are subject to risk management requirements (see article 34 recast CAD and article 22 recast BCD).

Q62. How do we know whether we are an exempt CAD firm and what does this mean in practice?

Broadly speaking, you are an *exempt CAD firm* if the only investment services that you are authorised to provide are investment advice or receiving and transmitting orders or both, without holding client money or securities.

As such, the starting point (article 7 recast CAD) is that you are only subject to base capital requirements which comprise the following broad options:

- base capital of euro 50,000; or
- professional indemnity insurance of euro 1,000,000 for any one claim and euro 1,500,000 in aggregate; or
- a combination of base capital and professional indemnity insurance resulting in an equivalent level of coverage to the options above.

Where you hold client money for purposes unconnected with providing investment advice or receiving and transmitting orders, in our view you can still be an *exempt CAD firm*. This might include, for instance, when you hold money or securities for clients to whom you only provide services that do not constitute investment services and therefore fall outside the scope of MiFID.

The conditions relating to the article 3 MiFID exemption look similar to those for an *exempt CAD firm*. There are important differences, however, between the two:

- the article 3 MiFID exemption (see Q.53 above) extends only to services provided in relation to transferable securities and units in collective investment undertakings, whereas no such restriction applies to *exempt CAD firms*; and
- broadly speaking, the article 3 MiFID exemption requires orders to be transmitted to authorised investment firms, credit institutions and collective investment schemes only, whereas no such restriction arises in the case of *exempt CAD firms*.

The category of *exempt CAD firm* may be relevant to various firms, including *securities and futures firms* that were *Category D firms*. It could also be relevant if you are a firm which only falls outside the article 3 MiFID exemption because you:

- transmit orders to unregulated collective investment schemes or offshore vehicles; or
- decide to opt into MiFID regulation to acquire passporting rights (see Q.56 above).

There is also a special exemption under the recast CAD for locals that do not fall within this exemption for local firms under MiFID. However, we do not think that UK regulated firms that are subject to the regulatory regime for locals prior to MiFID implementation are likely to fall within the exemption under the recast CAD.

Q63. If we are subject to the Insurance Mediation Directive, does this make any difference to the requirements which apply?

Yes. If the only investment services that you are authorised to provide are investment advice or receiving and transmitting orders or both, without holding client money or securities, you can still be an *exempt CAD firm*. However, you are subject to different base capital requirements. Broadly speaking, article 8 recast CAD requires you to have professional

indemnity insurance of euro 1,000,000 for any one claim and euro 1,500,000 in aggregate (this is the *IMD* requirement), plus coverage in one of the following forms:

- base capital of euro 25,000; or
- professional indemnity insurance of euro 500,000 for any one claim and euro 750,000 in aggregate; or
- a combination of base capital and professional indemnity insurance resulting in an equivalent level of coverage to the options above.

As mentioned in Q.62 above, when you hold client money or securities for purposes unconnected with providing investment advice or receiving and transmitting orders, in our view you can still be an *exempt CAD firm*. This might include, for instance, when you hold client money for those to whom you provide insurance mediation services.

You should also bear in mind that if you are a firm to whom article 2 or article 3 MiFID applies, you are not subject to the recast CAD (see PERG 13.5 above).

Q64. Are we a BIPRU 50K firm?

You are a *BIPRU 50K firm* if you:

- are not authorised to deal for own account in, or underwrite on a firm commitment basis issues of financial instruments;
- offer one or more of the following services: (a) reception and transmission of orders; (b) execution of orders; and/or (c) management of individual portfolios of investments (see Qs 15, 17 and 19 above); and
- are not authorised to hold client money or securities (because your *permission* contains a limitation or requirement prohibiting the holding of client money and does not include *safeguarding and administering investments*).

Q65. Are we a BIPRU 125K firm?

You are a *BIPRU 125K firm* if you:

- are not authorised to deal for own account in, or underwrite on a firm commitment basis issues of financial instruments;
- offer one or more of the following services: (a) reception and transmission of orders; (b) execution of orders; or (c) management of individual portfolios of investments (see Qs 15, 17 and 19 above); and
- do hold client money or securities or are authorised to do so.

You may also be a *BIPRU 125K firm* if you meet the conditions of article 5.2 recast CAD. Broadly speaking, this applies to investment firms which execute investors' orders and hold financial instruments for their own account provided that:

- such positions arise only as a result of the firm's failure to match investors' orders precisely;
- the total market value of all such positions is subject to a ceiling of 15% of the firm's initial capital;
- the firm meets the requirements laid down in articles 18, 20 and 28 recast CAD (including own funds requirements in respect of position risk, settlement and counterparty credit risk and large exposures); and
- such positions are incidental and provisional in nature and strictly limited to the time required to carry out the transaction in question.

Firms subject to article 5.2 recast CAD should also consider Q.68 below.

Q66. Are we a BIPRU 730K firm?

If you are a *CAD investment firm* and you are neither a *BIPRU 50K firm* nor a *BIPRU 125K firm* nor a *UCITS investment firm* (see Q.67 below), you will be a *BIPRU 730K firm*.

Q67. We are a UCITS investment firm. How will the recast CAD apply to us?

UCITS investment firms (*UCITS management companies* that are authorised to perform the additional services of portfolio management, investment advice and safeguarding and administration) are subject to the recast CAD in parallel with the capital requirements in the *UCITS Directive*.

If you are a *UCITS investment firm*, you continue to be required under the *UCITS Directive* to have:

- a minimum base capital requirement of euro 125,000; and
- an additional amount of own funds equal to 0.02% of the amount by which the value of the portfolios under management exceeds euro 250,000 (subject to an overall maximum base capital requirement of euro 10,000,000).

In our view, a *UCITS investment firm* should be a *limited licence firm* (see Q.68 below), as the *UCITS Directive* prevents it from dealing on own account outside of its scheme management activities. As a result, where a *UCITS investment firm* has a *dealing in investments as principal* permission, this should be limited to box management activities where MiFID financial instruments are concerned. A *UCITS management company* not authorised to perform the additional services described in the first paragraph above is not a *CAD investment firm*.

Q68. Are we a limited licence firm?

A *limited licence firm* is one that is not authorised to provide the investment services of:

- dealing on own account; and
- underwriting and/or placing financial instruments on a firm commitment basis.

You can be a *limited licence firm* if you are either:

- a *BIPRU 50K firm* (see Q.64 above); or
- a *BIPRU 125K firm*.

Generally, you cannot be a *limited licence firm* if you are a *BIPRU 730K firm*. However, you may be a *limited licence firm* if you operate a multilateral trading facility (and therefore are a *BIPRU 730K firm*) and do not have a *dealing in investments as principal* permission enabling you to deal on own account or to underwrite or place financial instruments on a firm commitment basis.

Q69. Are we a limited activity firm?

A *limited activity firm* is a *BIPRU 730K firm* that deals on own account only for the purpose of:

- fulfilling or executing a client order; or
- gaining entrance to a clearing and settlement system or a recognised exchange when acting in an agency capacity or executing a client order.

There is also a category for certain firms who, among other things, do not hold client money or securities and have no external customers. We do not think that any UK regulated firms are likely to fall within this third category of *limited activity firm*.

Q70. What is the effect of being a CAD investment firm which is neither a limited licence firm nor a limited activity firm?

You will be a *full scope BIPRU investment firm*, subject to the full range of recast CAD risk requirements.

Q71. We are an investment firm currently subject to CAD. Are our base capital requirements likely to change as a result of the recast CAD?

Generally speaking, we would expect most investment firms currently subject to CAD base capital requirements to be subject to the same base capital requirements following implementation of the recast CAD in the UK. This is summarised in high level terms in the following table:

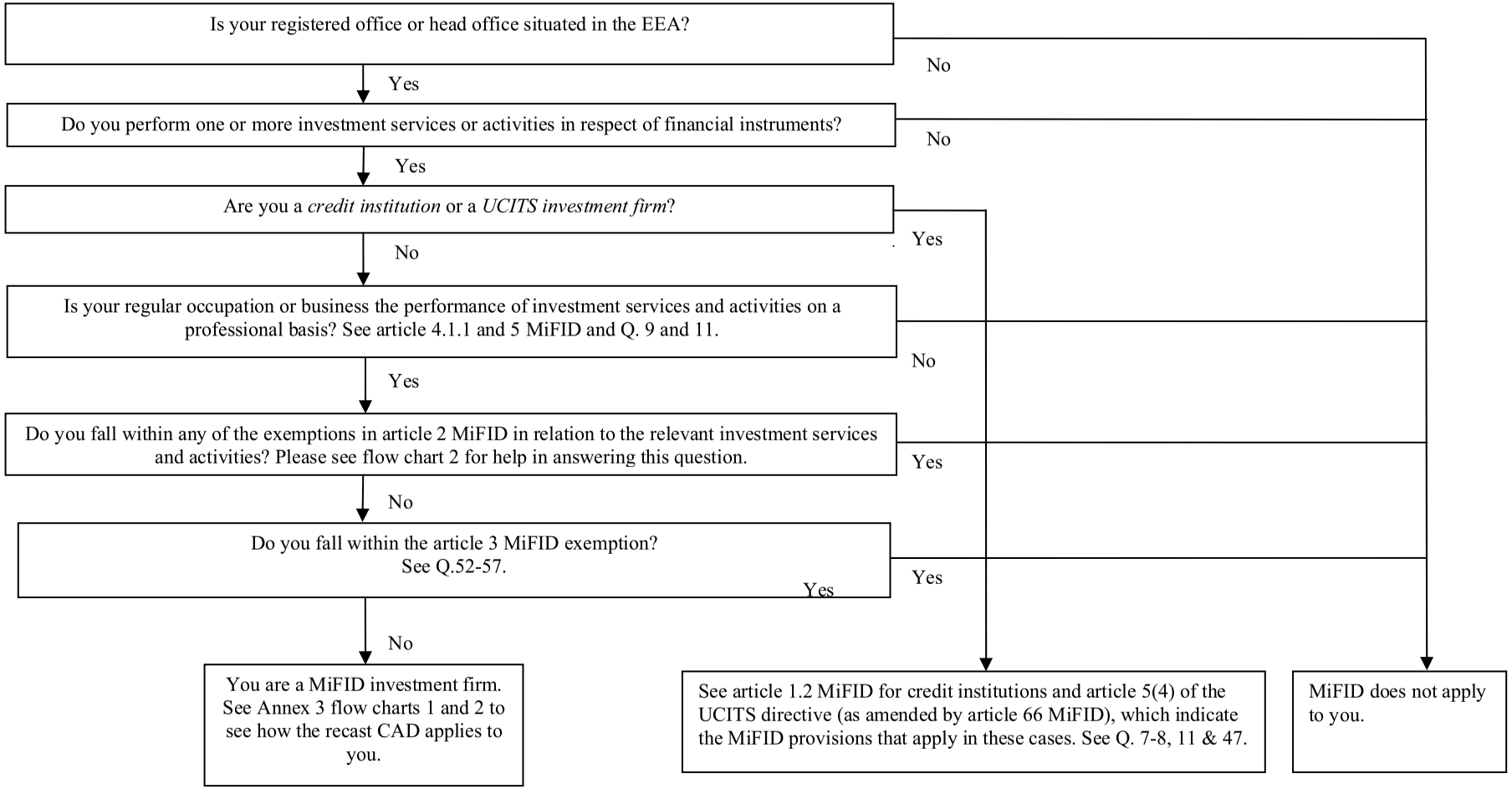
Old firm category under CAD			**New firm category under the recast CAD**
Securities and futures firm	**Personal investment firm**	**Investment management firm**	
Category A firm	Category A1 firm	Euro 730,000 firm	*BIPRU 730K firm*
Category B firm	Category A2 firm	Euro 125,000 firm	*BIPRU 125K firm*
Category C firm	Category A3 firm	Euro 50,000 firm	*BIPRU 50K firm*
Category D firm	Category A3 firm that is not permitted to manage	N/A	*Exempt CAD firm*

	investments		

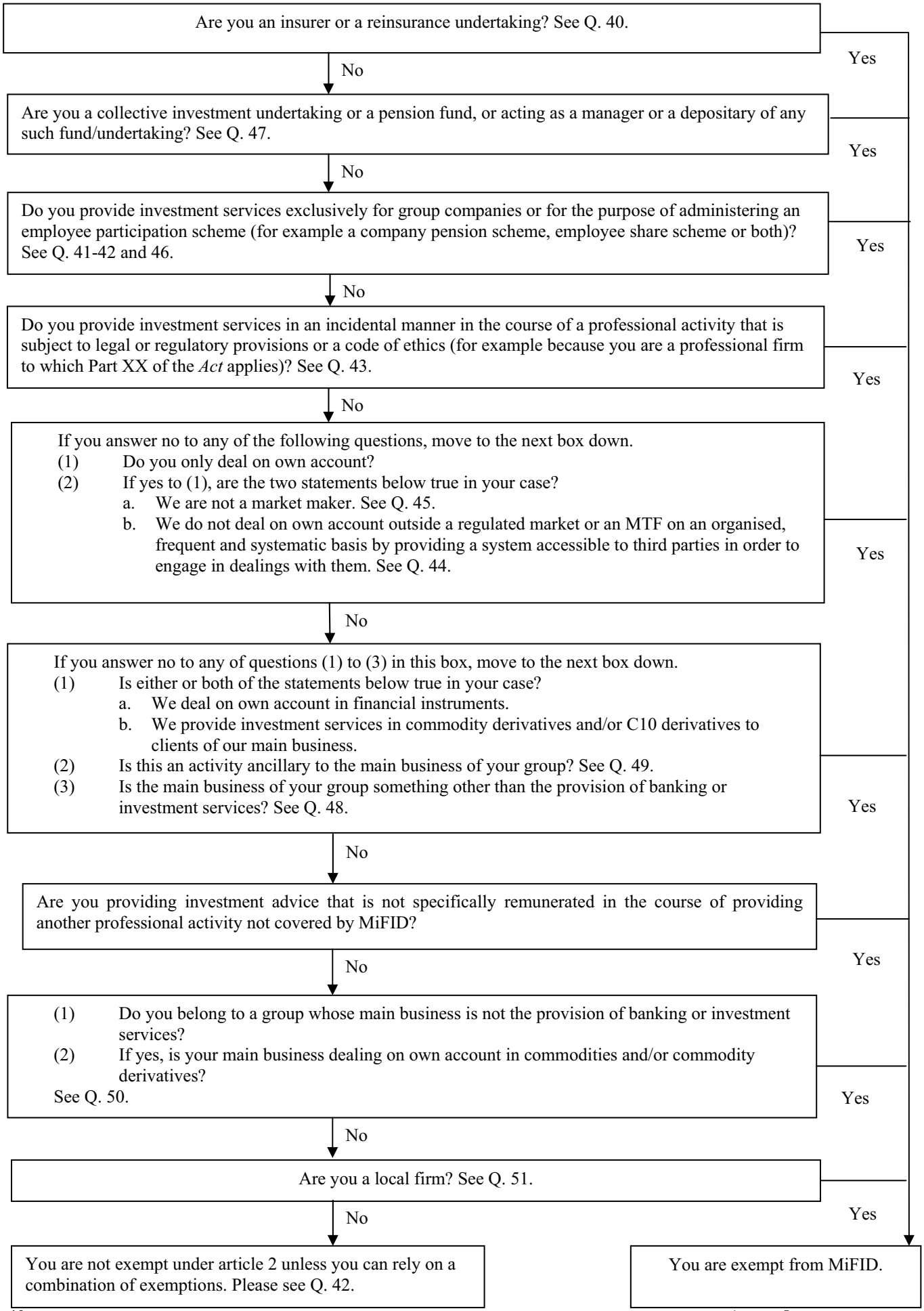
You will need to consider, however, changes in MiFID when compared to the ISD in order to see whether they impact on your base capital requirements. For example, firms operating an MTF will be subject to a base capital requirement of euro 730,000. The extension of scope to include investment advice as an investment service and commodity derivatives, credit derivatives and financial contracts for differences as financial instruments may also be relevant to you.

ANNEX 1

Flow chart 1- Does MiFID apply to us?



Flow chart 2- Am I exempt under article 2 MIFID?



ANNEX 2

Table 1 - MiFID Investment services and activities and the Part IV permission regime

MiFID Investment Services and Activities	Part IV permission	Comments
A1- Reception and transmission of orders in relation to one or more financial instruments	Arranging (bringing about) deals in investments (article 25(1) *RAO*). Making arrangements with a view to transactions in investments (article 25(2) *RAO*)	This is an existing ISD service. Generally speaking, only firms with permission to carry on the activity of arranging (bringing about) deals in investments in relation to securities and contractually based investments which are financial instruments can provide the service of reception and transmission. This is because a service must bring about the transaction if it is to amount to reception and transmission of orders. The activity of arranging (bringing about) deals in investments is wider than A1, so a firm carrying on this regulated activity will not always be receiving and transmitting orders, for example if it is carrying on the MiFID ancillary service of "advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to mergers and the purchase of undertakings". Article 25(2) *RAO* activities could also correspond to A1 where ongoing arrangements involve the arranger bringing about particular transactions. This could be the case, for example, where a firm operates an anonymous order-matching system. With the creation of a new regulated activity of operating a multilateral trading facility, it seems unlikely though that a firm that performs the article 25(2) *RAO* activity but not the article 25(1) activity will be receiving and transmitting orders. See Q. 15-16 for further guidance.
A2- Execution of orders on behalf of clients	Dealing in investments as agent (article 21 *RAO*)	This is an ISD service. Usually, where a firm executes orders on behalf of clients it will need permission to

	Dealing in investments as principal (article 14 *RAO*)	carry on the activity of dealing in investments as agent. Where a firm executes client orders by dealing on own account or on a true back-to-back basis, it also needs permission to carry on the activity of dealing in investments as principal. See Q. 17 for further guidance.
A3- Dealing on own account	Dealing in investments as principal (article 14 *RAO*)	Dealing on own account falls within the ISD, but only where a service is provided. Under MiFID, dealing on own account is caught even if no service is provided. Where a firm is dealing on own account, it needs permission to carry on the activity of dealing in investments as principal. See Q. 18 for further guidance.
A4- Portfolio management	Managing investments (article 37 *RAO*)	This is an ISD service. A firm performing the portfolio management service needs a permission to carry on the activity of managing investments. Firms may also need permission to perform other regulated activities to enable them to give effect to decisions they make as part of their portfolio management. See Q. 8, 19 and 47 for further guidance.
A5- Investment advice	Advising on investments (article 53 *RAO*)	This was an element of an ISD non-core service. A firm providing investment advice will need permission to carry on the activity of advising on investments. See Q. 20 to 23 for further guidance.
A6- Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis	Dealing in investments as principal (article 14 *RAO*) Dealing in investments as agent (article 21 *RAO*)	This corresponds broadly to the service of underwriting in respect of issues of ISD investments and/or placing of such issues described in Section A4 of the Annex to ISD. Where a firm underwrites the issue of financial instruments which it holds on its

		books before they are sold or offered to third parties, it needs permission to carry on the activity of dealing in investments as principal. Where an underwriting firm sells the relevant instruments whilst acting as agent for the issuer and then purchases any remaining instruments, it needs permission to carry on the activity of dealing in investments as agent in relation to its selling activity and dealing in investments as principal in relation to its purchase of the remaining instruments. See Q. 24 for further guidance
A7- Placing of financial instruments without a firm commitment basis	Dealing in investments as agent (article 21 *RAO*) Arranging (bringing about) deals in investments (article 25(1) *RAO*) Making arrangements with a view to transactions in investments (article 25(2) *RAO*)	This corresponds in part to the service in Section A4 of the Annex to ISD outlined in the commentary to A6. Where a firm arranges the placement of financial instruments with another entity, it needs permission to carry on the activities of arranging (bringing about) deals in investments and most likely making arrangements with a view to transactions in investments. Where a firm either sells the relevant instruments on behalf of the issuer, or purchases them on behalf of the entity with which they have been placed, it also needs permission to carry on the activity of dealing in investments as agent. See Q. 25 for further guidance.
A8- Operation of Multilateral Trading Facilities	Operating a multilateral trading facility (article 25B *RAO*)	This service replaces the ATS operators regime. Firms performing this service will need permission to carry on the regulated activity of operating a multilateral trading facility. Broadly speaking, any authorised person who operates an alternative trading system prior to 1 November 2007 is automatically granted permission to operate a multilateral trading facility, unless it notifies the FSA to the contrary by 1 October 2007.

		Firms will not require permission to carry on any other regulated activities if all they do is operate a multilateral trading facility. See Q. 26 and 27 for further guidance.

Table 2: MiFID financial instruments and the Part IV permission regime

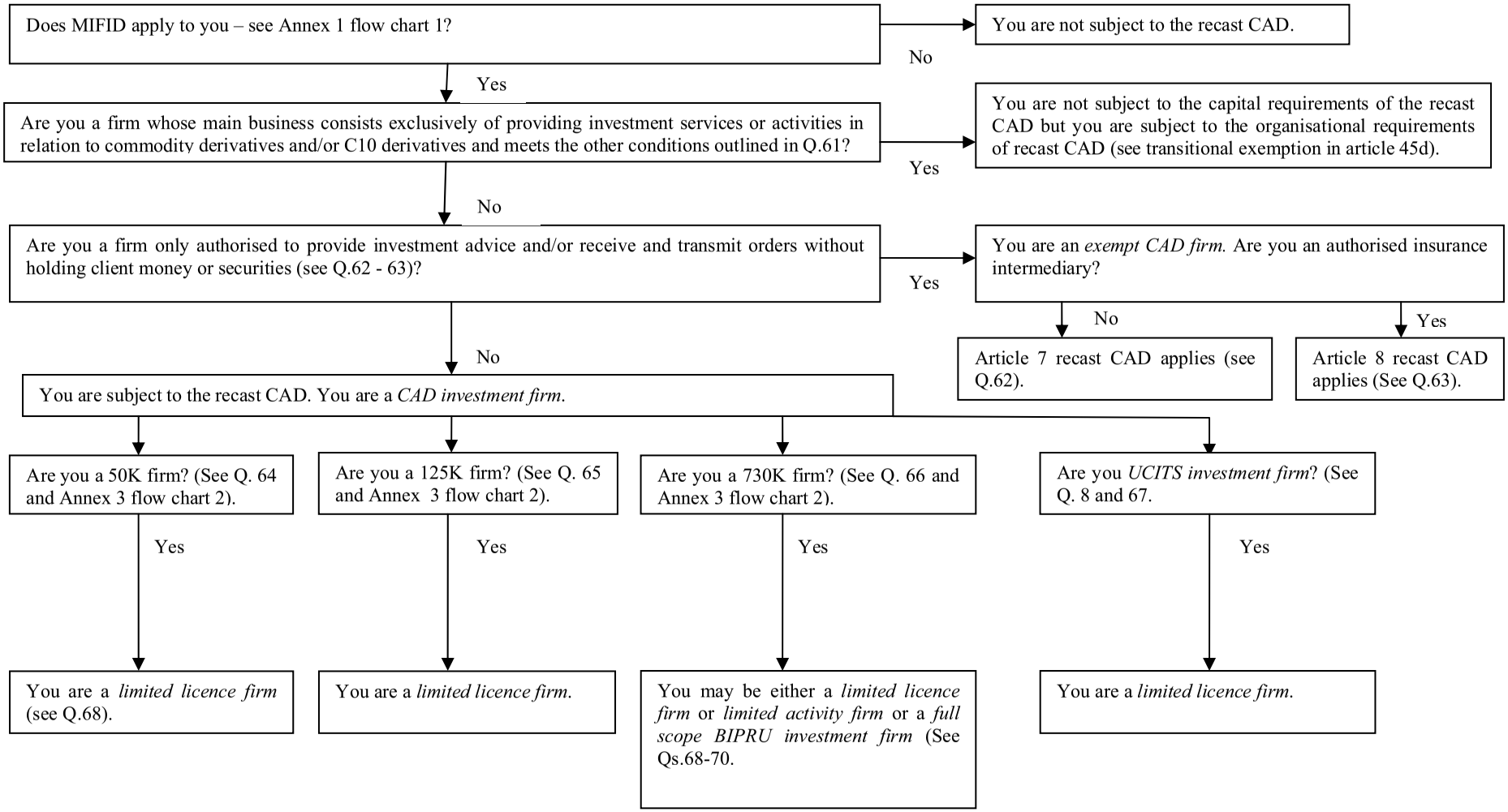
MiFID financial instrument	Part IV permission category	Commentary
C1- Transferable securities	share (article 76) debenture (article 77) government and public security (article 78) warrant (article 79) certificate representing certain securities (article 80) unit (article 81) option (excluding a commodity option and option on a commodity future) future (excluding a commodity future and a rolling spot forex contract) contract for differences (excluding a spread bet and a rolling spot forex contract) spread bet	Transferable securities are securities negotiable on the capital market excluding instruments of payment and include: (a) shares in companies (b) bonds; (c) depositary receipts; (d) warrants; and (e) miscellaneous securitised derivatives. Transferable securities comprise various categories of derivatives in the permission regime: for example, options (excluding commodity options and options on commodity futures); futures (excluding commodity futures and rolling spot forex contracts); contracts for differences (excluding spread bets and rolling spot forex contracts). The permission investment categories above, however, are wider than the MiFID definition of transferable securities, as they comprise both securitised and non-securitised instruments. Firms with permissions containing these investment categories will fall outside the article 3 MiFID exemption as transposed in domestic legislation, where they provide investment services in relation to non-securitised investments (for example, OTC derivatives concluded by a confirmation under an ISDA master agreement).

		For further guidance on the article 3 exemption see Q. 52-57; for further guidance on transferable securities see Q. 31.
C2- Money market instruments	debenture (article 77) government and public security (article 78) certificate representing certain securities (article 80)	The definition in article 4.1(19) MiFID refers to classes of instruments normally dealt in on the money markets.
C3- Units in a collective investment undertaking	unit (article 81) shares (article 76)	C3 includes units in regulated and unregulated collective investment schemes. This category also includes closed-ended corporate schemes, such as investment trust companies (hence the reference to shares in the adjacent column). For further guidance, see Q. 32.
C4- Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash	option (excluding a commodity option and an option on a commodity future) future (excluding a commodity future and a rolling spot forex contract) rolling spot forex contract contract for differences (excluding a spread bet and a rolling spot forex contract) spread bet	This category includes the financial instruments in sections B3-6 of the Annex to the ISD. For further guidance, see Q. 33.
C5- Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event)	commodity option and option on a commodity future commodity future contract for differences (excluding a spread bet and rolling spot forex contract)	C5 instruments will generally be contracts for differences. Where a C5 instrument provides for the possibility of physical settlement, it may also be either a commodity future or commodity option, depending on its structure.

		Note that for the purposes of the permission regime, commodity options and options on commodity futures are treated as a single permission category. (see PERG 2 Annex 2 Table 2). For further guidance see Q. 35-36.
C6- Options, futures, swaps, and any other derivative contracts relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF	commodity option and option on a commodity future commodity future contract for differences (excluding spread bet and rolling spot forex contract)	C6 instruments will generally be either commodity futures or commodity options, depending on their structure. Those instruments with a cash settlement option may also be contracts for differences. For further guidance see Q. 35-36.
C7- Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls	commodity option and option on a commodity future commodity future contract for differences (excluding spread bet and rolling spot forex contract)	C7 is supplemented by Level 2 measures (see article 38 of the draft *MiFID implementing Regulation*). For further guidance see Q. 35-36.
C8- Derivative instruments for the transfer of credit risk	option (excluding a commodity option and an option on a commodity future) contract for differences (excluding spread bet and rolling spot forex contract) spread bet rolling spot forex contract	C8 derivatives are financial instruments designed to transfer credit risk, often referred to as credit derivatives. For further guidance see Q. 33-34.
C9- Financial contracts for	contract for differences	C9 derivatives are those

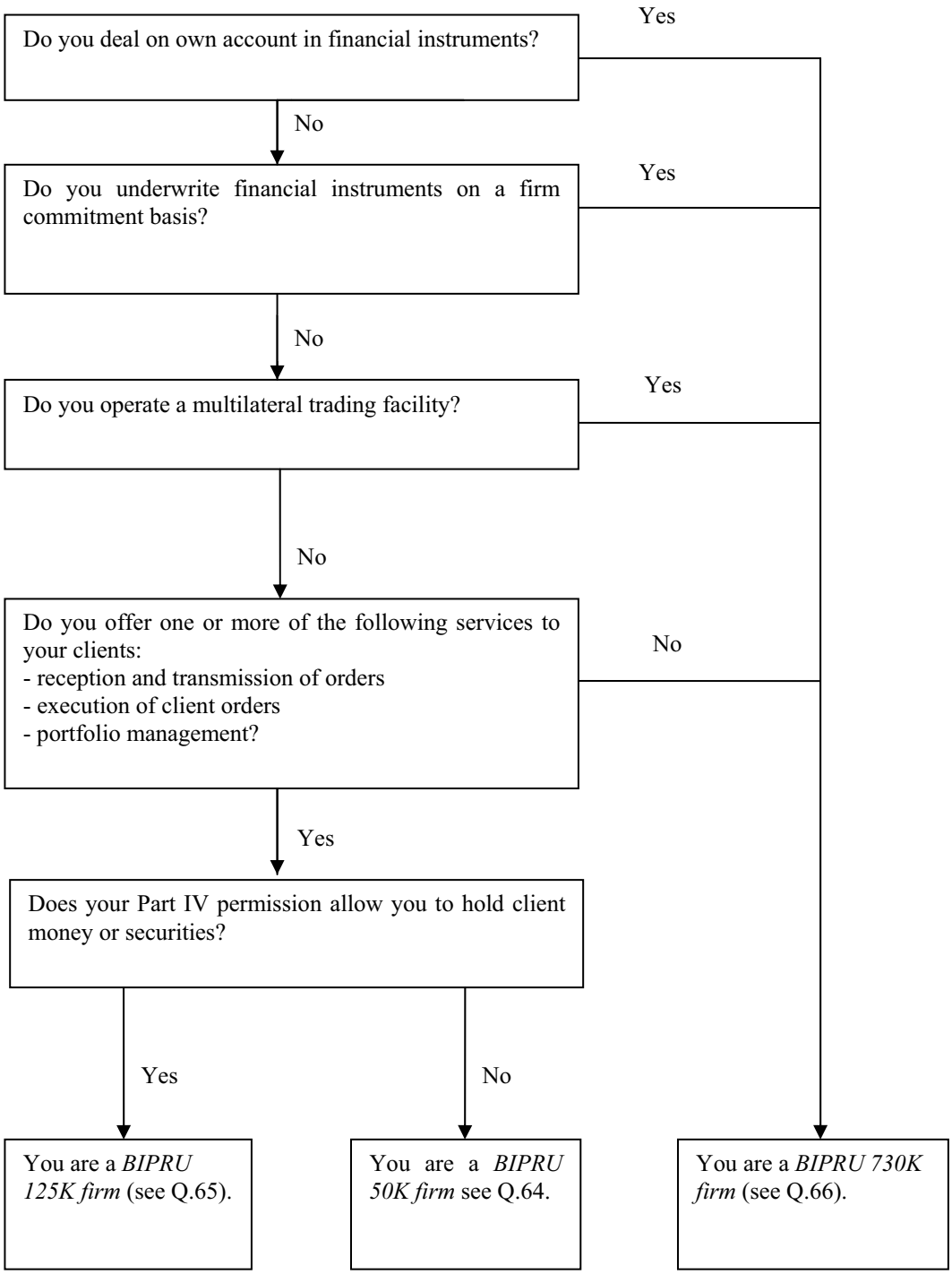
differences	(excluding spread bet and rolling spot forex contract) spread bet rolling spot forex contract	contracts for differences with a financial underlying, for example the FTSE index.
C10- Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls.	option (excluding commodity option and option on a commodity future) future (excluding a commodity future and a rolling spot forex contract) contract for differences (excluding spread bet and rolling spot forex contract) spread bet	C10 is supplemented by Level 2 measures (see articles 38 and 39 of the draft *MiFID implementing Regulation*) and comprises miscellaneous derivatives. For further guidance see Q. 37.

ANNEX 3
Flow chart 1- Are you subject to the recast CAD?



Flow chart 2 – *CAD investment firms* (excluding *UCITS investment firms*)

Are we a *BIPRU 50K firm*, a *BIPRU 125K firm* or a *BIPRU 730K firm*?



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