

08/20**

Financial Services Authority

Review of the
Prudential Rules for
Personal Investment
Firms

November 2008



Contents

1	Overview	3
2	Capital resources and requirements	8
3	Professional indemnity insurance	20
4	Leaving resources behind	25

Annex 1:	List of questions
Annex 2:	Cost benefit analysis
Annex 3:	Compatibility statement
Annex 4:	Capital resources calculation

Appendix 1:	Draft Handbook text
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The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 31 March 2009.

Comments may be sent by electronic submission using the form on the FSA's website at (www.fsa.gov.uk/Pages/Library/Policy/CP/2008/cp08_20_response.shtml).

Alternatively, please send comments in writing to:

Somia Shafiq
Capital Policy
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Telephone: 020 7066 9318
Fax: 020 7066 9319
E-mail: cp08_20@fsa.gov.uk

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A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

1 Overview

Introduction

- 1.1 In July 2007, we published Discussion Paper 07/04: *Review of the Prudential Rules for Personal Investment Firms* (the DP). In this Consultation Paper (CP), we refer to this as the ‘PIFs review’. The DP set out our early thinking in respect of potential changes to the prudential rules for personal investment firms (PIFs) and to industry practice, in order to better mitigate the market failures in the sector. Prudential rules here comprise capital resources and professional indemnity insurance (PII) requirements. In broad terms, a PIF is a firm for which the most substantial part of its gross income is derived from advising on investments or arranging deals in investments in relation to packaged products.
- 1.2 The DP invited responses to a number of questions designed to generate feedback, from the industry participants affected by our proposals and from other external stakeholders, on the need for changes to achieve the outcomes that we suggested were appropriate. The discussion period lasted until 7 January 2008 and was followed up with Feedback Statement (FS) 08/2. In the FS we summarised and commented on the responses and indicated how we would respond to the issues raised.

Links with the Retail Distribution Review (RDR)

- 1.3 The RDR, which is a separate but parallel project, is one of the core strands of our retail market strategy. It is essential for promoting a resilient, effective and attractive retail investment market and for delivering fair outcomes for consumers. It complements other FSA initiatives, including our work on Treating Customers Fairly and Financial Capability. The RDR set out to work with the market and facilitated comprehensive debates among a wide spectrum of practitioners, consumer representatives and other stakeholders on its future. The RDR FS was published on 25 November 2008 and its proposals are summarised in paragraph 1.6. We have reviewed the RDR proposals where they are relevant to this project and have considered our work with regard to the broader context of developments in the retail distribution sector.

Background

The PIFs review

- 1.4 Stakeholders had previously expressed concern that the current prudential requirements for PIFs are no longer fit for purpose. There have been two high profile failures in the PIF sector in recent years and one of the proposals from the RDR was that increased and risk-based capital resources requirements for PIFs should be explored.
- 1.5 Given the overlap between the PIFs review and the RDR, we presented our early thoughts and links to the RDR through the DP, which was published along with the RDR DP 07/1, A Review of Retail Distribution, in July 2007. We used the DP to set out our early analysis and findings and draw out the issues and challenges. We also picked up some of the RDR's themes and recommendations for further discussion across a broader group of stakeholders. The DP was intended to give us early feedback on the accuracy of our findings and the willingness of industry to: reform market behaviour; accept radical new proposals such as exit arrangements; and consider risk-based capital resources requirements.
- 1.6 The RDR FS¹ sets out a package of proposals to deliver the RDR's intended outcomes, which we intend to consult on next year, with the intention of full implementation by 31 December 2012, by which date all firms and individuals would need to meet the requirements. The measures that we regard as most fundamental to delivering the RDR's intended market outcomes are to:
 - improve the clarity for consumers of the characteristics of different service types and the distinctions between them;
 - raise professional standards; and
 - reduce the conflicts of interest inherent in remuneration practices and improve transparency of the cost of all advisory services.

Which firms are covered by this consultation?

- 1.7 Broadly, the PIFs review is relevant to PIFs that do not hold client assets and do not manage investments or deal in them as agent or principal. These firms are outside the scope of the MiFID² because their investment business falls within the scope of the MiFID Article 3 exemption, which HM Treasury has invoked in the UK. This exemption is available to firms that only receive and transmit orders in transferable securities and units in collective investment undertakings, to specified types of authorised firm, and provide advice on such investments without holding client assets. Such PIFs, while not subject to the full MiFID requirements, typically advise on and sell MiFID financial instruments (and equivalent insurance products) so compete with MiFID firms.

1 FS 08/6: *Retail Distribution Review Including feedback on DP 07/1 and the Interim Report.*

2 The Markets in Financial Instruments Directive.

4 CP08/20: Review of the prudential rules for PIFS (November 2008)

- 1.8 Since the issue of the DP a number of PIFs have chosen to opt-in to the MiFID so that they can use their passporting rights³ to service their clients in other Member States. These firms are referred to as exempt CAD⁴ firms (ECF). We have maintained the requirements for ECFs. The CP does not propose changes to the rules for ECFs other than in respect of terminology to be consistent with the rules for PIFs.

Market failure analysis

- 1.9 As we set out in the DP our market failure analysis identified the underlying failures for personal investment advice as:
- information asymmetry between consumers and advisors; and
 - principal-agent problems relating to a conflict of interest between consumers and advisors.
- 1.10 As discussed in the DP, these market failures are best addressed by Conduct of Business rules. However, the extent of claims on the Financial Services Compensation Scheme (FSCS) suggests that the market failures are not being fully corrected by current rules. The RDR's package of proposals seeks to address the root causes of long-term problems with how the retail investment market operates, for example to give more consumers confidence and trust in the market. The RDR proposals may address these market failures. The aim of these capital resources proposals is to complement the RDR in doing so. It aims to do so by requiring PIFs to bear more of the costs of redress claims for unsuitable advice, thereby internalising to an appropriate extent the externalities of their insolvency.

Structure of this paper

- 1.11 The CP is set out as follows.
- *Chapter 2: Capital resources and requirements* – This chapter streamlines and updates the capital resources and connected requirements calculations to apply them consistently to all firms in a clearer and simpler way.
 - *Chapter 3: Professional indemnity insurance* – This chapter outlines the proposed changes we intend to make to PII requirements. These changes include a new minimum additional capital requirement for firms holding PII policies with excluded business lines.
 - *Chapter 4: Leaving resources behind* – This chapter outlines the exploratory work we have carried out so far on developing a mechanism whereby PIFs that cease trading have arrangements in place so they bear more of the costs of their consumers' subsequent claims. That is 'the polluter pays'. We are not consulting formally on this work at this stage.

3 Passporting is where a UK firm wishes to carry on business in another EEA state (within the scope of a relevant EU Single Market Directive). This is called an EEA right in FSMA and exercising such rights is known as passporting.

4 Capital Adequacy Directive.

Who should read this paper?

- 1.12 This CP should primarily be of interest to non-MiFID PIFs, as it discusses options for changes to their prudential rules and to industry practice in the sector. It will be of relevance to MiFID PIFs, insurers and brokers providing PII and firms that provide long-term investment products through PIFs. This CP will also be of interest to consumers.

Summary of our work so far

- 1.13 As indicated in FS 08/2, the responses to the original DP and the three work streams suggested there may be limited scope for prudential rules to reduce the frequency of what we termed ‘mis-selling’ in the DP: there is more scope to reduce its impact. The reference to ‘mis-selling’ in the DP meant poor or unsuitable advice that leads to consumer loss, often resulting in a valid complaint leading to the payment of redress.
- 1.14 In the FS, we said we would consult on the options to refine and improve the capital resources regime and review professional indemnity insurance requirements.

In summary

- 1.15 Our proposals are:
- *capital resources*: revising the rules to simplify the calculation and make it consistent for all firms;
 - *capital requirements*: extending the expenditure-based requirement (EBR) to all firms based on three months of relevant annual expenditure with a minimum capital resources floor of £20,000 for all firms;
 - *own funds requirements*: removing the minimum requirement of £10,000 for all firms;
 - *PII*: setting out more specific requirements as to the level of additional capital resources needed where firms have exclusions in their PII policy; and
 - *leaving resources behind*: exploring mechanisms by which PIFs could be required to leave adequate resources behind to cover claims received after they have ceased authorisation. However, we believe that any proposals for change in this respect should be considered in light of the wider debate on pre-funding, which forms part of the work on Banking and Compensation Reform.

Reporting requirements

- 1.16 The proposed amendments to the Handbook on the capital resources regime and PII requirements will have a consequential effect on the reporting requirements. We shall consult on the proposed amendments to reporting data items, which include the

Retail Mediation Activities Return (RMAR), in 2009. Amending reporting requirements will necessitate changes to our electronic data collection, analysis and risk alert systems. These system changes will need to be effective from the commencement timetable of the proposed Handbook changes in this CP. The availability of funding to effect the system changes may impact on that timetable.

Next steps

- 1.17 We have aligned the issue of this CP with the RDR FS because of the connection between the two. The consultation period will last until 31st March 2009 and we expect to issue a Policy Statement (PS) when the rules are made: this is likely to be in the fourth quarter of 2009.

Smaller firms: This CP covers all non-MiFID PIFs (which we refer to as PIFs in this paper) and therefore the matters raised will affect smaller firms. The main issues for them to consider are the proposals in respect of capital resources, connected requirements, PII and the conclusion that the current PII rules seem appropriate. We have carefully considered the implications for smaller firms to ensure that any requirements are proportionate for them.

Consumers: This CP is important for consumers because the prudential requirements for non-MiFID PIFs may affect the quality of advice that they receive, as well as the ability to pay redress should the PIF provide unsuitable advice on investment products. Any changes to these requirements may also impact on the cost and supply of advice to consumers.

2 Capital resources and requirements

Introduction

Complex rules

- 2.1 The capital resources requirements for PIFs within the scope of this review were introduced by the Personal Investment Authority (PIA), a predecessor regulator, in 1994. The current format of the rules in IPRU (INV) Chapter 13 is broadly the same as in the PIA rules introduced when the Capital Adequacy Directive (CAD) was implemented in January 1996. In 2006, we amended the rules to reflect changes to firm classifications arising from the MiFID and the recast CAD. The lasting effect of these amendments is a very complicated set of prudential rules that has caused confusion for firms.
- 2.2 For example, all PIFs are currently subject to an own funds requirement of £10,000. In addition, if they are a network⁵ or have 26 or more advisers⁶, they are subject to an EBR of either four or thirteen weeks' 'relevant annual expenditure'. A network was made subject to a thirteen week EBR due to the extra risks perceived in transacting business through firms that it does not directly control other than by contractual arrangement.
- 2.3 We understand that the complexity of the rules can cause confusion for firms in identifying the sections that are relevant to them. The rules will no longer differentiate between low resource, network and other types of firms. All PIFs will be subject to the same prudential treatment.

Arbitrage opportunities

- 2.4 The existing rules for PIFs differentiate between low resource firms (those with 25 advisers or fewer) and other PIFs. As mentioned above, low resource firms are subject to £10,000 own funds, whereas other PIFs must meet additional capital resources

⁵ *Network*: Either (i) a firm with five or more appointed representatives (ARs) or (ii) a firm with fewer than five ARs, where the total number of advisers employed by those ARs is more than 25. Subject to a 13-week EBR.

⁶ *Firms with 26 or more advisers*: A firm that has a total of more than 25 advisers. The advisers in question may be employed by the firm itself or an AR. Subject to 4 weeks EBR.

rules, such as the adjusted net current assets test and EBR. The level of EBR varies across different types of PIFs, depending on the scale of their business activities. The capital resources that low resource firms need to meet the requirement are subject to less stringent features than those set for other PIFs. This distinction between the different types of PIFs through structure, size and numbers of advisers could be seen as encouraging firms to adopt business models based on what appears to be the most cost-effective prudential regime.

Our objective

- 2.5 Our proposed amendments will deliver a clear, simple and consistent approach to calculating the capital resources and requirements for all PIFs, regardless of their business model. By setting capital resources requirements at an appropriate level, coupled with capital resources of sufficient quality, we aim to reduce the market failures that lead to FSCS levy payer detriment in this sector.
- 2.6 PIFs that have opted into MIFID in order to take advantage of the passport are also relevant to our work. These ECFs essentially undertake the same business as PIFs, but are subject to a different prudential regime. Our proposed amendments to the rules for other PIFs will move towards consistent terminology in the rules on capital resources and connected requirements for both ECFs and other PIFs.

Summary cost benefit analysis for proposals on capital resources and capital requirements

Benefits

- 2.7 Inflation has eroded the real value of the capital resources we require PIFs to hold since these requirements were created in 1994. Our proposals increase the real value of capital resources we require to above the 1994 level. We expect higher capital requirements to increase incentives for firm managers to reduce the incidence of unsuitable advice. We believe higher capital resources will also imply a greater share of unsuitable advice claims is paid by firms rather than the FSCS. Such a transfer of burden would reduce the administrative costs of the FSCS. We believe PIFs' ability to exit the market before claims against them crystallize reduces the effectiveness of capital requirements somewhat, but not completely. Further, the proposals will simplify the capital resources rules for PIFs.
- 2.8 We expect these proposals to reduce the FSA's costs by £2.2 million per annum. We also expect our proposals to reduce compliance costs for the industry, to an extent we are not able to quantify but which we suspect is larger than £2.2 million. Annex 2 provides further details.
- 2.9 We expect that the proposed higher capital requirements will increase the probability that firms choosing to leave the industry will do so in an orderly manner, thereby reducing the administrative costs placed on the FSCS. We estimate this reduction to be in the region of £60,000. Details are provided in Annex 2.

- 2.10 Summing the two values above gives an estimated total benefit of £2.2 million per annum, plus the unquantified benefit in reduced compliance costs for firms.

Costs

- 2.11 We estimate that our combined capital resources proposals will require firms to raise an additional £600 – £850 million of capital by 2013. To turn this into an annual cost, we require an estimate of the cost of capital to PIFs. If we use an illustrative cost of capital of 4.2%, the annual cost would be £26-36m per year⁷. This is likely to be an over-estimate of the capital required as the calculation assumes that the number of PIFs will remain constant. However, the impact of these measures cannot be viewed in isolation of the RDR. It is possible that, in light of the costs of the combined measures in the RDR and these capital resources proposals, some PIFs will find it no longer profitable to continue operation. Therefore the capital PIFs require may be lower than the estimate provided. Firm exit could, however, create costs such as a reduction in the quantity or variety of services offered to consumers. We are not able to quantify the costs that would be associated with firm exit.
- 2.12 Annex 2 provides detailed derivations of the costs of capital listed above.
- 2.13 If firms incur additional costs, they may increase the price they charge consumers for advice or, as we note above, leave the market. Either response would, all else being equal, have a negative impact on consumers.

Capital requirements

- 2.14 PIFs are currently subject to the two financial resources tests detailed below, though low resource firms do not need to meet these tests and are only subject to a minimum own funds requirement of £10,000.

Financial Resource Test 1A	Financial Resources Test 2
Adjusted net current assets requirement	Expenditure-based requirement
Firms must at all times have adjusted net current assets of at least £1.	Firms must at all times have financial resources, calculated in accordance with the rules on capital resources, which equal or exceed the amount of: The highest of a proportion ⁸ of a firm's relevant annual expenditure; an amount equal to £400 multiplied by the number of advisers; or £10,000.

⁷ We stress that a 4.2% cost of capital would imply a PIF borrowed funds at, for example, 8.2%, held them in funds paying 4% interest, and thus had to pay a net cost of 4.2% of its borrowed funds as a risk premium.

⁸ These vary depending on the business model of the firm. Please refer to IPRU (INV) Chapter 13 for specific details.

Expenditure-based requirement (EBR)

- 2.15 We propose to extend the EBR to all firms and streamline the calculation to apply the same method for all firms.
- 2.16 The EBR has two key attributes: it reflects a measure of the size of the firm and it reflects the capital resources that a firm should hold in order to wind up in an orderly manner. It is also an easily understood concept; should be relatively simple to calculate; is reasonably certain (it is only calculated annually); and is likely to be proportional to the size of a firm. It is comparable to the fixed overheads requirement that applies to BIPRU firms and so provides a more level playing field for PIFs and ECFs.
- 2.17 For smaller firms, currently subject to the own funds requirement, the EBR calculation could be more complex, but this should not generate significant additional work for these firms, as we would expect them to already use information relating to their annual expenditure for their own internal management purposes.
- 2.18 We propose that all firms, regardless of their size and adviser numbers, should be subject to an EBR of three months, i.e. one quarter of relevant annual expenditure. Annual relevant expenditure refers to the fixed expenditure that a firm is committed to pay out regardless of the level of its income.
- 2.19 We refer to calendar months rather than weeks as this is a simpler concept to understand. Firms can translate one calendar month's EBR as $1/12 \times$ annual relevant expenditure, two calendar months = $2/12 \times$ annual relevant expenditure and so forth. This proposal maintains the standard for some of those firms with more than 25 advisers and eliminates the risk of lowering their capital requirement, but imposes the EBR on all firms.
- 2.20 We considered whether any other solution would deliver the outcome to meet our objective of ensuring PIFs had appropriate levels and quality of capital resources. We do not want our rules to encourage arbitrage opportunities between different business models and decided that applying a three month EBR would deliver an outcome most suited to our goals.
- 2.21 The proposed amendments to the EBR rules for PIFs include clarifying the language and making terminology consistent to remove any ambiguities. We have also made it clear that firms can exclude other variable expenditure from their EBR calculation, thus removing the need for firms to apply for a waiver under the current approach. Although we are not proposing any changes to the EBR policy for ECFs, we propose to amend the language and terminology for consistency purposes.

Q1: Do you agree with our proposal, to apply a three month EBR for all PIFs?

Minimum capital requirement

- 2.22 The analysis above explains how we propose to apply capital requirements for all firms. However, a firm's business structure could be such that it generates a very low EBR, which might not be commensurate with the business risks. We propose a minimum capital requirement that firms should hold regardless of their EBR calculation.
- 2.23 Low resource firms are currently subject to a flat-rate requirement, referred to as the own funds test. The EBR rules for other PIFs also include a minimum requirement. In both instances the minimum is £10,000.
- 2.24 A flat-rate capital requirement is simple to calculate and certain, making it particularly beneficial for small firms. However, there are drawbacks in that it bears no obvious relationship to a firm's risks. The current £10,000 own-funds requirement, which is the only requirement applied to low resource firms, is unlikely to deliver sufficient capital resources to cover most firms' risks, such as the need to meet unexpected expenditure. A number of respondents to DP 07/4 agreed with this point as they considered that PIFs' capital requirements were low compared to other regulated firms. In particular, there is no relationship with the size of the firm, which Europe Economics highlighted in the predictors of consumer loss study.
- 2.25 As an alternative to a minimum requirement, we considered one based on the number of advisers that the firm employs (either directly or indirectly using appointed representatives (ARs)). Although this requirement could be more proportional to the risks to the firm arising from the number of its advisers, it does not take into account the size of the firm by volume or value of business.
- 2.26 In line with the rest of our policy to align the capital resources and connected requirements for all firms, we propose to apply a minimum capital requirement and extend it to all firms regardless of their size. However, we consider the current flat-rate requirement of £10,000 (set in 1994) to be out-dated. To reflect subsequent inflation (estimated as bringing the minimum to £15,337 in 2008 if it had been linked to the Retail Prices Index (RPI)) and the minimum amount we consider a firm should be prepared to hold in its business to demonstrate credit worthiness, substance and commitment by its owners, we propose a minimum capital requirement of £20,000. This amount is in line with the €25,000 requirement for exempt CAD firms subject to the Insurance Mediation Directive (IMD). See Annex 2 for the detailed analysis.

Q2: Do you support our proposal to apply a minimum capital requirement of £20,000 for all firms?

Adjusted net current assets test

- 2.27 The adjusted net current assets test is broadly a solvency requirement. The test in its current form is the end result of a streamlining of the legacy prudential rules for PIFs. As this test is underpinned by a wider requirement for a firm to be able to meet its liabilities as they fall due, the test is in itself not adding any value, and we propose to remove it for all firms subject to IPRU (INV) chapter 13.

2.28 The removal of this test is not expected to change firms' behaviours. The costs and benefits of this proposal are expected to be negligible and there are no further cost benefit analysis (CBA) calculations on this in Annex 2.

Q3: Do you agree with our proposal to remove the adjusted net current assets test?

Capital resources

- 2.29 The capital resources calculation consists of two separate calculations; one to determine the capital for a firm's own funds and the other for the adjusted capital used to meet the EBR. PIFs that are currently referred to as low resource firms, do not have to calculate adjusted capital. Both calculations are suitably adapted for unincorporated PIFs. Having two different capital resource calculations suggests the different capital requirements could be met by capital of differing standards, which is not consistent with our prudential objectives.
- 2.30 Own funds are used to meet the £10,000 own-funds requirement and the definition involves a calculation of share capital and reserves (for a limited company) plus subordinated loans, minus any intangible assets and material current year losses.
- 2.31 Adjusted capital is the calculation of capital resources, which is used to meet the EBR. The relevant rules are complex but essentially involve deducting illiquid assets from own-funds, a restriction on the amount of subordinated loans and adjustments for assets such as land and buildings and investments.
- 2.32 As we are streamlining the capital requirements to remove the own funds test and replace it with a minimum capital floor as part of the EBR, there is no need to have two different methods to determine capital resources.
- 2.33 We propose:
- one definition of capital resources that applies consistently for all firms;
 - replacing complex rules with straightforward principles of calculating capital resources, in line with a more principles-based approach; and
 - some detailed changes to the calculation, including introducing a lower limit on inclusion of subordinated loans, clarifying the treatment of intra-group debtors and the use of personal assets by unincorporated firms (these changes are explained further below).
- 2.34 The proposals above will initially require some firms to undertake additional work to calculate their revised capital resources and connected requirement. Many of the additional components of capital resources may not be applicable to all firms, but if they are we would expect those firms to have the relevant information available for their own internal purposes.

- 2.35 It was clear from feedback to the DP and the drivers of capital work that firms value simplicity in the prudential rules. It is also clear from our review of the Retail Mediation Activities Return (RMAR) data that the degree of compliance with our rules, particularly among smaller PIFs, appears to be related to how simple they are to understand.
- 2.36 We propose a rationalised definition of capital for all non-MiFID PIFs to achieve a simplified approach that ensures the requirement is met by capital resources of an appropriate quality.

Q4: Do you have any comments on our approach to capital resources?

Proposed adjustments to the capital resources calculation

- 2.37 Annex 4 details the proposed capital resources calculation and we explain the various adjustments here.

Subordinated loans

- 2.38 Subordinated loans represent capital resources of a lower quality than share capital and reserves, as they do not absorb losses on a going concern basis. For further information on the features of capital please refer to DP 07/6, Definition of Capital⁹.
- 2.39 Currently, smaller PIFs, subject to the own-funds requirement, are not limited in their use of subordinated loans, while PIFs that are subject to the EBR are restricted to 400% of their share capital and reserves minus intangible assets. By comparison, ECFs are restricted to a limit of long-term subordinated loans of 50% of their tier one capital.
- 2.40 A 200% limit would align the gearing restrictions of PIFs more closely with the other full-scope¹⁰ investment firms, while at the same time recognising PIFs are not as likely to raise share capital in capital markets.
- 2.41 We propose a limit on subordinated loans of 200% of share capital and reserves (or equivalent) net of current year losses minus intangible assets.
- 2.42 The rules as proposed retain a standard form for subordinated loans which is unchanged from the current position. We would welcome views as to whether firms, using subordinated loans, find it helpful to use a form prescribed in this way.

Q5: Do you support the retention of a standard form for subordinated loans?

9 www.fsa.gov.uk/pages/Library/Policy/DP/2007/07_06.shtml

10 Investment firms subject to the re-cast Capital Adequacy Directive.

Illiquid assets

- 2.43 Illiquid assets are currently deducted as part of the adjusted capital requirement. We propose to continue with this policy in a revised definition of capital resources to ensure that it is represented by readily realisable assets only. This will be a new deduction for firms that are currently classified as low resource firms.

Intra-group debtors

- 2.44 The current adjusted capital calculation allows firms that are part of groups to include intra-group debtors as follows
- Non-trade debts can be included where the ‘...firm has no reason to doubt that they will be paid in full, on demand...’.
 - Trade debts can be included where they ‘...have been due and unpaid for less than 90 days...’ .
- 2.45 Our experience of the rule for non-trade intra-group debts is firms that are part of weakly-capitalised groups may include such amounts in the capital resources calculation, even though the financial position of the group may not support the immediate full repayment of these amounts. The relative solvency of the PIF may therefore be overstated. In practice, we may see that the amount of the non-trade intra-group debts can be a material amount.
- 2.46 To overcome this issue, we recognise the best evidence that a debt can be repaid in full is the fact that it has been so paid. Therefore, we propose to amend the rule so that all non-trade intra-group debtors are deducted in full from the capital resources calculation. This will mean that those firms and groups currently relying on intra-group funding will need to make arrangements to supplement their capital resources. Trade debts need not be deducted if they are unpaid for 90 days or less, but any trade debts still outstanding after 90 days should be deducted from capital resources. We do not expect firms to avoid the impact of these rules by artificial arrangements, such as rolling over due dates or paying and reinstating debts. This is a matter we intend to review further following implementation of the new rules.

Prepayments and accrued income

- 2.47 Prepayments and accrued income are currently included in the adjusted capital calculation, as long as the prepayments relate to goods or services to be received or performed within 90 days, or the accrued income is due within 90 days. In applying a policy consistent with the proposed treatment of debtors, we will continue to include these prepayments and accrued income.

Deposits

- 2.48 PIFs can currently include deposits of cash and balances on current or deposit accounts and even money deposited with a UK local authority, as long as these can be withdrawn within 90 days. As these deposits represent liquid funds, we will continue to allow firms to include these amounts in their capital resources calculation.

Current year net profits (losses)

- 2.49 The rules currently state that firms exempt from the provisions of Part VII of the Companies Act 2006, relating to the audit of accounts (section 477 (exemptions from audit)), are not required to have their retained profits audited and interim net profits verified for inclusion in capital resources.
- 2.50 As many PIFs are likely to be exempt from the statutory audit requirements, we propose to remove the need for verifying or auditing profits included in capital resources.

Contingent liabilities

- 2.51 PIFs other than low resource firms are required to deduct contingent liabilities. However, the current rules do not specify how much firms should deduct in respect of those contingent liabilities.
- 2.52 We propose to clarify that all firms should deduct the expected value of any contingent liabilities in respect of third party claims. (The expected value is the amount determined after weighting all the possible outcomes by their associated probabilities. The full value should be deducted where there is an intra-group or a connected party guarantee.) This might include overdrafts of other group companies for which the firm has given a guarantee.
- 2.53 We will extend the requirement to deduct contingent liabilities to all PIFs, though we expect many are unlikely to have circumstances causing contingent liabilities. So, in practice, this proposal may not generate additional requirements for most firms.

Personal assets

- 2.54 Currently, sole traders and partners can use personal assets as capital resources to make up any shortfall against the requirement. We do not propose any changes to this principle. However, it is important that personal assets treated as introduced capital resources should meet the same quality standards as assets held within the business. We propose these assets should be subject to the same deductions and adjustments.

Indemnity commission clawback debtors

- 2.55 The current rules require firms to make a provision (i.e. a deduction from capital resources) for the amount of expected commission repayment with a specified minimum of 2.5% of the value of indemnity commission received in the previous 12 months. We would expect firms to make an appropriate provision for this regardless of our rules, as it is required under accounting standards, even though the accounting standards do not specify a minimum amount.
- 2.56 Accounting standards allow a firm to include the amount they (particularly networks) can reclaim from their appointed representatives (ARs). Our policy, as developed through the rule waiver process, has been to allow firms to include a reasonable value for these debtors within adjusted capital, usually limited to a maximum of 85% of the accounts value. Although this approach is now established, it is not explicit in the rules.

- 2.57 Accounting standards are now clearer than before and we expect firms to be able to apply them properly. If we remove the prudential filter on indemnity clawback, we would not maintain the current policy that firms should make a provision for the minimum amount of 2.5% and firms would be able to include the value of the related debtor. However, any concerns as to the recoverability of such amounts should already be addressed when drawing up the accounts. We think the measures we are taking to refine prudential standards will reduce potential risks.

Discounted amount for investments

- 2.58 The current rules allow firms to include their investments in financial instruments (subject to a discounted amount) as assets in their capital resources calculation. Values can fluctuate depending on market conditions and we therefore cannot rely on including the full value of the investment in the capital resources calculation. In other words, these investments in financial instruments are risky assets and this should be reflected in the capital resources calculation. The current policy of applying a discount amount for investments is an adjustment that effectively applies a capital charge. We propose to continue this policy as it represents a prudent measure of capital resources and requirements.

Deficiencies in subsidiaries

- 2.59 Firms are required to deduct any deficiencies of net assets in their subsidiaries to recognise that, as the parent entity, they might be required to cover the shortfall. We shall continue to require this deduction.

Liability for tax

- 2.60 Similar to the treatment of indemnity commission clawback, accounting standards address the treatment for taxation and we expect accounts to include appropriate provision for tax liabilities. We propose to remove this prudential filter.

Long-term liabilities to connected persons

- 2.61 Long-term liabilities due to connected persons are not currently subject to the gearing restriction in the PIFs rules. In other words, they are included as capital resources rather than treated as liabilities. Unless these liabilities are subordinated we do not believe these should represent capital resources. We propose that only subordinated liabilities should qualify as capital. We discuss the need for this element of capital to be restricted earlier in this paper.

PASS loan adjustments

- 2.62 PASS loan adjustments arose following the pensions review. Life insurers contributed funds to provide loans to assist smaller PIFs in paying their pension review claims. Smaller PIFs could claim funds, which were used to pay claimants directly. These loans were eligible as capital resources, subject to certain restrictions. These loans should now have been repaid and they do not represent capital resources. We do not propose to include them within the amended definition of capital resources.

Market risk adjustments

- 2.63 There are certain market risk adjustments within the current adjusted capital rules. These do not appear to be relevant for PIFs and we propose removing them. The market risk adjustment includes debtors and creditors relating to unsettled securities transactions and the net open foreign currency position. For a full list, refer to the proposed amendments to the rules at Appendix 1.

Q6: Do you have any comments on the proposed amendments to the capital resources calculation?

Transitional provisions

- 2.64 The proposals will generate new capital resources requirements and adjustments to the capital resources calculation for all firms, in particular for those currently referred to as low resource firms.
- 2.65 We propose to introduce transitional provisions to raise additional capital resources over a period of time. One option we envisage is a staged transition, with full implementation to be achieved by 31 December 2012, at the same time as the proposals arising from the RDR are implemented. See Table 1 which sets out how we propose to transition the new capital resources requirements under this option. This would be the latest time we would expect to implement fully the proposed rule amendments. Another option would be to shorten the transitional period to end on an earlier date. This would ensure firms meet the new standards of capital resources and accompanying requirements to address, on a more timely basis, the market failures identified.
- 2.66 A fixed transitional period might be clear and simple and allow firms to make the appropriate arrangements to adjust their capital resources in line with the proposed rules by the stipulated deadline. The staged transition would set milestones which will enable firms and others including the FSA to monitor progress made towards full compliance with the new requirements.
- 2.67 Appendix 1 shows the proposed rules in IPRU (INV) chapter 13 that will come into effect after the transitional period.

Q7: Do you have any comments on the options above, in particular whether the transitional arrangements should end earlier than the end of 2012?

Table 1 PIFs CP transitional arrangements				
Implementation date	31 December 2009	31 Dec 2010	31 Dec 2011	31 Dec 2012 (Full implementation)
Capital requirement				
20K requirement		15K		20K
EBR		One month requirement (firms currently subject to a higher requirement will remain subject to that requirement)	Two month requirement (firms currently subject to a higher requirement will remain subject to that requirement)	Three month requirement for all firms
Capital resources deduction				
Subordinated debt 200%			400% limit on subordinated debt	200% limit on subordinate debt
PII requirements	For policies taken out on or after 31st December 2009. Additional capital requirements.			

3 Professional indemnity insurance

Introduction

- 3.1 In this chapter, we outline proposed changes to enhance our regulatory approach to professional indemnity insurance (PII) policy exclusions for PIFs. We also summarise how we intend to simplify our existing PII rules.
- 3.2 In December 2007, we commissioned Frontier Economics (Frontier) to review anecdotal evidence that our PII requirements were not delivering adequate protection for PIFs in the event of consumer claims. Frontier¹¹ found ‘no evidence of a current lack of competition or excessive levels of profitability in the market providing PII to PIFs’. Although we are not proposing to make substantial changes to the existing PII regime, we are recommending changes to our rules relating to exclusions.

Strengthening additional capital requirements

- 3.3 Broadly, PII is designed to protect firms from the financial consequences of unsuitable advice beyond their current capacity to pay and provide cover for general errors and omissions. This allows firms to continue business with less capital resources and/or enables them to put resources to more productive use. We understand that some firms use policy exclusions to improve the cost effectiveness of PII. We do not object to this, particularly when it is done as part of a risk assessment performed by the firm. However, it is important that our rules are clear on what minimum additional capital resources should be retained to cover such exclusions, to ensure that PIFs retain their ability to meet valid consumer claims.
- 3.4 The current PII regulatory framework relies on PIFs holding sufficient additional capital resources to cover the exposure created by PII exclusions. Our current rules do not specify the amount of capital resources that needs to be held. Exclusions may reduce the effectiveness of PII and, as a result, valid unsuitable advice or other claims may need to be met from existing capital resources if the advice relates to an excluded business line. If a firm’s capital resources are insufficient to meet outstanding claims from consumers, the firm may be declared in default and the FSCS (and other market participants, including other PIFs) may need to meet the cost of such claims.

11 Frontier Economics, A market study of Professional Indemnity Insurance for Personal Investment Firms, April 2008, p.3 www.fsa.gov.uk/pubs/other/report_pii.pdf

- 3.5 In their report, Frontier¹² found that in more benign PIF PII markets, exclusions were not widely incorporated in policy terms. However, they indicated that if a large increase in the number of claims relating to a particular product were to arise in the future, insurers may seek to exclude that business line from coverage in future policies.
- 3.6 PIFs also use exclusions to reduce their PII premiums or, alternatively, as a mechanism to reduce insurers' risk so that they are comfortable providing PII cover. This is consistent with the situation when the PIF PII market significantly hardened in 2003 and we issued nearly 1,000 waivers to firms. This type of market can be characterised by a lack of coverage in certain types of higher risk business lines and for increased cost of cover for firms.
- 3.7 We think that it would be more prudent for firms to hold a minimum level of additional capital resources where a business line is excluded. Policy exclusions that are not relevant to the business conducted by a particular PIF would not be caught by this requirement. Flexibility would be important to allow firms to make use of exclusions where the cost of cover is otherwise prohibitive, or firms are unable to obtain cover at all.
- 3.8 The minimum additional capital resources requirements we propose are outlined below.

Relevant income (£000s)		Minimum capital resources (£000s)
more than	up to	
0	100	5
100	200	12
200	300	18
300	400	21
400	500	23
500	600	25
600	700	27
700	800	28
800	900	30
900	1,000	31
1,000	1,500	37
1,500	2,000	42
2,000	2,500	46

12 *ibid*, p.35

2,500	3,000	51
3,000	3,500	55
3,500	4,000	59
4,000	4,500	63
4,500	5,000	67
5,000	6,000	73
6,000	7,000	79
7,000	8,000	85
8,000	9,000	90
9,000	10,000	95
10,000	100,000	95y
100,000	n/a	950
For firms with relevant income more than £10m but up to £100m value, y is calculated by relevant income/£10m		

- 3.9 We have constructed this table using the current additional capital trade off applied to PII policies with a £20,000 excess under the current rule IPRU (INV) 13.1.4(12)E. This basis has been used because we do not have specific data on the exposures created through existing PII exclusions. We have designed this table so as to create a floor for PIF additional capital requirements.
- 3.10 Firms will still need to assess their exposure where their PII policy excludes business lines and hold sufficient capital to cover this risk with capital above the minimum requirement if necessary. Where a firm's PII policy excludes a business line that it has never transacted, and does not intend to transact, then it will not be required to hold the minimum additional capital resources.
- 3.11 For example, if a firm has relevant income of £4.7 million, a PII policy with an excluded business line and the firm has either advised on this business line in the past or intends to do so in the future, they would need to hold additional capital resources of at least £67,000.
- 3.12 An estimate of the costs and benefits of our proposal is outlined below.

Cost Benefit Analysis

Benefits

- 3.13 The PII requirements will benefit consumers to the extent that they increase PIFs' ability to make higher redress payments while authorised. While a consumer can receive redress from the FSCS if the PIF is insolvent, the FSCS claim process is lengthier than direct dealing with the offending PIF. Since consumers will prefer to receive compensation sooner rather than later, faster compensation is to their benefit.

Costs

- 3.14 Our data show that approximately 2% of PIFs will need to hold additional capital resources to cover their PII exclusions under the new proposals. We estimate that complying with the new proposals will require additional capital of £1.6 million during benign periods. Again using our illustrative cost of capital of 4.2%, this implies an annual cost of £67,200.
- 3.15 However, when PII cover is more difficult to obtain (meaning the price of PII cover increases and/or PII exclusions become more common), these proposed capital requirements are likely to impose higher costs on some PIFs. We are unable to forecast the exact costs, but provide the following examples extrapolated from the current data shown above: the additional capital cost to PIFs at 5% PII exclusion rate would be approximately £4 million and at 20% would be £15.9 million. The annual costs, calculated as above, are £168,000 and £668,000 respectively.
- 3.16 We do not expect the change from evidential provisions to a rule in the Handbook (in particular for the PII £6 million indemnity limit and £5,000 excess) to change firms' behaviours. We expect the policy to have negligible benefits and costs. There are no further CBA calculations on this proposal in the CP.

Q8: Do you agree with our proposed minimum additional capital requirements for policy exclusions?

Handbook proposals

- 3.17 Appendix 1 outlines the new rules we propose. Our current regulatory framework relies on a combination of rules, evidential provisions and guidance, which set out that PIFs should hold a reasonable amount of additional capital resources to cover liabilities arising from an excluded business line or activity. In order to ensure that more firms have sufficient additional capital to cover PII policy exclusions we intend to convert our current relevant requirements into rules. This should remove any doubt about the current application of our rules.
- 3.18 We have also made a number of drafting changes to improve the clarity of the rules. For example, we have updated references so they are consistent with the definition of capital resources we discussed in Chapter 2.

3.19 We have re-structured the PII section of the rules to make them clearer and logical to follow. The re-structuring does not represent a change to the substance of the rules.

Q9 Do you agree with the proposed Handbook changes in Appendix 1?

4 Leaving resources behind

Introduction

- 4.1 In FS08/2 (April 2008) we said that we would explore appropriate mechanisms whereby PIFs that cease trading have arrangements in place so that they bear more of the costs of their consumers' subsequent claims (that is, 'the polluter pays'). The concern that those remaining in the market meet the full extent of departed firms' subsequent claims through the FSCS has been consistently expressed in feedback from the sector¹³.
- 4.2 As part of the PIFs review, we took the opportunity to consider policy on how resources might be left behind (LRB) to meet some of these costs. There was strong support for the principle of LRB in the responses to the DP.
- 4.3 In the DP, we set out three ways in which LRB might be used to settle successful claims of unsuitable advice made against firms that have ceased trading. These were run-off PII, a segregated trust to purchase run-off PII and a bonding requirement. Since the FS, we have explored these and other options.

Options mentioned in FS08/2

Run-off PII and segregated trust for run-off PII

- 4.4 Frontier explained that run-off PII is currently available on an annual 'claims made' basis. However, not many PIFs have taken it up in spite of the fact that there has been strong support for the LRB principle itself. This is possibly because of the cost involved and the need to take cover out each year.
- 4.5 In terms of creating a segregated trust to purchase run-off PII, Frontier looked at the amount PIFs might have to hold in order to make this purchase. They found that it was difficult to determine this amount in advance, with the issue further complicated by the cyclical 'hard' and 'soft' nature of the insurance market.

13 It should be noted that this is the approach that underpins all the activities of the FSCS. It is not specific to PIFs.

Bond and regulator run-off scheme

- 4.6 We studied the experience of other professional sectors in operating schemes of this nature. The schemes tend to operate with direct regulator involvement if not control. While ‘the polluter pays’, this comes with regulatory costs. There is an additional cost when the scheme’s funds are insufficient to meet the actual claims, so that those remaining in business end up funding the claims. Having an additional body responsible for compensation may also complicate consumers’ understanding of the compensation arrangements in place. Therefore, we think that the regulator-operated approach may not be a suitable solution.

Exploration of how LRB may work in practice

- 4.7 Apart from the options mentioned in the DP and the FS, we have also been exploring other ways that LRB may work in practice. Our focus is on how we might develop a requirement for a PIF, as a condition of authorisation, to have adequate resources to pay for consumers’ claims arising after it ceases to be authorised. Since we observed that a regulator-operated approach may not be a suitable option, we have been looking at an approach where the responsibility for making LRB arrangements rests with the firm and thinking of ways in which this may be achieved.
- 4.8 We have identified three possible options:
- LRB arrangements could be put in place when a firm leaves authorisation in an orderly fashion.
 - A trust could be set up at authorisation, with adequate funds to be used when the firm leaves authorisation in an orderly fashion or otherwise.
 - A combination of both regimes, so that the requirement to set up an LRB trust may be triggered at a certain point during authorisation, so funds would be available whether the firm leaves authorisation in an orderly fashion or otherwise.
- 4.9 There would need to be a basis for calculating the amount that could be left behind and/or subject to the trust. One approach would be to base the calculation on the firm’s redress payments and adviser number history so that it reflects the firm’s experience while authorised. However, this raises issues such as the quality of complaints/redress data available and the potential for manipulation of the firm’s internal complaint processes (to the detriment of consumers) in order to reduce the LRB requirement. This approach could be underpinned by a fixed minimum LRB requirement with the firm carrying out the compensation and adviser history calculations so that if the outcome is more than the fixed minimum, the firm leaves this amount behind.
- 4.10 We have also been considering whether LRB might be used to meet customer claims indefinitely or for a number of years following authorisation. Our view is that the LRB period should be of sufficient duration that the resource is there when needed, but as there would be cost involved in holding this capital, it should not be held for

so long that the costs to PIFs eventually outweigh the benefits. The experience of other professional sectors is that a period of six years is sufficient. However, this is a matter that would require further consideration if an LRB scheme were to be taken further.

- 4.11 Another aspect we have been exploring is whether after the LRB period has expired, any unused funds could be returned to the firm. If this is applied, the PIFs that do not have many claims of unsuitable advice upheld may be able to recover most of their funds left behind under the LRB scheme. This would be beneficial to PIFs in a position where most of their customers had no cause for complaint.
- 4.12 Where a PIF leaves authorisation in an orderly fashion, it could meet the LRB requirement in a number of ways (unless a trust was created). The PIF could:
- Enter into a commercial arrangement to transfer the responsibility for future claims, in respect of past business, to another authorised person. Currently, this occurs in our permissions process in some cases where a firm changes its legal status, e.g. from a partnership to a limited liability partnership (LLP); or
 - Leave resources within the firm. This option could be used by a firm that expected to continue to undertake non-regulated business.
 - Make an arrangement for adequate capital resources to be left with an appropriate person. The person appointed by the PIF could administer the fund, pay claims and distribute any surplus resources at the end of the period. The arrangements between the PIF and the LRB manager would be on a commercial basis and this option could be used by a firm that wanted to ‘wind up’ its business.
- 4.13 Consideration of how LRB may work in practice if PIFs are charged with putting the arrangements in place raises complex practical, legal and economic issues. These need further exploration. We would also need to know how such a regime may interact with the FSCS and the Financial Ombudsman Service (FOS). In particular, we would need to be satisfied that the proposals would not result in a worse outcome for customers by reducing the funds currently available for compensation or making it more difficult for the consumer to receive redress.

Funding of the FSCS

- 4.14 The FSCS assesses and settles (where upheld and within limits) consumer claims against firms in default. A firm is in FSCS default where it is unable or likely to be unable to pay claims against it. The FSCS is funded by levies on authorised firms. In the context of our work on LRB, and as with other sectors, the firms remaining in authorisation ultimately meet the cost of the consumer claims of those in default.
- 4.15 Currently, the FSCS is funded ‘ex-post’. The FSCS raises compensation levies, looking forward over a 12-month period, for any compensation levy requirements resulting from actual defaults or anticipated defaults over the relevant period. There are also

mechanisms in place for the FSCS to raise additional levies following unanticipated events or to fund an increased level of compensation payments.

- 4.16 The Tripartite Authorities are, in the context of recent work on the banking sector, working on strengthening the UK framework for financial stability and depositor protection. One of the objectives is providing effective compensation arrangements in which consumers have confidence. As part of this, funding arrangements for the deposit-taking sub-class of the FSCS are being considered.
- 4.17 Following publication of the latest consultation document in July 2008¹⁴, HM Treasury introduced the Banking Bill to Parliament on 7 October 2008. The Bill includes amendments to the Financial Services and Markets Act 2000 (FSMA) which would allow HM Treasury to make regulations which would enable the FSCS to fund itself using contingency funds (i.e. pre-funding) as well as under the current funding model (i.e. post-funding).
- 4.18 If the Bill is passed unchanged, a contingency fund could be established through regulations. HM Treasury would have powers to govern certain aspects of the fund, including its size, the period over which it should be built up and its membership. We would retain the power to set tariff measures for raising levies for the fund, as well as rules to govern its interaction with the current funding model. The issue of pre-funding has been looked at solely in the context of deposit-taking firms. No decision has yet been taken as to whether contingency (pre-) funding will be introduced for deposit-takers. Further consultation and engagement with stakeholders would take place before any conclusion was reached.
- 4.19 This debate is relevant to our work on LRB for PIFs because it concerns the funding of consumer claims against financial firms in default. Therefore, we shall monitor the developments in respect of FSCS funding arrangements before engaging in further consideration of the LRB options.

LRB outlook

- 4.20 Developing appropriate mechanisms, whereby PIFs that cease trading have arrangements in place to bear more of the costs of their consumers' subsequent claims, is a new area of prudential policy. We have examined the operation of schemes that other professional bodies have put in place for dealing with members' claims after they have ceased authorised practice. We have also looked at work that has already been carried out by us, such as the work on 'phoenixing' firms.
- 4.21 So far we have found no existing mechanism that appears likely to be practical and cost effective for PIFs. We propose to continue to develop the options for LRB, but in view of the considerations above, there is no formal consultation on LRB at this stage. We welcome comments on the work which has been done to date.

14 Financial Stability and Depositor Protection: Further consultation – July 2008
www.fsa.gov.uk/pubs/cp/jointcp_stability.pdf

4.22 We have deferred consideration of the LRB work stream pending the outcome of the Banking and Compensation Reform review. As this paper does not include any LRB proposals, we have not provided a cost benefit analysis.

Q10 Do you have any comments on LRB as discussed above?

List of questions

- Q1 Do you agree with our proposal, to apply a three month EBR for all PIFs?
- Q2 Do you support our proposal to apply a minimum capital requirement of £20,000 for all firms?
- Q3 Do you agree with our proposal to remove the adjusted net current assets test?
- Q4 Do you have any comments on our approach to capital resources?
- Q5 Do you support the retention of a standard form for subordinated loans?
- Q6: Do you have any comments on the proposed amendments to the capital resources calculation?
- Q7: Do you have any comments on the options above, in particular whether the transitional arrangements should end earlier than the end of 2012?
- Q8: Do you agree with our proposed minimum additional capital requirements for policy exclusions?
- Q9 Do you agree with the proposed Handbook changes in Appendix 1?
- Q10 Do you have any comments on LRB as discussed above?

Cost benefit analysis

Benefits

1. As Chapter 2 outlines, we anticipate that our proposed changes to capital resources and requirements will provide benefits in the form of a reduction in the administrative burden to the FSCS, reduced costs to the FSA, and reduced compliance costs to PIFs.
2. We outline below our estimate of the reduction in the administrative burden to the FSCS. To calculate the administrative burden, we perform 3 steps. First, we calculate the volumes of FSCS redress payments excluding the exceptional claims for mortgage endowments and personal pensions. Table 2 below calculates this as £7.8 million using past redress payments by the FSCS for claims against PIFs from 2001-2007.

Table 2

Table 2: Mean of FSCS redress, 2001-07 (£ million)								
	2007	2006	2005	2004	2003	2002	2001	Total
Total redress	N/a	149.5	201.2	174.7	197.6	194.4	40.9.3	958
PIF redress	21.2	89.7	103.1	61.4	66.9	63.9	14.5	400
Personal Pensions	10.1	56.7	67.2	47.6	63.9	61.8	13.6	311
Endowment Mortgages	6.7	22.7	11.0	2.8	1.4	0.7	0.3	39
Other PIF redress	4.3	10.4	24.9	11.0	1.6	1.3	0.7	50
Mean of Other PIF redress 2001-07 £7.8m								

- Second, using this estimate of the mean ‘Other PIF redress’ of £7.8m, we calculate the reduction in FSCS payments. In doing so, we assume for simplicity that these proposals prevent PIFs from leaving the industry as a result of holding insufficient capital. This reduction is shown in Table 3 below, based on historical data from the FSCS. From a review of FSCS files we believe that more than 4% of PIFs leave the industry due to insufficient capital. However, this value could change in light of the combined effect of these capital resources proposals and the RDR. Therefore, the 4% PIF exit rate (and the consequential reduction in FSCS payments) can only be taken as a guide.

PIFs leaving the industry 2001-07	3,370
FSCS files for PIFs identifying capital as the reason for exit	136 (4% of total)
Other PIF redress estimate (Table 2)	£7.8 million
Reduction of FSCS redress	£313,000 pa

- Third, using the data from the FSCS we calculate that about 18% of the past cost to the FSCS of PIF failures is the administrative cost of making payments and recovering PIF debts. Applying the 18% to the reduction in FSCS payments gives an expected reduction in FSCS administration costs to be in the region of £60,000 annually.
- We expect that our proposals will also result in a compliance cost saving for PIFs as we have simplified firm capital requirements. We will provide an estimate of these cost savings once we receive inputs from the relevant trade association. However, we expect the cost saving to industry will be at least as large as the £2.2 million we expect the FSA to save, as we understand that firms will only contact the FSA after internal deliberation.
- We estimate likely cost savings of £2.2 million for the FSA from these proposals. Table 4 below provides details, taken from an internal FSA survey.

Hours per complex capital requirement query	60
Recent percentage of problem cases for relationship managed firms	11%
Number of firms if this percentage is applied to whole PIF industry	610
Cost per hour	£61
Reduction in FSA’s cost per annum	£2.2m

7. Summing the two benefit figures (of £56,340 and £2.2 million) gives a minimum benefit of £2.2 million per annum.

Costs

8. As shown in Table 5 below, we estimate that our combined capital resources proposals will require PIFs to raise an additional £600 – £850 million by 2013.
9. Table 5 uses the most recent RMAR returns to estimate the amount of capital needed to be raised across the PIF industry. Our analysis indicates that approximately half of all PIFs will not need to raise any additional capital.

New capital to be raised (£s)	£m	Number of firms
0	0 - 0	2691 - 2576
0-10,000	2.5 - 2.3	483 - 429
10,000-20,000	12 - 11.4	1037 - 813
20,000-30,000	3.5 - 8.4	144 - 351
30,000-50,000	8.6 - 12.1	222 - 308
50,000-100,000	19.7 - 25.9	277 - 357
100,000-300,000	57.2 - 55.5	327 - 325
300,000-500,000	23.3 - 32.1	64 - 84
500,000-1m	34.7 - 29.8	50 - 43
1m-4m	45.3 - 73.7	25 - 40
4m-20m	115.3 - 55.2	14 - 7
20m+	292.3 - 527	6 - 7
Total	614.5 - 833.4	5340

- 10 This is likely to be an over-estimate of the capital required as the calculation assumes that the number of PIFs will remain constant. However, the impact of these measures cannot be viewed in isolation of the RDR. It is possible that, in light of the costs of the combined measures in the RDR and these capital resources proposals, some PIFs will find it no longer profitable to continue operation. Therefore, the capital required by PIFs may be lower than the estimate provided.

Compatibility statement

1. This annex explains why we have concluded that the proposals set out in this Consultation Paper are compatible with our general duties under section 2 of the Financial Services and Markets Act (FSMA). The requirement for a compatibility statement is set out in section 155 (2) c of FSMA.

Compatibility with our statutory objectives

2. The proposals are aimed principally at meeting our market confidence and consumer protection objectives.

Market confidence

3. We intend our prudential rules to maintain confidence in the UK financial system by reducing the risk of market disruption arising from the financial failure of PIFs.
4. Our proposed revisions to the requirements for capital resources and PII contribute towards this by ensuring that the risk of PIFs not being able to give redress following legitimate complaints is mitigated by adequate levels of capital resources.

Consumer protection

5. The proposed changes reduce the risk of consumers claiming redress from PIFs that cannot afford to pay it.

Public awareness and reducing financial crime

6. The proposed changes have no significant direct impact on our public awareness or financial crime objectives.

Principles of good regulation

7. Under section 2 (3) of FSMA we must consider, when carrying out our general functions, the specific matters set out below.
 - a. *The need to use our resources in the most efficient and economic way*
8. There is much discussion between us and PIFs about the meaning of the capital resources rules that apply to them. By removing current ambiguity in the rules, we expect the proposals to free up our resources from these repetitive discussions.
 - b. *The responsibilities of those who manage the affairs of authorised persons*
9. Consideration of this principle was not material to the decisions underpinning our proposals. Under our proposals, the senior management of firms will remain responsible for ensuring that their firms are adequately capitalised.
 - c. *The principle that a burden or restriction should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction*
10. The changes proposed will have cost implications for some firms, depending on their responses in terms of capital planning. In imposing this burden, we have had regard to the benefits set out in the cost benefit analysis.
 - d. *The desirability of facilitating innovation in connection with regulated activities*
11. Our proposals are not specifically designed to facilitate innovation and we do not expect them to have any effect on innovation.
 - e. *The international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom*
12. The location of PIFs within the UK's retail financial markets does not involve any competition between UK and non-UK firms. We do not expect our proposals to have any effect on the competitive position of the UK.
 - f. *The need to minimise the adverse effects on competition that may arise from anything done in the discharge of the FSA's functions*
13. The impact of these proposals cannot be viewed in isolation from the Retail Distribution Review (RDR). It is possible that, in light of the combined costs of the measures in the RDR and these capital resources proposals, some PIFs will find it no longer profitable to continue in operation.

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

14. We expect the proposals to facilitate efficient competition by making firms pay more of the redress for which they are individually responsible. This would reduce the extent to which firms competing on the basis of price and quality are undermined by firms with unsustainable business models.

h. Acting in a way which we consider most appropriate for the purpose of meeting our statutory objectives

15. We believe the proposals we have set out most appropriately address the aforementioned market failures and therefore are the most appropriate method of meeting our statutory objectives.

Capital resources calculation

The items in Stage B must be deducted from the items in Stage A. The result must then be added to items in Stage C ((A-B) + C).		
Stage A	Item	Note
	Paid up share capital excluding preference shares redeemable by shareholders within two years	Exclude any redeemable preference shares that fall due within two years. If preference shares are not redeemable by the shareholder within two years, they must be treated in accordance with rules 13.3.11R and 13.3.14R.
	Eligible LLP members' capital	
	Balances on proprietor's or partners': <ul style="list-style-type: none"> • capital accounts • current accounts Less: <ul style="list-style-type: none"> • excess LLP members' drawings • excess of current year drawings over current year profits 	
	Share premium account	

	Retained profits (losses) plus current year net profits (losses) (Note 1)	<p>Retained profits and retained losses are subject to the following adjustments:</p> <p>(1) the firm must deduct any unrealised gains or, where applicable, add back any unrealised losses on cash flow hedges of financial instruments measured at cost or amortised cost;</p> <p>(2) in respect of a defined benefit occupational pension scheme, the firm must derecognise any defined benefit asset;</p> <p>(3) the firm may substitute for a defined benefit liability the firm's deficit reduction amount. The election must be applied consistently in respect of any one financial year; and</p> <p>(4) where applicable, the firm must deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but exclude from the deduction or addition any asset or liability that will give rise to future cash flows) together with any associated deferred tax.</p>
	Revaluation reserve	These amounts do not need to be audited or verified.
	Subordinated loans	Subject to the limits set out in rules 13.3.11R – 13.3.14R

Stage B	Item	Note
	Intangible assets	Deduct intangible assets in full.
	Contingent liabilities	Deduct any contingent liability (including the overdraft of any other company that the firm has guaranteed).
	Deficiencies in subsidiaries	Include a deduction for the amount by which the liabilities of any subsidiary (excluding its capital and reserves) exceed its tangible assets. This requirement applies only to the extent that the firm has not already made such a provision in its financial statements.
	Non-trade debtors (including from group and connected companies)	Deduct amounts in full.
	Trade debtors (including from group and connected companies)	Deduct amounts due and unpaid for more than 90 days.
	Land and buildings (net of any liabilities secured on the assets)	Deduct 30% of the net book value of land and buildings.
	Accrued income	Deduct amounts receivable after more than 90 days.
	Prepayments	Deduct amounts which relate to goods or services to be received or performed after more than 90 days.
	Deposits	Deduct amounts other than: (a) cash and balances on current accounts and on deposit accounts with an approved bank or National Savings Bank which can be withdrawn within 90 days; (b) money on deposit with a UK local authority which can be withdrawn within 90 days; (c) money deposited and evidenced by a certificate of tax deposit.
	Other assets	Deduct amounts in full.

Stage C	Item	Note
C	Personal assets of partnerships or sole traders	A sole trader or a partnership may include personal assets (based on a current independent valuation) to make up any shortfall in the required capital resources needed to meet its capital resources requirement. The assets must be discounted by the factors given in stage B of this Table and must not be needed to meet liabilities arising from personal activities or another business activity not regulated by us.

Draft Handbook text

**CAPITAL RESOURCES AND PROFESSIONAL INDEMNITY INSURANCE
REQUIREMENTS FOR PERSONAL INVESTMENT FIRMS INSTRUMENT 2009**

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 powers);
 - (2) section 156 (General supplementary powers); and
 - (3) 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. (1) This instrument comes into force on [date 2009], except as in (2).
- (2) Part 2 of Annex B to this instrument comes into force on [date 2010].

Amendments to the Handbook

- D. The Glossary of definitions is amended in accordance with Annex A to this instrument.
- E. The Interim Prudential sourcebook for Investment Businesses (IPRU(INV)) is amended in accordance with Annex B to this instrument.

Citation

- F. This instrument may be cited as the Capital Resources and Professional Indemnity Insurance Requirements for Personal Investment Firms Instrument 2009.

By order of the Board

[Date 2009]

Annex A

Amendments to the Glossary of definitions

Part 1

In this Part, underlining indicates new text and striking through indicates deleted text.

- adviser* an individual who is: a *representative*, an *appointed representative* or a *tied agent*, or, for the purposes of IPRU(INV) chapter 13, a *financial adviser*.
- initial capital* (1) ...
- (5) (in the case of an *institution* that is an *EEA firm*) capital resources calculated in accordance with the *CRD implementation measures* of its *Home State* for Article 4 of the *Capital Adequacy Directive* (Definition of initial capital) or Article 9 of the *Banking Consolidation Directive* (Initial capital requirements); ~~and~~
- (6) (for the purposes of the definition of *dealing on own account* and in the case of an *undertaking* not falling within (3) or (4)) *capital resources* calculated in accordance with (3) and paragraphs (3) and (4) of the definition of *capital resources*; ~~and~~
- (7) (in *IPRU(INV) chapter 13*) the initial capital of a *firm* calculated in accordance with *rule 13.1A.6*.
- net short position* (1) a net short position which gives rise to an economic exposure to the issued *share* capital of a company.
- Any calculation of whether a *person* has a short position must take account of any form of economic interest in the *shares* of the company.
- (2) (in *IPRU(INV) chapter 13*) the situation in which a *firm* has contracted to *sell* more of an *investment* than it holds or will hold or, in respect of *options*, where it has sold rights which exceed the rights bought.
- representative* (1) an individual who:
- (a)...
- (2) (in *IPRU(INV) chapter 13* in relation to *designated investment business*) an individual appointed by a provider firm or by an *appointed representative* or where applicable, *tied agent* of that *firm*, to carry out either or both of the following activities:
- (a) giving advice on investments to customers on the merits of packaged products offered by that firm (or any other provider firm within the same marketing group); or
- (b) arranging (bringing about) deals in investments in relation

to such products.

(3) In (2), a provider firm is a *firm* that is:

(a) a *product provider*; or

(b) a *marketing group associate*.

Part 2

Insert the following definitions in the correct alphabetical order. This text is new and is not underlined.

<i>annual financial statements</i>	the financial statements in respect of the year ending on the <i>firm's</i> annual accounting reference date, which is the date to which a corporate <i>firm's</i> accounts are prepared for the purposes of the Companies Acts, or, where the <i>firm</i> is not subject to the Companies Acts, the equivalent date chosen by the <i>firm</i> and notified to the <i>FSA</i> .
<i>category B firm</i>	a <i>personal investment firm</i> , other than an <i>exempt CAD firm</i> .
<i>category B1 firm</i>	a <i>category B firm</i> whose <i>permission</i> includes <i>dealing in investments as principal</i> .
<i>category B2 firm</i>	a <i>category B firm</i> whose <i>permission</i> does not include <i>dealing as principal</i> ; and is not subject to a <i>requirement</i> preventing the holding or controlling of <i>client money</i> or <i>custody assets</i> .
<i>category B3 firm</i>	a <i>category B firm</i> whose <i>permission</i> includes only <i>insurance mediation activity</i> in relation to <i>non-investment insurance contracts</i> , <i>home finance mediation activity</i> , <i>assisting in the administration and performance of contracts of insurances</i> , <i>arranging transactions in life policies</i> and other insurance contracts, <i>advising on investments</i> and receiving and transmitting, on behalf of investors, orders in relation to <i>securities</i> and <i>units in collective investment schemes</i> ; but which is subject to a <i>requirement</i> not to hold or control <i>client money</i> or <i>custody assets</i> .
<i>financial adviser</i>	<p>(1) an individual appointed by an independent intermediary or by its <i>appointed representative</i> or where applicable, <i>tied agent</i>, to provide any or all of the following services:</p> <ul style="list-style-type: none">(a) giving advice on <i>investments</i> to <i>clients</i>;(b) <i>arranging (bringing about) deals in investments</i> or <i>executing transactions</i> involving, in each case, <i>designated investments</i> with or for <i>clients</i>;(c) <i>managing investments</i>;(d) receiving or holding <i>client money</i> or other <i>client assets</i>;(e) <i>safeguarding and administering investments</i>. <p>(2) For the purposes of this definition, an independent intermediary is a <i>firm</i> acting as an intermediary but excluding:</p> <ul style="list-style-type: none">(a) a <i>firm</i> which is a member of a <i>marketing group</i>;(b) a <i>product provider</i> which <i>sells</i> its own <i>packaged products</i>.
<i>marketing group</i>	a group of <i>persons</i> who: <p>(1) are allied together (either formally or informally) for purposes</p>

	of marketing <i>packaged products</i> of the <i>marketing group</i> ; and
	(2) each of whom, if it holds itself out in the <i>United Kingdom</i> as marketing <i>packaged products</i> to <i>private customers</i> , does so only as an <i>investment manager</i> or in relation to <i>packaged products</i> of the <i>marketing group</i> .
<i>marketing group associate</i>	a <i>firm</i> other than a <i>product provider</i> which is a member of a <i>marketing group</i> .
<i>net long position</i>	the situation in which a <i>firm</i> holds or will hold more <i>units in a investment</i> than it has contracted to <i>sell</i> or, in respect of <i>options</i> , where it has bought rights which exceed rights sold.
<i>net open foreign currency position</i>	(in <i>IPRU(INV)</i> chapter 13) a <i>firm's net long position</i> or <i>net short position</i> , whichever is the higher, in a currency other than in which the <i>firm's</i> books of account are maintained.
<i>opted-in exempt CAD firm</i>	an <i>exempt CAD firm</i> which complies with the requirements in regulation 4C (or any successor provision) of the Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2007 (SI 2007/126).
<i>property fund</i>	<ol style="list-style-type: none"> (1) a <i>regulated collective investment scheme</i> dedicated to land and interests in land; (2) a fund of funds of which one or more of the funds to which it is dedicated falls within (1); (3) a constituent part of an umbrella fund which, if it were a separate fund, would fall within (1).
<i>special adjustment</i>	(in <i>IPRU(INV)</i> chapter 13) a <i>position risk adjustment</i> , counterparty risk adjustment and foreign exchange adjustment.
<i>verified</i>	<p>(in <i>IPRU(INV)</i> chapter 13) where interim net profits are to be included in a <i>firm's</i> capital resources, checked by an external auditor who has undertaken at least to:</p> <ol style="list-style-type: none"> (1) satisfy himself that the figures forming the basis of the interim profits have been properly extracted from the underlying accounting records; (2) review the accounting <i>policies</i> used in calculating the interim profits so as to obtain comfort that they are consistent with those normally adopted by the <i>firm</i> in drawing up its <i>annual financial statements</i> and are in accordance with the accounting principles set out in chapter 13; (3) perform analytical procedures on the result to date, including comparisons of actual performance to date with budget and with the results of prior period(s); (4) discuss with management the overall performance and financial <i>position</i> of the <i>firm</i>;

- (5) obtain adequate comfort that the implications of current and prospective litigation, all known claims and commitments, changes in business activities and provisioning for bad and doubtful debts have been properly taken into account in arriving at the interim profits; and
- (6) follow up problem areas of which he is already aware in the course of auditing the *firm's* financial statements, a copy of whose report asserting that the interim net profits are reasonably stated has been submitted to the *FSA* (although this does not apply to *exempt CAD firms*).

Annex B
Amendments to the Interim Prudential sourcebook for Investment Businesses
(IPRU(INV))
Part 1

In this Annex, underlining indicates new text and striking through indicates deleted text.

CHAPTER 13: FINANCIAL RESOURCE REQUIREMENTS FOR PERSONAL INVESTMENT
FIRMS

APPLICATION, GENERAL REQUIREMENTS AND PROFESSIONAL INDEMNITY
INSURANCE REQUIREMENTS

APPLICATION

- 13.1.1 R (1) This chapter applies to a *firm* which is a *personal investment firm*.
- (2) For a *personal investment firm* which is an *exempt CAD firm*,¹ the following apply:¹
- (a) sections 13.1 and 13.1A; and
 - (b) if it is not an *opted-in exempt CAD firm*, sections 13.2 to 13.8;
 - (c) if it is an *opted-in exempt CAD firm*, sections 13.9 to 13.12 (but reading references to *€category B firm* as references to the *firm*).
- (3) ~~Section 13.1 and sections 13.9 to 13.12 apply to~~ For a *personal investment firm* which is a *€category B firm*, section 13.1 and sections 13.9 to 13.12 apply.
- (4) ~~The definitions in the Glossary at Appendix 13(1) apply to this chapter.~~
- 13.1.1A G ~~Firms are reminded that a *media firm* is not a *personal investment firm*.~~

PURPOSE

¹ IPRU(INV) 13.1.1R amended by the Handbook Administration (No 11) Instrument 2008, which came into force on 6 November 2008.

- 13.1.2 G This chapter amplifies *threshold condition 4* (Adequate resources) by providing that a *firm* must meet, on a continuing basis, a basic solvency requirement and a minimum capital resources requirement. This chapter also amplifies *Principles 3* and *4* which require a *firm* to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems and to maintain adequate financial resources by setting out capital resources for a *firm* according to the regulated activity or activities it carries on.
- 13.1.3 G Although financial resources and appropriate systems and controls can generally mitigate operational risk, professional indemnity insurance has a role in mitigating the risks a *firm* faces in its day to day operations, including those arising from not meeting the legally required standard of care when *advising on investments*. The purpose of the *rules* in this section is also to ensure that a *firm* has in place the type, and level, of professional indemnity insurance necessary to mitigate these risks. This includes, in the case of a *UK firm* exercising an *EEA right*, cover for breaches of obligations imposed by or under laws, or provisions having the force of law, in each *EEA State* in which the *firm* carries on business.

GENERAL REQUIREMENTS

- 13.1.24 R A *firm* must at all times:
- (1) have and maintain ~~at all times financial~~ capital resources of the kinds and amounts specified in, and calculated in accordance with, the *rules* of this chapter; and
 - (2) be able to meet its liabilities as they fall due.

REQUIREMENT TO HOLD PROFESSIONAL INDEMNITY INSURANCE

- 13.1.5 R A *firm* must take out and maintain at all times professional indemnity insurance that is at least equal to the requirements in this section from:
- (1) an *insurance undertaking* which is authorised to transact professional indemnity insurance in the *EEA*; or
 - (2) a *person* of equivalent status in:
 - (a) a *Zone A* country;
 - (b) the Channel Islands, Gibraltar, Bermuda or the Isle of Man.

[Note: Article 4(3) of the *Insurance Mediation Directive*]

- 13.1.6 R An *exempt CAD firm* is not required to effect and maintain professional indemnity insurance unless it chooses to do so (see 13.1A).

COMPARABLE GUARANTEE

- 13.1.7 R (1) A firm is not required to effect or maintain professional indemnity insurance if a bank, building society or an insurer provides the firm with a comparable guarantee.
- (2) If the firm is a member of a group in which there is a bank, building society or an insurer, the firm's comparable guarantee must be from that bank, building society or insurer.
- (3) A comparable guarantee means an enforceable, written agreement on terms at least equal to those required by IPRU(INV) 13.1.9R to 13.1.13R, as appropriate.

13.1.3(1) G Under ~~Principles 3 and 4~~ a firm is required to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems and to maintain adequate financial resources. Under ~~Principle 9~~ a firm is obliged to take reasonable care to ensure the suitability of its ~~advice on investments~~ and discretionary decisions for any customer who is entitled to rely upon its judgement.

13.1.3(2) G Although financial resources and appropriate systems and controls can generally mitigate operational risk, professional indemnity insurance has a role in mitigating the risks a firm faces in its day to day operations, including those arising from not meeting the legally required standard of care when ~~advising on investments~~. The purpose of 13.1.4(1) to 13.1.4(15) is to ensure that a firm has in place the type, and level, of professional indemnity insurance necessary to mitigate these risks. This includes, in the case of a UK firm exercising an EEA right, cover for breaches of obligations imposed by or under laws, or provisions having the force of law, in each EEA State in which the firm carries on business.

RELEVANT INCOME

13.1.3(3) R The term "relevant income" in IPRU(INV) ~~13.1~~ this section refers to all income received or receivable which is commission, brokerage, fees or other related income, whether arising from the firm's permitted activities or not, for the last accounting year prior to inception or renewal of the professional indemnity insurance policy ("the policy").

- 13.1.4(1) R (1) ~~A firm must take out and maintain at all times professional indemnity insurance that is at least equal to the requirements of 13.1.4(2) to 13.1.4(15).~~
- (2) ~~Paragraph (1) does not apply to an exempt CAD firm unless it chooses to comply with these rules (see 13.1A).~~

POLICY TERMS

13.1.4(2) R The policy must incorporate terms which are appropriate and must make provision for:

9

(a) cover in respect of any claim for loss or damage, for which the *firm* may be liable as a result of an act or omission by:

(i)(1) the *firm*; or

(ii)(2) any *person* acting on behalf of the *firm* including *employees, appointed representatives* or its other agents;

LIMITS OF INDEMNITY — ~~IMD INSURANCE INTERMEDIARY OR AN EXEMPT CAD FIRM~~

13.1.10² R (b) ~~if~~ the *firm* is an *IMD insurance intermediary* that maintains professional indemnity insurance under 13.1A.34(1)(b), ~~the~~ appropriate minimum *limits of indemnity* per year ~~which~~ are; no lower than:

(i)(1) €1,120,200 for a single claim against the *firm*; and

(ii)(2) €1,680,300 in the aggregate;

[Note: Article 4(3) of the *Insurance Mediation Directive*]

13.1.11³ R (ba) ~~if~~ the *firm* is an *exempt CAD firm* that maintains professional indemnity insurance under 13.1A.3(1)(b), ~~the~~ appropriate minimum *limits of indemnity* per year ~~which~~ are; no lower than:

(i)(1) €1,000,000 for a single claim against the *firm*; and

(ii)(2) €1,500,000 in the aggregate;

[Note: Article 67(3) of *MiFID* and Article 7 of *CAD* (see also *rule* 13.1A.3)]

13.1.12 R (e) ~~if~~ the *firm* is both an *IMD insurance intermediary* and an *exempt CAD firm* that maintains professional indemnity insurance under 13.1A.4(1)(b), ~~the~~ appropriate additional *limits of indemnity* to ~~13.1.4(2)(b)~~ 13.1.10R per year ~~which~~ are no lower than:

(i)(1) € 500,000 for a single claim against the *firm*; and

(ii)(2) € 750,000 in the aggregate.

[Note: Article 67(3) of *MiFID* and Article 8 of *CAD* (see also ~~rule~~ *rule* 13.1A.4)]

LIMITS OF INDEMNITY — ~~OTHER FIRMS~~

² The FSA is consulting on proposed amendments to the limits of indemnity set out in *IPRU(INV)* 13.1.4(2)R (now re-numbered 13.1.10R) in the Quarterly Consultation Paper published in October 2008 (CP 08/16).

³ The FSA is consulting on proposed new *IPRU(INV)* 13.1.4(2)R(ba) (now re-numbered 13.1.11R) in the Quarterly Consultation Paper published in October 2008 (CP 08/16).

- 13.1.13 R ~~(d)~~ If the *firm* is not an *IMD insurance intermediary* or an *exempt CAD firm*, then the following *limits of indemnity* apply:
- ~~(i)~~ (1) if the *firm* has relevant income of up to £3,000,000, no lower than £500,000 for a single claim against the *firm* and £500,000 in the aggregate; or
- ~~(ii)~~ (2) if the *firm* has relevant income of more than £3,000,000, no lower than £650,000 for a single claim against the *firm* and £1,000,000 in the aggregate.

13.1.4(2)
A)-14⁴ G Article 4(7) of the *Insurance Mediation Directive* requires the *limits of indemnity* to be reviewed every five years to take into account movements in European consumer prices. These *limits* will therefore be subject to further adjustments on the basis of index movements advised by the European Commission.

13.1.4(3)
15 R If a policy is denominated in any currency other than euros, an *IMD insurance intermediary* must take reasonable steps to ensure that the *limits of indemnity* are, when the policy is effected (i.e. agreed) and at renewal, at least equivalent to those required in by 13.1.4(2)(b)10R and 13.1.11R.

READILY REALISABLE OWN FUNDS

13.1.4(4) G ~~For the purposes of the following provisions relating to professional indemnity insurance, the FSA expects items included in *own funds* to be regarded as "readily realisable" only if they can be realised, at any given time, within 90 days.~~

13.1.16 G A *firm* should consider whether the overall cover is adequate taking account of 13.1.22G(2) and whether the *firm* should seek additional cover or legal expenses insurance. (Legal defence costs are costs of defence against claims that fall under the terms of the policy.)

13.1.17 G The cover provided by the policy should be wide enough to include the liability of the *firm*, its *appointed representatives*, its *tied agents*, *employees* and its agents for breaches under the *regulatory systems* or civil law. If the *firm* operates outside the UK then the policy should cover other *regulatory requirements* imposed under the laws of other countries in which the *firm* operates.

POLICIES PROVIDING COVER FOR MORE THAN ONE FIRM

13.1.18 R If the policy provides cover to more than one *firm* then:

(1) the relevant income for calculating the *limits of indemnity* is that of all the *firms* named in the policy combined;

⁴ The FSA is consulting on proposed new *IPRU(INV)* 13.1.4(2A)R (now re-numbered 13.1.14R) in the Quarterly Consultation Paper published in October 2008 (CP 08/16).

- (2) each firm named in the policy must have the benefit of the minimum limits of indemnity as required in this section; and
- (3) each firm named in the policy must notify the FSA if the aggregate cover in the policy falls below the minimum limits of indemnity.

LIMITS OF INDEMNITY – ADDITIONAL REQUIREMENTS

13.1.4(5) ~~E~~ (a) In addition to the specific requirements in 13.1.4(2)9R to 13.1.13R, ~~to incorporate appropriate terms,~~ the policy should must make 19 ~~R~~ provision for the following:

- (1) (i) for a firm with relevant income of more than £6,000,000, the aggregate limit identified in the table below:

Relevant income is (£)		Minimum aggregate <i>limit of indemnity</i> (£)
more than	up to	
...		

- (2) (ii) full retroactive cover in respect of the kinds of liabilities described in 13.1.4(2)9R for claims arising from work carried out by the firm, or on its behalf, in the past; and

- (3) (iii) cover in respect of Ombudsman awards made against the firm.

(b) ~~Compliance with (a) may be relied on as tending to establish compliance with the requirement in 13.1.4(2) for the professional indemnity insurance terms to be appropriate.~~

(c) ~~Contravention of (a) may be relied on as tending to establish contravention of the requirement in 13.1.4(2) for the professional indemnity insurance terms to be appropriate.~~

13.1.4(6) ~~G~~ ~~A firm should consider whether the overall cover is adequate taking account of 13.1.4(9)(b) and whether the firm should seek additional cover or legal expenses insurance. (Legal defence costs are costs of defence against claims that fall under the terms of the policy.)~~

13.1.4(7) ~~G~~ ~~The cover provided by the policy should be wide enough to include the liability of the firm, its appointed representatives, or where applicable, its tied agent, employees and its agents for breaches of the firm's duty of skill and care, fiduciary duty, duty to look after documents or assets, fraud, and breaches of obligations imposed by or under the Act (or the Financial Services Act 1986 if relevant). If the firm operates outside the UK then the policy should cover other regulatory requirements imposed under the laws of other countries in which the firm operates.~~

EXCLUSIONS-LIMITATIONS

- 13.1.4(8) 20 R The policy must not be subject to conditions or exclusions which unreasonably limit ~~the~~ its cover provided for in 13.1.4(2) (whether by exclusion of cover, by policy excesses or otherwise).

EXCLUSIONS

- 13.1.21 R The policy must not:

- (1) exclude any type of business or activity that has been carried out by the *firm* in the past or will be carried out by the *firm* during the time for which the policy is in force, unless the *firm* holds additional capital resources, in accordance with 13.1.23R; or
- (2) exclude liabilities which are identified or crystallised as a result of regulatory action against the *firm* (either individually or as a member of a class of *authorised persons*).

- 13.1.4(9) 22 G (a) The *FSA* considers it reasonable for a *firm's* policy to exclude cover for:
- (1)
- (i) specific business lines if that type of business has not been carried out by the *firm* in the past and will not be carried out by the *firm* during the life of the policy; or
- (ii) specific claims that have been previously notified to the *firm's insurer* and claimed for under another policy.
- (b)
- (b) The *FSA* does not consider it reasonable for a *firm's* policy to treat legal defence costs cover as part of the *limits of indemnity* if this reduces the cover available for any individual substantive claim.
- (2)

ADDITIONAL CAPITAL RESOURCES – EXCLUSIONS

- 13.1.23 R The amount of additional capital resources that a *firm* must hold where its policy excludes business or activities that have been carried out by the *firm* in the past or will be carried out by the *firm* should be calculated by referring to the *firm's* relevant income in the following table:

<u>Relevant income £000s</u>		<u>Minimum additional capital resources £000s (Notes 1 and 2)</u>
<u>more than</u>	<u>up to</u>	
<u>0</u>	<u>100</u>	<u>5</u>
<u>100</u>	<u>200</u>	<u>12</u>
<u>200</u>	<u>300</u>	<u>18</u>
<u>300</u>	<u>400</u>	<u>21</u>
<u>400</u>	<u>500</u>	<u>23</u>

<u>500</u>	<u>600</u>	<u>25</u>
<u>600</u>	<u>700</u>	<u>27</u>
<u>700</u>	<u>800</u>	<u>28</u>
<u>800</u>	<u>900</u>	<u>30</u>
<u>900</u>	<u>1,000</u>	<u>31</u>
<u>1,000</u>	<u>1,500</u>	<u>37</u>
<u>1,500</u>	<u>2,000</u>	<u>42</u>
<u>2,000</u>	<u>2,500</u>	<u>46</u>
<u>2,500</u>	<u>3,000</u>	<u>51</u>
<u>3,000</u>	<u>3,500</u>	<u>55</u>
<u>3,500</u>	<u>4,000</u>	<u>59</u>
<u>4,000</u>	<u>4,500</u>	<u>63</u>
<u>4,500</u>	<u>5,000</u>	<u>67</u>
<u>5,000</u>	<u>6,000</u>	<u>73</u>
<u>6,000</u>	<u>7,000</u>	<u>79</u>
<u>7,000</u>	<u>8,000</u>	<u>85</u>
<u>8,000</u>	<u>9,000</u>	<u>90</u>
<u>9,000</u>	<u>10,000</u>	<u>95</u>
<u>10,000</u>	<u>100,000</u>	<u>95y</u>
<u>100,000</u>	<u>n/a</u>	<u>950</u>
<u>Note 1 – For firms with relevant income of more than £10m but up to £100m value y is calculated by relevant income/ £10m.</u>		
<u>Note 2 – The calculation of a firm’s capital resources is set out in sections 13.1A to 13.12 (see rule 13.1.1 for application of these sections to an exempt CAD firm and a category B firm).</u>		

13.1.24 G The firm should hold additional capital resources in excess of those minimum amounts set out in this table where the required amounts of additional capital resources provide insufficient cover, taking into account the firm’s individual circumstances.

EXCESS LEVEL

13.1.4(10) E-R (a) The policy should must not:
25

- (i) make provision for payment by the *firm* of an excess on any claim of more than £5,000, ~~unless (This does not apply to the extent that the *firm* holds additional *own funds* in a readily realisable form capital resources, in accordance with 13.1.4(12))~~ 27R; or
 - (ii) ~~exclude any type of business or activity that has been carried out by the *firm* in the past or will be carried out by the *firm* during the time for which the policy is in force. (This does not apply to the extent that the *firm* holds, by way of additional *own funds* in a readily realisable form, an amount equivalent to a reasonable provision against its potential liabilities for that business or activity. Guidance on this is given in 13.1.4(13) and (14)); or~~
 - (iii) ~~exclude liability which is identified or crystallised as a result of regulatory action against the *firm* (either individually or as a member of a class of *authorised person*).~~
- (b) ~~Contravention of (a) may be relied on as tending to establish contravention of 13.1.4(8).~~

EXCESS LEVEL

13.1.4(11) ~~E-R~~ 26 The reference to “excess” in ~~13.1.4(10)(a)(i)~~ is to the highest excess level required to be paid under the policy unless that excess relates to a type of business that has not been carried out by the *firm* in the past. In those circumstances, the reference is to the next highest excess level required by the policy.

ADDITIONAL OWN FUNDS CAPITAL RESOURCES – EXCESS

13.1.4(12) ~~E-R~~ 27 The amount of additional *own funds* capital resources that a *firm* must hold where the policy’s excess on any claim is more than £5,000 ~~in 13.1.4(10)(a)(i) should~~ must be calculated by referring to the *firm*’s relevant income and excess obtained in the following table:

All amounts are shown in £000s (Notes 1 and 2)	
Relevant income is	Excess obtained, up to and including
more than	...
<u>Note 1</u> – For <i>firms</i> with relevant income of more than £10m but up to £100m value y is calculated by relevant income/ £10m.	

Note 2 – The calculation of a *firm's* capital resources is set out in sections 13.1A to 13.12 (see rule 13.1.1 for application of these sections to an *exempt CAD firm* and a *category B firm*).

EXCLUSIONS

- 13.1.4(13) G ~~A *firm* should take into account the following when assessing the amount of additional *own funds* to be held as provision as described in 13.1.4(10)(a)(ii):~~
- ~~(a) the type of business line or activity excluded and the types of claim which might arise from it;~~
 - ~~(b) the number of contracts written or volume of activity;~~
 - ~~(c) the number of complaints received by the *firm* relating to the excluded business or activity;~~
 - ~~(d) generally accepted accounting principles applicable to provisions; and~~
 - ~~(e) any other relevant information.~~
- 13.1.4(14) G ~~If the *firm* holds additional *own funds* in accordance with 13.1.4(13) then the amount should be reviewed regularly. The reviews should take account of changes in the status of the policy exclusion(s) and any relevant changes to the *firm's* circumstances.~~

POLICIES PROVIDING COVER FOR MORE THAN ONE FIRM

- 13.1.4(15) R ~~If the policy provides cover to more than one *firm* then in relation to 13.1.4(2) and (3):~~
- ~~(a) the relevant income for calculating the *limits of indemnity* is that of all the *firms* named in the policy combined;~~
 - ~~(b) each *firm* named in the policy must have the benefit of the minimum *limits of indemnity* as required in 13.1.4(2);~~
 - ~~(c) each *firm* named in the policy must notify the *FSA* if the aggregate cover in the policy falls below the minimum in 13.1.4(2).~~

EXEMPTION FROM HOLDING PROFESSIONAL INDEMNITY INSURANCE

- 13.1.5 R (1) ~~A *firm* is not required to effect or maintain professional indemnity insurance if a *bank, building society, insurer* or a *firm* which is a *friendly society* provides the *firm* with a comparable guarantee.~~

- (2) ~~If the *firm* is a member of a *group* in which there is a *bank*, *building society*, *insurer* or a *firm* which is a *friendly society*, the *firm's* comparable guarantee must be from that *bank*, *building society*, *insurer* or *friendly society*.~~
- (3) ~~A comparable guarantee means an enforceable, written agreement on terms at least equal to those required by *IPRU(INV)* 13.1.4(2)R.~~

- 13.1.6 R ~~A *firm* must take out professional indemnity insurance from:~~
- (a) ~~any *insurance undertaking* which is authorised to transact professional indemnity insurance in the *EEA*; or~~
 - (b) ~~a *person* of equivalent status in~~
 - (i) ~~a *Zone A* country;~~
 - (ii) ~~the Channel Islands, Gibraltar, Bermuda or the Isle of Man.~~

NOTIFICATION REQUIREMENTS

- 13.1.7 G ~~*Rule* 13.1.9 is a notification *rule* and is in addition to any notification requirements in the Supervision Manual (Sup 15).~~
- 13.1.8 G ~~*Firms* are reminded to comply with *SUP* 15.7 (Form and method of notification) when notifying the *FSA* in accordance with *rule* 13.1.9.~~
- 13.1.928 R A *firm* must notify the *FSA* immediately if it becomes aware, or has information which reasonably suggests, that any of the ~~matters in Table 13.1(1)~~ following matters in relation to its professional indemnity insurance has occurred, may have occurred or may occur in the foreseeable future.;

~~Table 13.1(1)~~

~~This table forms part of 13.1.9~~

NOTIFIABLE EVENTS

1. ~~In relation to professional indemnity insurance, required in accordance with 13.1.4(1) to 13.1.4(15) and 13.1.5, if:~~
- (a) ~~(1)~~ (1) it cannot be obtained within 28 days of the inception or renewal date;
 - (b) ~~(2)~~ (2) it is cancelled;
 - (c) ~~(3)~~ (3) the amount of aggregate cover is exhausted;
 - (d) ~~(4)~~ (4) the *firm* commences business lines for which it has not obtained cover;

- (e) ~~(5)~~ the *firm* is relying on ~~13.1.4(15)~~ a policy that provides cover for more than one *firm*; or
- (f) ~~(6)~~ the *firm* is relying on ~~13.1.5~~ a comparable guarantee provided in accordance with the *rules* in this chapter.

~~2.~~ In respect of an *exempt CAD firm* ~~complying with section 13.3:~~

- ~~(a) *own funds* falling below the applicable reference level;~~
- ~~(b) *own funds* reaching the applicable € level specified in *rule* 13.3.1;~~
- ~~(c) change of control causing loss of eligibility for that alternative test;~~

~~3.~~

- ~~(a) [deleted]~~
- ~~(b) [deleted]~~
- ~~(c) [deleted]~~
- ~~(d) [deleted]~~
- ~~(e) [deleted]~~
- ~~(f) [deleted]~~

- ~~13.1.105 R [deleted]~~
- ~~13.1.11 G [deleted]~~
- ~~13.1.12 R [deleted]~~
- ~~13.1.13 G [deleted]~~
- ~~13.1.14 R [deleted]~~
- ~~13.1.15 R [deleted]~~
- ~~13.1.16 R [deleted]~~
- ~~13.1.17 R [deleted]~~

⁵ *IPRU(INV)* 13.1.10R to 13.1.17R were deleted by the Senior Management Arrangements, Systems and Controls (Extension of Common Platform Provisions) Instrument 2008 (FSA 2008/40), which comes into force on 1 April 2009.

Part 2: Comes into force on [December 2010]

Transitional provisions

1 Table Transitional provisions applying to IPRU(INV)

(1)	(2)	(3)	(4)	(5)	(6)
	Material to which the transitional provision applies		Transitional provision	Transitional provision: dates in force	Handbook provision: coming into force
1			[Deleted: material moved to UPRU]	[Deleted: material moved to UPRU]	[Deleted: material moved to UPRU]
2			[Deleted]	[Deleted]	[Deleted]
<u>1</u>	<u>13.1.21 and 13.1.23</u>	<u>R</u>	<u>The requirement to hold additional capital resources where a policy excludes business or activities that have been carried out by the <i>firm</i> in the past or will be carried out by the <i>firm</i> only applies to a <i>professional indemnity policy</i> taken out, renewed or extended with effect from [31st December 2009].</u>	<u>[December 2009]</u>	<u>[December 2009]</u>
<u>2</u>	<u>13.3.2</u>	<u>R</u>	<u>A <i>category B firm</i> is not required to meet the capital resources requirement set out in <i>rule</i> 13.3.2 until [December 2012], unless the <i>firm</i> is already subject to a higher capital resources requirement, in which case this transitional provision</u>	<u>From [December 2010] to [December 2012]</u>	<u>[December 2010]</u>

			<p>does not apply.</p> <p><u>From [December 2010] to [December 2011], the <i>firm's</i> capital resources requirement can be calculated in accordance with whichever of (1) or (2) produces the higher amount:</u></p> <p><u>(1) 1/12 of its fixed annual expenditure, calculated in accordance with 13.3.3R to 13.3.8R; or</u></p> <p><u>(2) £15,000.</u></p> <p><u>From [December 2011] to [December 2012], the <i>firm's</i> capital resources requirement can be calculated in accordance with whichever of (3) or (4) produces the higher amount:</u></p> <p><u>(3) 1/6 of its fixed annual expenditure, calculated in accordance with 13.3.3R to 13.3.8R; or</u></p> <p><u>(4) £15,000.</u></p>		
<u>3</u>	<u>13.3.13(2)</u>	<u>R</u>	<p><u>A <i>category B firm</i> can calculate the amount of the <i>firm's</i> total capital and reserves excluding preference <i>share</i> capital, less the amount of its intangible assets, multiplying it by 400% until [December 2012].</u></p>	<p><u>From [December 2010] to [December 2012]</u></p>	<p><u>[December 2010]</u></p>

...

- 13.1.1 R (1) ...
- (2) For a *personal investment firm* which is an *exempt CAD firm*, the following apply:
- (a) sections 13.1 and 13.1A; and
- (b) if it is not an *opted-in exempt CAD firm*, sections 13.2 to 13.8;

- (c) if it is an *opted-in exempt CAD firm*, sections 13.9 to 13.123 (but reading references to *category B firm* as references to the *firm*).
- (3) For a *personal investment firm* which is a *category B firm*, section 13.1 and sections 13.9 to 13.123 apply.

...

ADDITIONAL CAPITAL RESOURCES – EXCLUSIONS

- 13.1.23 R The amount of additional capital resources that a *firm* must hold where its policy excludes business or activities that have been carried out by the *firm* in the past or will be carried out by the *firm* should be calculated by referring to the *firm's* relevant income in the following table:

Relevant income £000s		Minimum additional capital resources £000s (Notes 1 and 2)
more than	up to	
...		
Note 2 – The calculation of a <i>firm's</i> capital resources is set out in sections 13.1A to 13.123 (see <i>rule</i> 13.1.1 for application of these sections to an <i>exempt CAD firm</i> and a <i>category B firm</i>).		

...

ADDITIONAL CAPITAL RESOURCES – EXCESS

- 13.1.27 R The amount of additional capital resources that a *firm* must hold where the policy's excess on any claim is more than £5,000 should be calculated by referring to the *firm's* relevant income and excess obtained in the following table:

All amounts are shown in £000s (Notes 1 and 2)	
Relevant income is	Excess obtained, up to and including
more than	...
Note 2 – The calculation of a <i>firm's</i> capital resources is set out in sections 13.1A to 13.123 (see <i>rule</i> 13.1.1 for application of these sections to an <i>exempt CAD firm</i> and a <i>category B firm</i>).	

...

13.1A ~~FINANCIAL CAPITAL RESOURCES AND PROFESSIONAL INDEMNITY INSURANCE~~
~~REQUIREMENTS FOR AN EXEMPT CAD FIRM~~

APPLICATION

13.1A.1 R ...

~~REQUIREMENT TO HOLD INITIAL CAPITAL AND PROFESSIONAL INDEMNITY~~
~~INSURANCE REQUIREMENTS~~

13.1A.2 R The ~~financial capital~~ resources requirement for a *personal investment firm* which is an *exempt CAD firm* is the higher of:

- (1) the requirement that is applied by section 13.1A; and
- (2) (a) the requirement that is applied by sections 13.2 to 13.8;
or
(b)⁶ if it is an *opted-in exempt CAD firm*, sections 13.9 to 13.12 ~~3~~ (but reading references to *category B firm* as references to the *firm*).

13.1A.3 R (1) A *firm* which is not an *IMD insurance intermediary* must have:

- (a) *initial capital* of €50,000; or
- (b) professional indemnity insurance at least equal to the requirements of 13.1.4(2)(b)11R and 13.1.4(3)15R to 13.1.627R; or
- (c) a combination of *initial capital* and professional indemnity insurance in a form resulting in a level of coverage equivalent to (a) or (b).

[Note: Article 67(3) of *MiFID* and Article 7 of *CAD* (see also ~~rule~~ rule 13.1.4(2)(b)10)]

- (2) If a *firm* chooses to comply with either (b) or (c) above, it must nevertheless have *initial capital* of at least £10,000.

13.1A.4 R (1) A *firm* that is also an *IMD insurance intermediary* must have professional indemnity insurance at least equal to the limits set out in 13.1.4(2)(b)10R and, in addition, has to have:

- (a) *initial capital* of €25,000; or

⁶ *IPRU(INV)* 13.1A.2R(b) amended by the Handbook Administration (No 11) Instrument 2008, which came into force on 6 November 2008.

- (b) professional indemnity insurance at least equal to the requirements of ~~13.1.4(2)(e)12R~~ and ~~13.1.4(3)15R~~ to ~~13.1.627R~~; or
- (c) a combination of *initial capital* and professional indemnity insurance in a form resulting in a level of coverage equivalent to (a) or (b).

[Note: Article 67(3) of *MiFID* and Article 8 of *CAD* (see also ~~rule~~ rule ~~13.1.4(2)(e)12~~)]

(2) ...

...

~~13.2 FINANCIAL RESOURCES TESTS~~

~~13.2.1 R An exempt CAD firm must meet:~~

- ~~(1) [deleted]~~
- ~~(2) Financial Resources Test 1A (the Adjusted *Net current assets* Test) calculated in accordance with section 13.4; and~~
- ~~(3) Financial Resources Test 2 (the Expenditure-based Test) calculated in accordance with section 13.5.~~

~~13.2.2 G [deleted]~~

~~13.2.3 G Table 13A is a summary of the financial resources test for *exempt CAD firm*.~~

~~Table 13.A~~

~~This table forms part of guidance 13.2.3~~

~~SUMMARY OF FINANCIAL RESOURCES FOR EXEMPT CAD FIRMS~~

Type of <i>firm</i>	Financial Resources Test 1A Adjusted <i>net current assets</i> Test	Financial Resources Test 2 Expenditure-based Test	Rules/section references
--------------------------------	--	--	-------------------------------------

<i>Exempt CAD firm</i>	Adjusted net current assets of £1	Financial resources equal to the highest of 4/52 of Relevant Annual Expenditure or 13/52 of Relevant Annual Expenditure without <i>special adjustments</i> or £400 per <i>adviser</i>	13.1A.14 13.4 13.5.1D and 13.5.2 to 13.5.4
----------------------------	---	--	---

<i>Exempt CAD firm which is a network</i>	Adjusted net current assets of £1	Financial resources equal to the higher of 13/52 of Relevant Annual Expenditure or £400 per <i>adviser</i>	13.1A.14 13.4 13.5.1B and 13.5.2 to 13.5.4
---	---	--	---

13.3 Financial Resources Test 1—Own funds

13.3.1 R [deleted]

13.3.1A G [deleted]

13.3.2 R [deleted]

13.3.2A R [deleted]

13.3.2B G [deleted]

Table 13.3.2(2)

[deleted]

Alternative to Financial Resources Test 1

13.3.3 R [deleted]

- 13.3.3A R ~~{deleted}~~
- 13.3.3B R ~~{deleted}~~
- 13.4 Financial Resources Test 1A ~~Adjusted net current assets~~
- 13.4.1 R ~~An exempt CAD firm must adjust its net current assets as follows:~~
- ~~(1) exclude assets which cannot be realised or recovered within twelve months;~~
 - ~~(2) exclude amounts receivable from connected persons to the extent that they are not properly secured, except amounts that are deposits referred to at item (11) in Part I of table 13.5.4(1) or at item (11) in Part I of table 13.5.4(2);~~
 - ~~(3) value investments at current market value, using the bid price for a net long position in an investment and the offer price for a net short position in an investment;~~
 - ~~(4) where applicable, deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but exclude from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.~~
- 13.4.2 R ~~An exempt CAD firm must at all times have adjusted net current assets of at least £1.~~
- 13.532 FINANCIAL RESOURCES TEST 2 EXPENDITURE-BASED REQUIREMENT
- REQUIREMENT
- 13.5.1 R ~~{deleted}~~
- 13.5.1A R ~~{deleted}~~
- 13.5.1B2.1 R An exempt CAD firm which is a network must have financial capital resources calculated in accordance with whichever of (1); or (2) produces the higher amount:
- ~~(1) 13/52 one quarter of its relevant fixed annual expenditure, calculated in accordance with rule 13.5.22.3; or~~
 - (2) an amount equal to £400 multiplied by the number of its advisers.
- 13.5.1C R ~~{deleted}~~
- 13.5.1D2.2 R (1) ~~{deleted}~~

- (2) An exempt CAD firm which is not permitted to carry on the activity of managing investments or to delegate such activity to an investment firm must have ~~financial capital~~ resources calculated in accordance with whichever of ~~(3), (4) or (5)~~ (2), (3) or (4) produces the highest amount.
- (3) ~~Financial Capital~~ resources which taking into account all the special adjustments amount to 4/52 of its ~~relevant fixed~~ annual expenditure calculated in accordance with ~~rules 13.5.22.3 to 13.2.7~~; or
- (4) ~~financial capital~~ resources which disregarding all the special adjustments amount to ~~13/52~~ one quarter of its ~~relevant fixed~~ annual expenditure, calculated in accordance with ~~rules 13.5.22.3 to 13.2.7~~; or
- (5) ~~financial capital~~ resources taking into account all the special adjustments of an amount equal to £400 multiplied by the number of its advisers.

CALCULATION OF ~~RELEVANT~~ FIXED ANNUAL EXPENDITURE

13. ~~5.22.3~~ R (1) An exempt CAD firm must calculate its ~~relevant fixed~~ annual expenditure by reference to the amount described as total expenditure in its most recently prepared set of annual financial statements. If those statements were for a period other than 12 months, the amounts in the firm's profit and loss account must be adjusted proportionately.
- (2) Where an exempt CAD firm has just begun trading or has not been authorised long enough to submit such statements, the firm must calculate its ~~relevant fixed~~ annual expenditure on the basis of forecast or other appropriate accounts submitted to the FSA.
- (3) An exempt CAD firm may, subject to rule 13.5.32.6, deduct from its total expenditure the items set out in table 13.5.22.3.

Table 13.5.22.3

This table forms part of rule 13.5.22.3

DEDUCTIONS FROM EXPENDITURE	
(a)	Staff bonuses (except to the extent that they are guaranteed);
(b)	employees' and directors' shares in profits (except to the extent that the amount is guaranteed);
(c)	other appropriations of profits;
(d)	shared commissions and fees payable paid which are directly related to commissions and fees received <u>receivable</u> that are included within <u>total revenue</u> ;

(e)	interest charges in respect of borrowings made to finance the acquisition of its <i>readily realisable investments</i> ;
(f)	interest paid to <i>clients</i> on <i>client money</i> ;
(g)	interest paid to <i>counterparties</i> ;
(h)	fees, brokerage and other charges paid to <i>recognised clearing houses</i> , <i>recognised investment exchanges</i> and <i>intermediate brokers</i> for the purposes of executing, registering or clearing transactions;
(i)	foreign exchange losses;
(j)	a firm must not deduct any exceptional expenditure <u>other variable expenditure.</u>

13.5.2A G
2.4

(1) ...

13.2.5 G

For the purpose of this section, fixed expenditure is expenditure which is inelastic relative to fluctuations in an exempt CAD firm's levels of business. Fixed expenditure is likely to include most salaries and staff costs, office rent, payment for the rent or lease of office equipment, and insurance premiums. It may be viewed as the amount of funds which a firm would require to enable it to cease business in an orderly manner, should the need arise. This is not an exhaustive list of such expenditure and a firm will itself need to identify (taking appropriate advice where necessary) which costs amount to fixed expenditure.

ADJUSTMENTS TO CALCULATION OF RELEVANT FIXED ANNUAL EXPENDITURE

13.
5.32.6

R ~~A firm must ensure that the expenditure base properly reflects the ongoing annual operating costs of the firm by having proper regard to its circumstances when deciding whether to include or exclude any item of expenditure or to make any other adjustment to the calculation of relevant annual expenditure.~~

An exempt CAD firm must adjust its fixed expenditure calculation so far as necessary if and to the extent that since the date covered by the most recent annual financial statements or (if IPRU(INV) 13.2.3R(2) applies) since the budget was prepared:

(1) its level of fixed expenditure changes materially; or

(2) its regulated activities comprised within its permission change.

13.2.7 R

If an exempt CAD firm has a material proportion of its expenditure incurred on its behalf by third parties and such expenditure is not fully recharged to that firm then the firm must adjust its fixed expenditure calculation by adding back in the whole of the difference between the amount of the expenditure and the amount recharged.

13.5.3A G ~~In rule 13.5.3 the FSA would expect a firm to take proper account of the effect of, for example, the ongoing annual operating costs of the firm being met by another party, or of a significant change in the structure of the firm's business during the year.~~

The FSA would consider as 'material' 10% of a firm's expenditure incurred on its behalf by third parties.

CALCULATION OF FINANCIAL CAPITAL RESOURCES TO MEET TESTS 1, 1A OR 2 THE EXPENDITURE-BASED REQUIREMENT

13.5.42.9 R An exempt CAD firm must be able to calculate its financial capital resources at any time on the basis of the balance sheet it could draw up at that time. For this purpose:

(1) ~~{deleted}~~

(2) ~~An exempt CAD firm must, adjust the assets in the balance sheet as specified in table 13.5.4(2) A and include the liabilities after making the adjustments specified in that table 13.5.4(2); and~~

(3) ...

(2)

13.5.4A R ~~{deleted}~~

~~TABLE 13.5.4(1) PART I [DELETED]~~

~~TABLE 13.5.4(1) PART II [DELETED]~~

TABLE 13.5.4(2) A PART I

This table forms part of *rule 13.5.42.9*

EXEMPT CAD FIRM <i>EXEMPT CAD FIRM</i>		
ASSETS	CALCULATION	TYPE OF ADJUSTMENT
(1) Land and Buildings	Exclude in full. (A loan secured by a charge on land and buildings may be deducted from liabilities in accordance with item (14) of Part II of this table.	An Illiquid Adjustment
(2) <i>Investments</i>	Exclude in full the value of <i>shares</i> in <i>connected companies</i> .	An Illiquid Adjustment

	<p>Include any <i>net long position</i> in any fixed or current asset investment</p> <p>(a) valued at its current <i>bid price</i> (or, in the case of a with profits <i>life policy</i>, at its surrender value), and</p> <p>(b) discounted by the applicable percentage specified in table 13.5.4A <u>B</u>.</p>	A Position Risk Adjustment
(3) <i>Investments</i> subject to Repurchase, Reverse Repurchase, Stock Borrowing or Stock Lending transactions	<p>Include <i>investments</i> for which the <i>firm</i> has entered as principal into a repurchase, reverse repurchase, stock borrowing or stock lending transaction, after making (I) a deduction in accordance with item (2) <u>of this table</u>, and (II) a deduction calculated by</p> <p>(a) computing the <i>firm's</i> exposure (the difference between the <i>market value</i> of the <i>securities</i> and the loan or collateral (including accrued interest) where that difference is not in the <i>firm's</i> favour, after adjusting for any excess collateral), and</p> <p>(b) multiplying that exposure by the applicable percentage in table 13.5.4C <u>D</u>.</p>	<p>A Position Risk Adjustment</p> <p>A Counterparty Risk Adjustment</p>
(4) Debtors relating to Unsettled <i>Securities</i> Transactions – Cash against Documents	<p>Include debtors where the <i>firm</i> has entered into a transaction in <i>securities</i> or <i>units in collective investment schemes</i> as agent on a cash against documents basis and the transaction remains unsettled, after deducting an amount calculated by</p> <p>(a) computing the difference between the agreed settlement price for those <i>investments</i> and their current <i>market value</i> where that difference is not in the <i>firm's</i> favour, and</p> <p>(b) multiplying that difference by the applicable percentage specified in table 13.5.4B <u>C</u>.</p>	A Counterparty Risk Adjustment

	Exclude amounts that have been due and unpaid for more than 90 days.	An Illiquid Adjustment
(9) Prepayments	<p>Include the amount of prepayments which relate to goods or services to be received or performed within 90 days, after discounting the amount by the applicable percentage specified in table 13.5.4C D.</p> <p>Exclude the amount of prepayments relating to more than 90 days.</p>	<p>A Counterparty Risk Adjustment</p> <p>An Illiquid Adjustment</p>
(10) Accrued income	<p>Include accrued income, including any such income not yet due and receivable in respect of fees earned in the performance of <i>investment management</i> services that is receivable within 90 days, after discounting the amount by the applicable percentage specified in table 13.5.4C D.</p> <p>Exclude accrued income receivable after 90 days.</p>	<p>A Counterparty Risk Adjustment</p> <p>An Illiquid Adjustment</p>
(11) <i>Deposits</i>	...	
(12) Other amounts due from Government bodies or local authorities	<p>Include other amounts due from UK Government bodies or local authorities if they are agreed and due within 90 days, after discounting the amounts by the applicable percentage specified in table 13.5.4C D.</p> <p>Exclude amounts that are not due to be paid within 90 days.</p>	<p>A Counterparty Risk Adjustment</p> <p>An Illiquid Adjustment</p>
(13) All other assets	<p>Exclude in full.</p> <p>If not otherwise excluded in full in this table, this category should include any holding in eligible capital instruments of an insurance undertaking, insurance holding company, or reinsurance undertaking that is a <i>subsidiary</i> or participation.</p> <p>Eligible capital instruments include ordinary share capital, cumulative preference shares, perpetual securities and long-term subordinated loans, that are eligible for insurance undertakings under <u>PRU 2 INSPRU</u>.</p>	An Illiquid Adjustment
Where applicable – <i>Large exposures</i>	Deduct an amount calculated in accordance with rule 13.6.2.	A Large exposure Adjustment

Table 13.5.4(2) A Part II

This table forms part of *rule 13.5.42.9*

EXEMPT CAD FIRM <i>EXEMPT CAD FIRM</i>		
LIABILITY	CALCULATION	TYPE OF ADJUSTMENT
(14) Secured Liabilities	...	...
(15) Subordinated loans	...	...
(16) Commission on indemnity terms from the sale of <i>life policies</i> or <i>pension contracts</i>	...	...
(17) <i>Investments</i> (Short Positions)	Include a <i>net short position</i> (a) valued at its <i>offer price</i> , and (b) increased by the applicable percentage specified in table 13.5.4A <u>B</u> .	A Position Risk Adjustment
(18) Deficiency in <i>subsidiary</i>	...	...
(19) Liability for tax	...	...
(20) Creditors relating to Unsettled <i>Securities</i> Transactions Cash against Documents	Include creditors where a <i>firm</i> has entered into a transaction in <i>securities</i> or <i>units in collective investment schemes</i> as agent on a cash against documents basis, and the transaction remains unsettled, after adding an amount calculated by (a) computing the difference between the agreed settlement price for those <i>investments</i> and their current <i>market value</i> , and (b) multiplying that exposure by the applicable percentage specified in table 13.5.4B <u>C</u> .	A Counterparty Risk Adjustment

(21) Creditors relating to Unsettled Securities Transactions Free Deliveries	<p>Include an amount for creditors where (acting as agent) the <i>firm</i> has delivered certificates of title for <i>securities</i> or <i>units in collective investment schemes</i> before receiving payment for them, or where the <i>firm</i> has bought such <i>investments</i> before receiving certificates of good title for them, after adding an amount calculated by</p> <p>(a) (i) (where the <i>firm</i> has paid for them but not received certificates of good title for them) computing their current <i>market value</i>;</p> <p>(ii) (where the <i>firm</i> has delivered the certificates without receiving payment for them) computing the full amount due to a <i>firm</i> under the contract for sale; and</p> <p>(b) multiplying that exposure by the applicable percentage specified in table 13.5.4C <u>D</u>.</p>	A Counterparty Risk Adjustment
(22) <i>Over the counter derivatives</i>	<p>Include as a liability an amount for its positions in such <i>derivatives</i> calculated by</p> <p>(a) computing the credit equivalent of those positions in accordance with table 13.5.4D <u>E</u>, and</p> <p>(b) increasing that credit equivalent by the applicable percentage specified in table 13.5.4C <u>D</u>,</p> <p>(in addition to making an adjustment in accordance with item (17) of this table and (in respect of bought <i>OTC</i> equity <i>options</i> and covered <i>warrants</i>) in accordance with item (25)).</p>	A Counterparty Risk Adjustment
(23) Contingent Liabilities	...	...
(24) Preference Shares	<p>Include as a liability any amounts in excess of the amounts which may be treated as financial capital resources specified in table 13.3.2(2) 13.1A.17R(1) and SUP 16.</p>	
(25) <i>Net open foreign currency position</i>	<p>Include as a liability an amount in respect of its foreign exchange risk calculated in accordance with table 13.5.4E <u>F</u>.</p>	A Foreign Exchange Risk Adjustment
(26) All other liabilities	...	

Table 13.5.4A B

This table forms part of *rule 13.5.42.9*

POSITION RISK
...

Table ~~13.5.4B~~ C

This table forms part of rule 13.5.42.9

UNSETTLED SECURITIES TRANSACTIONS	
Number of business days after due settlement date	Percentage
...	

Table ~~13.5.4C~~ D

This table forms part of rule 13.5.42.9

COUNTERPARTY RISK	
Type of Counterparty	Deduction
...	

Table ~~13.5.4D~~ E

This table forms part of rule 13.5.42.9

OVER THE COUNTER DERIVATIVES	
a. ...	

Table ~~13.5.4E~~ F

This table forms part of *rule* 13.5.42.9

FOREIGN EXCHANGE RISK	
(a) ...	

SUBORDINATED LOANS

13.5.52.10 R An *exempt CAD firm* may treat a subordinated loan as a ~~financial capital~~ resources as specified in table 13.1A.15R and subject to ~~rule 13.5.5C2.12~~, if the long term subordinated loan is eligible for such treatment in accordance with ~~rule 13.5.5A2.11~~.

13.5.5A2.11 R A long term subordinated loan is eligible for such treatment if:

- (1) it is fully paid up;

- (2) it has an original maturity of at least five years, or where it has no fixed term, it is subject to five years' notice of repayment;
- (3) repayment, prepayment or termination is only permitted under the loan agreement:
 - (a) on maturity, or on expiration of the period of notice, if after such payment or termination a *firm* meets 120% of its financial-capital resources requirement; or
 - (b) on winding up after the claims of all other creditors and all outstanding debts have been settled;
- (4) the amount used in the calculation of its financial-capital resources is reduced on a straight line basis over the last five years of its term;
- (5) it is in the standard form prescribed by the *FSA* for long term subordinated loans.

~~13.5.5B~~ R ~~{deleted}~~

~~13.5.5C~~ R The total amount of long term subordinated loans that an *exempt CAD firm* 2.12 may include in the calculation of its financial-capital resources is restricted as stipulated in 13.1A.17R and in *SUP* 16.

~~13.6~~ ~~{Deleted}~~

~~13.7~~ ~~{Deleted}~~

~~13.8~~ ~~{Deleted}~~

13.9.3 FINANCIAL-CAPITAL RESOURCES-TESTS REQUIREMENT FOR CATEGORY B FIRMS

~~13.9.1~~ R ~~A Category B firm must meet:~~

- (1) ~~financial Resources Test 1 (the *Own funds* Test) calculated in accordance with section 13.10;~~
- (2) ~~Financial Resources Test 1A (the *Adjusted Net current assets* Test) calculated in accordance with section 13.11, unless the *firm* is a *low resource firm* which is not permitted to carry on the activity of managing investments in respect of portfolios containing only *life policies*; and~~
- (3) ~~Financial Resources Test 2 (the *Expenditure-based* Test) calculated in accordance with section 13.12 unless the *firm* is a *low resource firm*.~~

13.9.1A G Table 13b is a summary of the financial resources test for a *Category B firm*.

Table 13B This table forms part of *rule 13.9.1*

SUMMARY OF FINANCIAL RESOURCES FOR CATEGORY B FIRMS				
Type of firm	Financial Resources Test 1 <i>Own funds Test</i>	Financial Resources Test 1A <i>Adjusted Net current assets Test</i>	Financial Resources Test 2 <i>Expenditure-based Test</i>	<i>Rule/section References</i>
<i>Category B1 (including any Network in this category)</i>	£10,000	<i>Adjusted net current assets of £1</i>	Liquid capital equal to the highest of 13/52 of relevant annual expenditure or £400 per adviser or £10,000	13.10 13.11 13.12.1 € 13.12.2 to 13.12.5 A
<i>Category B2 which is permitted to carry on the activity of investment management in respect of portfolios containing only life policies or to delegate such activity to an investment firm</i>	£10,000	<i>Adjusted net current assets of £1</i>	Adjusted capital equal to the higher of 13/52 of relevant annual expenditure or £400 per adviser	13.10 13.11 13.12.1 D 13.12.2 to 13.12.5 A

<i>Category B2 with 26+ advisers</i>	£10,000	Adjusted <i>net current assets</i> of £1	Adjusted capital equal to the higher of 8/52 of relevant annual expenditure or £400 per adviser	13.10 13.11 13.12.1 E 13.12.2 to 13.12.5 A
<i>Category B2 with 1-25 advisers</i>	£10,000	Adjusted <i>net current assets</i> of £1	Adjusted capital equal to the higher of 4/52 of relevant annual expenditure or £400 per adviser	13.10 13.11 13.12.1 F 13.12.2 to 13.12.5 A
<i>Category B3 which is permitted to carry on the activity of managing investments in respect of portfolios containing only life policies or to delegate such activity to an investment firm</i>	£10,000	Adjusted <i>net current assets</i> of £1	Adjusted capital equal to the higher of 8/52 of relevant annual expenditure or £400 per adviser	13.10 13.11 13.12.1 E 13.12.2 to 13.12.5 A

<i>Category B3 with 26+ advisers</i>	£10,000	Adjusted <i>net current</i> assets of £1	Adjusted capital equal to the higher of 4/52 of relevant annual expenditure or £400 per adviser	13.10 13.11 13.12.1 F 13.12.2 to 13.12.5 A
<i>Category B3 with 1–25 advisers</i>	£10,000	N/A	N/A	13.10
<i>Network in Category B2 or B3</i>	£10,000	Adjusted <i>net current</i> assets of £1	Adjusted capital equal to the higher of 13/52 of relevant annual expenditure or £400 per adviser	13.10 13.11 13.12.1 D 13.12.2 to 13.12.5 A
<i>All Category B firms that do not hold client money or assets, but are permitted to establish, operate or wind up a personal pension scheme.</i>	£10,000	Adjusted <i>net current</i> assets of £1	Adjusted capital equal to the highest of 6/52 of relevant annual expenditure, £400 per adviser, £10,000 and any other expenditure-based requirement set out in 13.12.1 applicable to the <i>firm</i> .	13.10 13.11 13.12.1 13.12.2 to 13.12.5 A

All <i>Category B</i> firms that hold <i>client money</i> or assets and are permitted to establish, operate or wind up a personal pension scheme.	£10,000	Adjusted <i>net current assets</i> of £1	Adjusted capital equal to the highest of 13/52 of relevant annual expenditure, £400 per adviser, and £10,000	13.10 13.11 13.12.1 G 13.12.2 to 13.12.5 A
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13.10 Financial Resources Test 1 – Own funds Requirement

13.10.1 R A *Category B* firm's own funds must at all times be at least £10,000.

Calculation

13.10.2 R A *Category B* firm's own funds must be calculated in accordance with table 13.10(2).

Table 13.10(2).

This table forms part of *rule* 13.10.2

<i>OWN FUNDS</i>	
Companies	Sole Traders: Partnerships
Paid up <i>share</i> capital (excluding preference <i>shares</i> redeemable by shareholders within 2 years) <i>Eligible LLP members' capital</i> <i>Share</i> premium account Retained profits (see 13.10.2AR) and interim net profits (Note 1)	Balances on proprietor's or partners' ² capital accounts current accounts (see 13.10.2AR)
Revaluation reserves	Revaluation reserves
Short term subordinated loans	Short term subordinated loans
Debt capital	
less	less

Intangible assets Material current year losses <i>Excess LLP members' drawings</i>	Intangible assets Material current year losses Excess of current year drawings over current year profits
<p>Note 1</p> <p>Retained profits must be audited and interim net profits must be verified by the <i>firm's</i> external auditor, unless the <i>firm</i> is exempt from the provisions of Part VII of the Companies Act 1985 (section 294A (Exemptions from audit)), or where applicable, Part 16 of the Companies Act 2006 (section 477 (Small companies: Conditions for exemption from audit)) relating to the audit of accounts.</p>	

- 13.10.2A R For the purpose of calculating a *Category B firm's own funds*, the following adjustments apply to retained profits or, (for non-corporate entities), current accounts figures.
- (1) a *Category B firm* must deduct any unrealised gains or, where applicable, add back in any unrealised losses on cash flow hedges of financial instruments measured at cost or amortised cost;
 - (2) a *Category B firm* must derecognise any defined benefit asset;
 - (3) a *Category B firm* may substitute for a *defined benefit liability* its *deficit reduction amount*. The election must be applied consistently in respect of any one financial year.
 - (4) a *Category B firm* must deduct any unrealized gains on investment property and include these within revaluation reserves.
 - (5) where applicable, a *Category B firm* must deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but exclude from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.
- 13.10.2B G A *firm* should keep a record of and be ready to explain to its supervisory contacts in the *FSA* the reasons for any difference between the *deficit reduction amount* and any commitment the *firm* has made in any public document to provide funding in respect of a defined benefit occupational pension scheme. Where a *Category B firm* is a sole trader or a partnership:
- (1) it can use (to the extent necessary to make up any shortfall in the required resources) any of its personal assets (not being needed to meet liabilities arising from its personal activities and any business activities not regulated by the *FSA*);

- (2) ~~the firm's total financial resources, from whatever source, must at all times be sufficient to cover its total liabilities.~~
- 13.10.3 R (1) ~~Where a Category B3 firm with 1-25 advisers has a facility under the PASS Loan Agreement Scheme it may make an adjustment in its own funds calculation in accordance with (2).~~
- (2) ~~a firm in (1) can regard as additional to its own funds the lower of either:~~
- (a) ~~the amount of the loan facility agreed (less any loan repayments already made and less the amount of the facility withdrawn or lapsed); or~~
- (b) ~~the amount of the firm's provision for redress (net of any professional indemnity insurance recoverable) at the time of its application for the loan facility.~~

13.11 Financial Resources Test 1A – Adjusted net current assets

Application

- 13.11.1 R This section does not apply to a *low resource firm*.

Requirement

- 13.11.2 R ~~A Category B firm must adjust its net current assets as follows:~~
- (1) ~~exclude assets which cannot be realised or recovered within twelve months;~~
- (2) ~~exclude amounts receivable from connected persons to the extent that they are not properly secured, except amounts that are deposits referred to in item (11) of table 13.12.3(1) or item (11) in table 13.12.3(2);~~
- (3) ~~value investments at current market value, using the bid price for a net long position in an investment and the offer price for a net short position in an investment;~~
- (4) ~~where applicable, deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but exclude from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.~~
- 13.11.3 R ~~A Category B firm must at all times have adjusted net current assets of at least £1.~~

13.12 FINANCIAL RESOURCES TEST 2 – EXPENDITURE-BASED REQUIREMENT

13.12.1 Application

13.12.1A R This section does not apply to a *low resource firm*.

REQUIREMENT

13.12.1B R A *Category B firm* must have at all times financial capital resources
3.1 calculated in accordance with *rules* 13.12.23.3 to 13.12.53.14 which
equal or exceed the amount specified in *rules* 13.12.1C3.2 to F as
applicable.

13.12.1C R A *Category B1 firm*, including a *Network* must have financial meet a
3.2 capital resources requirement calculated in accordance with whichever
of (1); or (2) ~~or (3)~~ produces the higher amount.

- (1) ~~13/52~~ 1/4 of its relevant fixed annual expenditure, calculated in
accordance with 13.12.23.3R to 13.12.2D3.8R; or
- (2) an amount equal to £400 multiplied by the number of its *advisers*;
or
- (3) £120,000;
(2)

13.12.1D R (1) — A *Category B2 firm* which is permitted to carry on the activity of
investment management in respect of portfolios containing only
life policies or to delegate such activity to an *investment firm* must
have financial resources calculated in accordance with whichever
of (3) or (4) produces the higher amount.

(2) — A *Network* in Category B2 or B3 must have financial resources
calculated in accordance with whichever of (3) or (4) produces the
higher amount.

(3) — ~~13/52~~ of its relevant annual expenditure, calculated in accordance
with 13.12.2 to 13.12.2D; or

(4) — an amount equal to £400 multiplied by the number of its *advisers*.

13.12.1E R (1) — A *Category B2 firm* with more than 25 *advisers* which is not a
Network and is not permitted to carry on the activity of *managing*
investments in respect of portfolios containing only *life policies* or
to delegate such activity to an *investment firm* must have financial
resources calculated in accordance with whichever of (3) or (4)
produces the higher amount.

- (2) — A *Category B3 firm* which is permitted to carry on the activity of *investment management* in respect of portfolios containing only *life policies* or to delegate such activity to an *investment firm* must have financial resources calculated in accordance with whichever of (3) or (4) produces the higher amount.
- (3) — 8/52 of its relevant annual expenditure, calculated in accordance with 13.12.2 to 13.12.2D; or
- (4) — an amount equal to £400 multiplied by the number of its *advisers*.
- 13.12.1F R (1) — A *Category B2 firm* with fewer than 26 *advisers* which is not a *Network* and is not permitted to carry on the activity of *managing investments* in respect of portfolios containing only *life policies* or to delegate such activity of *investment management* to an *investment firm* must have financial resources calculated in accordance with whichever of (3) or (4) produces the higher amount.
- (2) — A *Category B3 firm* which is not permitted to carry on the activity of *investment management* in respect of portfolios containing only *life policies* or to delegate such activity to an *investment firm* must have financial resources calculated in accordance with whichever of (3) or (4) produces the higher amount.
- (3) — 4/52 of its relevant annual expenditure, calculated in accordance with 13.12.2 to 13.12.2D; or
- (4) — an amount equal to £400 multiplied by the number of its *advisers*.
- 13.12.1G R A *category B firm* whose permission includes *establishing, operating or winding up a personal pension scheme* must have financial resources calculated in accordance with (1) or (2):
- (1) For a *firm* which holds *client money* or assets, the highest of:
- (a) 13/52 of its relevant annual expenditure, calculated in accordance with 13.12.2 to 13.12.2D;
- (b) an amount equal to £400 multiplied by the number of its *advisers*; and
- (c) £10,000.
- (2) For a *firm* which does not hold *client money* or assets, the highest of:
- (a) 6/52 of its relevant annual expenditure, calculated in accordance with 13.12.2 to 13.12.2D;

- (b) ~~an amount equal to £400 multiplied by the number of its advisers;~~
- (c) £10,000; and
- (d) ~~any other expenditure-based requirement set out in 13.12.1 applicable to the firm.~~

CALCULATION OF ~~RELEVANT~~ FIXED ANNUAL EXPENDITURE

- 13.12.2
3.3 R A ~~Category B~~ firm must calculate its ~~relevant fixed~~ annual expenditure by reference to the amount described as total expenditure in its most recent ~~prepared set of annual financial statements~~. If those statements were for a period other than 12 months, the amounts in its profit and loss account must be adjusted proportionately RMAR drawn up at its accounting reference date.
- 13.12.2A
3.4 R Where a ~~Category B~~ firm has just begun trading or ~~have~~ has not been authorised long enough to submit such an RMAR, the firm must calculate its ~~relevant fixed~~ annual expenditure on the basis of forecast or other appropriate accounts submitted to the FSA.
- 13.12.2B
3.5 R A ~~Category B~~ firm may deduct from its ~~relevant total~~ annual expenditure the items (a) to (f) set out in table 13.12.23.3, unless the firm is a Category B1 firm, in which case it may not deduct item (e).

Table 13.12.23.3

This table forms part of rule 13.12.23.3

DEDUCTIONS FROM EXPENDITURE	
(a)	staff bonuses <u>(except to the extent that they are guaranteed)</u> ;
(b)	<i>employees' and directors' shares</i> in profits <u>(except to the extent that the amount is guaranteed)</u> ;
(c)	interest charges in respect of borrowings made to finance the acquisition of its <i>readily realisable investments</i> ;
(d)	shared commissions <u>and fees payable</u> paid which are directly related to commissions <u>and fees received</u> receivable that are <u>included within total revenue</u> ;
(e)	emoluments of <i>directors</i> , partners or a sole trader;
(f)	a firm must not deduct any exceptional expenditure <u>other variable expenditure</u> .

13.3.6 G For the purpose of this section, fixed expenditure is expenditure which is inelastic relative to fluctuations in a firm's levels of business. Fixed expenditure is likely to include most salaries and staff costs, office rent, payment for the rent or lease of office equipment, and insurance premiums. It may be viewed as the amount of funds which a firm would require to enable it to cease business in an orderly manner, should the need arise. This is not an exhaustive list of such expenditure and a firm will itself need to identify (taking appropriate advice where necessary) which costs amount to fixed expenditure.

ADJUSTMENTS TO CALCULATION OF RELEVANT FIXED ANNUAL EXPENDITURE

13.12.2C R A firm must ensure that the expenditure base properly reflects the ongoing annual operating costs of the firm by having proper regard to its circumstances when deciding whether to include or exclude any item of expenditure or to make any other adjustment to the calculation of relevant annual expenditure.

A firm must adjust its fixed expenditure calculation so far as necessary if and to the extent that since the date covered by the most recent annual RMAR or (if 13.3.4R applies) since the forecast was prepared:

- (1) its level of fixed expenditure changes materially; or
- (2) its regulated activities comprised within its permission change.

13.3.8 R If a firm has a material proportion of its expenditure incurred on its behalf by third parties and such expenditure is not fully recharged to that firm then the firm must adjust its fixed expenditure calculation by adding back in the whole of the difference between the amount of the expenditure and the amount recharged.

13.12.2D G In rule 13.12.2C the FSA would expect a firm to take proper account of the effect of, for example, the ongoing annual operating costs of the firm being met by another party, or of a significant change in the structure of the firm's business during the year.

The FSA would consider as material 10% of a firm's total expenditure incurred on its behalf by third parties.

CALCULATION OF FINANCIAL CAPITAL RESOURCES TO MEET TESTS 1, 1A OR 2 THE EXPENDITURE-BASED REQUIREMENT

13.12.3 R (1) This rule does not apply to a low resource firm;
3.10

(2) A category B firm must be able to calculate its financial capital resources at any time in accordance with table 13.3.10 Part I on the basis of the balance sheet the firm could draw up by the firm at that time. For this purpose:

(1)

- (a) a *Category B1 firm* must adjust the assets in the balance sheet as specified in Part I of table 13.12.3(1) and include the liabilities after making the adjustments specified in Part II of table 13.12.3(1);
 - (b) a *Category B2 or B3 firm* to which 13.12 applies must adjust the assets in the balance sheet as specified in Part I of table 13.12.3(2) and include the liabilities after making the adjustments specified in Part II of table 13.12.3(2).
- (2) A firm must recognise an asset or liability, and measure its amount, in accordance with the relevant accounting principles applicable to it for the purpose of preparing its annual financial statements unless a rule requires otherwise.
- (3) ~~the assets and liabilities in the balance sheet are also subject to the following adjustments:~~
- (a) ~~a *Category B firm* must deduct any unrealised gains or, where applicable, add back in any unrealised losses on cash flow hedges of *financial instruments* measured at cost or amortised cost;~~
 - (b) ~~in respect of a *defined benefit occupational pension scheme*, a *Category B firm* must derecognise any defined benefit asset;~~
 - (c) ~~a *Category B firm* may substitute for a defined benefit liability the *firm's deficit reduction amount*. The election must be applied consistently in respect of any one financial year;~~
 - (d) ~~where applicable, a *Category B firm* must deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but exclude from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.~~

Table 13.3.10 Part I

This table forms part of *rule 13.3.10*

<u>To calculate a firm's capital resources, the items in Stage B must be deducted from the items in Stage A. The result must then be added to the items in Stage C ((A-B) + C).</u>		
<u>Stage A</u>	<u>Item</u>	<u>Adjustment</u>
<u>1</u>	<u>Paid up share capital excluding preference shares redeemable</u>	<u>Exclude any redeemable preference shares which fall due within two years. If preference shares are not redeemable by the shareholder</u>

	<u>by shareholders within 2 years</u>	<u>within 2 years, they must be treated in accordance with 13.3.13R and 13.3.14R.</u>
<u>2</u>	<u>Eligible LLP members' capital</u>	
<u>3</u>	<u>Balances on proprietor's or partners':</u> <ul style="list-style-type: none"> • <u>Capital accounts</u> • <u>Current accounts</u> <u>Less</u> <ul style="list-style-type: none"> • <u>Excess LLP members' drawings</u> • <u>Excess of current year drawings over current year profits</u> 	
<u>4</u>	<u>Share premium account</u>	
<u>5</u>	<u>Retained profits (losses) plus current year net profits (losses)</u>	<u>Retained profits and retained losses are subject to the following adjustments:</u> <ol style="list-style-type: none"> <u>(1) the firm must deduct any unrealised gains or, where applicable, add back in any unrealised losses on cash flow hedges of financial instruments measured at cost or amortised cost;</u> <u>(2) in respect of a defined benefit occupational pension scheme, the firm must derecognise any defined benefit asset;</u> <u>(3) the firm may substitute for a defined benefit liability the firm's deficit reduction amount. The election must be applied consistently in respect of any one financial year; and</u> <u>(4) where applicable, the firm must deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but exclude from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.</u> <u>Retained profits (or losses) do not need to be audited and current year net profits (or losses) do not need to be verified.</u>
<u>6</u>	<u>Revaluation reserve</u>	

<u>7</u>	<u>Subordinated loans</u>	<u>Subject to the limits set out in 13.3.11R to 13.3.14R.</u>
<u>Stage B</u>	<u>Item</u>	<u>Adjustment</u>
<u>8</u>	<u>Intangible assets</u>	<u>Deduct intangible assets in full.</u>
<u>9</u>	<u>Contingent liabilities</u>	<u>Deduct any contingent liability (including the overdraft of any other company which the <i>firm</i> has guaranteed).</u>
<u>10</u>	<u>Deficiencies in <i>subsidiaries</i></u>	<u>Include a deduction for the amount by which the liabilities of any <i>subsidiary</i> (excluding its capital and reserves) exceed its tangible assets. This requirement applies only to the extent that the <i>firm</i> has not already made such a provision in its balance sheet.</u>
<u>11</u>	<u>Non-trade debtors (including from <i>group</i> and <i>connected</i> companies)</u>	<u>Deduct amounts in full.</u>
<u>12</u>	<u>Trade debtors (including from <i>group</i> and <i>connected</i> companies)</u>	<u>Deduct amounts due and unpaid for more than 90 days.</u>
<u>13</u>	<u>Land and buildings (net of any liabilities secured by a charge on the assets)</u>	<u>Deduct 30% of the net book value of land and buildings.</u>
<u>14</u>	<u><i>Investments</i></u>	<u>Deduct the applicable percentage for <i>investments</i> as specified in table 13.3.10 Part II.</u>
<u>15</u>	<u>Accrued Income</u>	<u>Deduct amounts receivable after more than 90 days.</u>
<u>16</u>	<u>Prepayments</u>	<u>Deduct amounts which relate to goods or services to be received or performed after more than 90 days.</u>
<u>17</u>	<u><i>Deposits</i></u>	<u>Deduct amounts other than:</u> <u>(a) cash and balances on current accounts and on <i>deposit</i> accounts with an <i>approved bank</i> or National Savings Bank which can be withdrawn within 90 days;</u> <u>(b) money on <i>deposit</i> with a UK local authority which can be withdrawn within 90 days;</u>

		<u>18(c) money deposited and evidenced by a certificate of tax deposit.</u>
<u>18</u>	<u>Other illiquid assets</u>	<u>Deduct amounts in full.</u>
<u>Stage C</u>	<u>Item</u>	<u>Adjustment</u>
<u>19</u>	<u>Personal assets of partnerships or sole traders</u>	<u>A sole trader or a partnership may include personal assets (based on a current independent valuation) to make up any shortfall in the required capital resources needed to meet its capital resources requirement. The assets must be discounted by the factors given in stage B of this Table and must not be needed to meet liabilities arising from personal activities or another business activity not regulated by the FSA.</u>

Table 13.12.3(1) Part I

This table forms part of *rule 13.12.3*

<i>FIRMS CATEGORY B1</i>	
CALCULATION OF ASSETS	
ASSETS	ADJUSTMENTS
(1) Land and Buildings	Exclude in full. (A loan secured by a charge on land and buildings may be deducted from liabilities in accordance with item (14) of Part II of this table.)

<p>(2) <i>Investments</i></p>	<p>Include any <i>net long position</i> in any fixed or current asset investment (including <i>shares</i> in any connected company)</p> <p>(a) valued at its current bid price (or, in the case of a with profits <i>life policy</i>, at its surrender value), and</p> <p>(b) discounted by the applicable percentage specified in table 13.12.3A.</p> <p>A <i>firm</i> which acts as a market maker in second-hand <i>life policies</i> must comply with the relevant requirements in respect of second-hand <i>life policies</i> held by the <i>firm</i> and include such a policy.</p> <p>(a) valued at its surrender value at the date on which the <i>firm</i> acquired it, or its latest available surrender value if different.</p> <p>(b) where a life office whose policy is held by the <i>firm</i> has altered adversely the basis on which it calculates surrender values, the <i>firm</i> must revise its valuation of the second-hand <i>policy</i> as soon as practicable after becoming aware of the alteration.</p>
<p>(3) <i>Investments</i> subject to Repurchase, Reverse Repurchase, Stock Borrowing or Stock Lending transactions</p>	<p>Include <i>investments</i> for which the <i>firm</i> has entered as principal into a repurchase, reverse repurchase, stock borrowing or stock lending transaction on its own behalf, after making (I) a deduction in accordance with item (2), and (II) a deduction calculated by computing its exposure (the difference between the <i>market value</i> of the securities and the loan or collateral (including accrued interest) where that difference is not in the <i>firm's</i> favour, after adjusting for any excess collateral).</p>

<p>(4) Debtors relating to Unsettled Securities Transactions Cash against Documents</p>	<p>Include debtors where the <i>firm</i> has entered into a transaction on its own behalf in <i>securities</i> or <i>units</i> in <i>collective investment</i> schemes on a cash against documents basis, and the transaction remains unsettled, after deducting an amount calculated by</p> <p>(a) computing the difference between the agreed settlement price for those <i>investments</i> and their current <i>bid price</i> where that difference is not in the <i>firm's</i> favour, and</p> <p>(b) multiplying that difference by the applicable percentage specified in table 13.12.3B.</p>
<p>(5) Debtors relating to Unsettled Securities Transactions Free Deliveries</p>	<p>(a) Include the full amount due to the <i>firm</i> from debtors if a <i>firm</i> has delivered <i>securities</i> or <i>units</i> in <i>collective investment schemes</i> before receiving payment for them, or paid for such investments before receiving certificates of good title for them, so long as not more than three days have passed since delivery</p> <p>(b) If more than three days have passed since delivery, exclude in full.</p>
<p>(6) <i>Regulated collective investment schemes</i></p>	<p>Include an amount owing in respect of a transaction in <i>units</i> in a <i>regulated collective investment scheme</i> only if the amount has been due and unpaid for 30 days or less after the settlement date of the transaction to which it relates.</p>
<p>(7) Loans secured on <i>investments</i></p>	<p>If the <i>firm</i> holds client title documents as security for</p> <p>(a) the repayment of money it has lent; or</p> <p>(b) money due to the <i>firm</i> in connection with the purchase for or sale to another person of those investments, which the <i>firm</i> has for genuine commercial reasons agreed to postpone,</p> <p>the <i>firm</i> may include as an asset the lower of the following:</p> <p>(i) the total amount due;</p> <p>(ii) the <i>market value</i> of the <i>investments</i> multiplied by the appropriate rates set out in table 13.12.3A.</p>

(8) Trade debtors	<p>Include amounts owing only in respect of</p> <p>(a) (i) commission; (ii) investment management fees; (iii) other fees earned in connection with the firm's investment business,</p> <p>which are due from other authorised or <i>EEA firms, recognised investment exchanges or recognised clearing houses</i> and have been due and unpaid for 30 days or less;</p> <p>(b) (i) investment management fees; or (ii) pensions administration which have been due from its customers and unpaid for 30 days or less.</p> <p>(c) All other trade debtors must be deducted in full.</p>
(9) Prepayments	<p>Include prepayments which relate to goods or services to be received or performed within 90 days.</p>
(10) Accrued income	<p>(a) Accrued income relating to investment management fees not yet due and payable may be included if the fees relate to services provided within the previous six months.</p> <p>(b) Other accrued income may be included if it relates to interest on marketable debt instruments or on deposits included in item (11).</p>
(11) <i>Deposits</i>	<p>The following may be included:</p> <p>(a) cash and balances on current accounts and on deposit accounts with an approved bank or National Savings Bank which can be withdrawn within 90 days;</p> <p>(b) money on deposit with a UK local authority which can be withdrawn within 90 days;</p> <p>(c) money deposited and evidenced by a certificate of tax deposit.</p>

(12) Other Debts	<p>(a) Amounts owing in respect of</p> <ul style="list-style-type: none"> (i) interest on <i>investments</i>; (ii) repayments of marketable debt instruments at maturity or call; (iii) dividends declared by authorised or not <i>EEA firms</i> or by companies in respect of <i>shares</i> listed on a recognised or designated investment exchange; <p>which have been due and unpaid for 30 days or less may be included.</p> <p>(b) Other amounts due from UK government bodies may be included if they are agreed and due within 30 days.</p>
(13) All other assets	Exclude in full.

Table 13.12.3(1) Part II

This table forms part of *rule 13.12.3*

<i>FIRMS IN CATEGORY B1</i>	
CALCULATION OF LIABILITIES	
LIABILITIES	ADJUSTMENTS
(14) Secured Liabilities	<p>Include in full, except the amount of the liabilities secured by a charge on land and buildings which may be reduced by the smallest of the following amounts:</p> <ul style="list-style-type: none"> (a) the aggregate amount of the <i>firm's</i> secured liabilities which are due more than one year after the balance sheet date; (b) (if the land and buildings have been valued by an independent professional valuer within the past 18 months) 85% of the amount certified by the valuer as their market value; (c) 85% of the net book value of the land and buildings.
(15) Subordinated loans	<p>Include in full, except any short term subordinated loan in the standard form prescribed by the <i>FS4</i> which may be treated as capital up to the limits specified in <i>rules 13.12.5</i> and <i>13.12.5A</i>.</p>

(16) Commission on indemnity terms from the sale of <i>life policies</i> or pension contracts	Include as a liability a provision for repayment, in the event that premiums cease within the indemnity period, which must equal or exceed 2.5% of the commissions the <i>firm</i> has received on indemnity terms during the previous twelve months. This provision must be reasonable having regard to its circumstances and, in particular, its previous lapse ratio.
(17) Short Positions	Include a <i>net short position</i> (a) valued at its offer price and (b) increased using the applicable percentage rate in table 13.12.3A.
(18) Deficiency in <i>subsidiary</i>	Include as a liability the amount by which the liabilities of any <i>subsidiary</i> (excluding its capital and reserves) exceed its tangible assets. This requirement applies only to the extent that the <i>firm</i> has not already made such a provision elsewhere in its financial statements.
(19) Liability for tax	Include as a liability a provision for taxation on the whole of the profits of the <i>firm's</i> business up to its balance sheet date.
(20) Creditors relating to Unsettled <i>Securities</i> Transactions – Cash against Documents	Include creditors where the <i>firm</i> has entered into a transaction on its own behalf in <i>securities</i> or <i>units</i> in <i>collective investment schemes</i> on a cash against documents basis, and the transaction remains unsettled, after adding an amount calculated by (a) computing the difference between the agreed settlement price for those <i>investments</i> and their current <i>market value</i> where that difference is not in the <i>firm's</i> favour, and (b) multiplying that difference by the applicable percentage specified in table 13.12.3B.

(21) Creditors relating to Unsettled Securities Transactions – Free Deliveries	<p>Include an amount for creditors where (acting on the <i>firm's</i> own behalf) the <i>firm</i> has delivered certificates of title for <i>securities</i> or <i>units</i> in <i>collective investment schemes</i> before receiving payment for them, or where a <i>firm</i> has bought such <i>investments</i> before receiving certificates of good title for them, as follows:</p> <p>(a) (if the <i>firm</i> has paid for them and not more than 3 days have passed since the payment was made) include in full:</p> <p>(b) (if more than 3 days have passed since the payment was made) include the full value of the <i>securities</i> at their current <i>offer price</i>.</p>
(22) <i>Over the counter derivatives</i>	<p>If the <i>firm</i> holds positions in derivatives on its own behalf must</p> <p>(a) make the adjustment in item (17) of this table, and</p> <p>(b) deduct the credit equivalent of those positions computed in accordance with table 13.12.3C. In addition, bought <i>OTC options</i> and covered <i>warrants</i> will be subject to table 13.12.3D.</p>
(23) Contingent Liabilities	<p>A <i>firm</i> must include a provision for any contingent liabilities which exist at its balance sheet date that must be made.</p>
(24) Redeemable Preference Shares	<p>Include as a liability any redeemable preference <i>shares</i> which fall due within two years. If <i>shares</i> are not redeemable by the shareholder within 2 years, they must be treated in accordance with rules 13.12.5 and 13.12.5A.</p>
(25) Foreign currency risk	<p>If the <i>firm</i> holds positions on its own behalf in foreign currencies or has assets or liabilities denominated in foreign currencies, the <i>firm</i> must calculate a provision to cover the risk in accordance with table 13.12.3D and include the amount as a liability</p>
(26) All other liabilities	<p>Include in full.</p>

Table 13.12.3(2) Part I

This table forms part of *rule 13.12.3*

<i>FIRMS IN CATEGORIES B2 AND B3</i> (except <i>low resource firms</i>)	
CALCULATION OF ASSETS	
ASSETS	ADJUSTMENTS
(1) Land and buildings	<p>Include land and buildings which are not subject to any charge only if they have been valued either</p> <p>(a) at 60% of their net book value, or</p> <p>(b) (if valued by an independent professional valuer within the past three years) at 60% of the amount certified by the valuer to be the <i>market value</i>.</p>
(2) Motor vehicles	<p>(a) Include motor vehicles acquired less than 12 months ago valued at 50% of their cost</p> <p>(b) Include motor vehicles acquired within the past 24 months (but more than 12 months ago) valued at 25% of their cost</p> <p>(c) Exclude in full any other motor vehicles.</p>
(3) <i>Investments</i>	<p>Include any <i>net long position</i> in any fixed or current asset investment (including <i>shares</i> in any connected company)</p> <p>(a) valued at its current <i>bid price</i> (or, in the case of a <i>with profits life policy</i>, at its surrender value) and</p> <p>(b) discounted by the applicable percentage specified in table 13.12.3A.</p>
(4) Debtors relating to Unsettled <i>Securities</i> Transactions Cash against Documents	<p>Include debtors where a <i>firm</i> has entered into a transaction on its own behalf in <i>securities</i> or <i>units in collective investment schemes</i> on a cash against documents basis and the transaction remains unsettled after deducting an amount calculated by</p> <p>(a) computing the difference between the agreed settlement price for those <i>investments</i> and their current <i>bid price</i> where that difference is not in the <i>firm's</i> favour and</p> <p>(b) multiplying that difference by the applicable percentage specified in table 13.12.3B.</p>

<p>(5) Debtors relating to Unsettled Securities Transactions Free Deliveries</p>	<p>(a) Where the <i>firm</i> has delivered <i>securities</i> or <i>units</i> in <i>collective investment schemes</i> before receiving payment for them or paid for such <i>investments</i> before receiving certificates of good title for them include the full amount due to a <i>firm</i> from debtors so long as not more than 3 days have passed since delivery.</p> <p>(b) Exclude in full if more than 3 days have passed since delivery.</p>
<p>(6) <i>Regulated collective investment schemes</i></p>	<p>Include an amount owing in respect of a transaction in <i>units</i> in a <i>regulated collective investment scheme</i> only if the amount has been due and unpaid for not more than 90 days after the settlement date of the transaction to which it relates.</p>
<p>(7) Debts of <i>group</i> or <i>connected companies</i></p>	<p>Include amounts due from <i>group</i> or <i>connected companies</i> (which do not relate to trade debts) where a <i>firm</i> has no reason to doubt that repayment will be made in full on demand.</p>
<p>(8) Trade debtors</p>	<p>Include amounts due from trade debtors (including <i>group</i> or <i>connected companies</i>) which have been due and unpaid for less than 90 days.</p>
<p>(9) Prepayments</p>	<p>Include prepayments which relate to goods or services to be received or performed within 90 days.</p>
<p>(10) Accrued income</p>	<p>(a) Include accrued income not yet due and payable in respect of fees earned in the performance of investment management services that is receivable within six months.</p> <p>(b) Include any other accrued income receivable within 90 days.</p>
<p>(11) <i>Deposits</i></p>	<p>Include amounts in respect of</p> <p>(a) cash and balances on current accounts and on <i>deposit</i> accounts with an <i>approved bank</i> or National Savings Bank which can be withdrawn within 90 days;</p> <p>(b) money on <i>deposit</i> with a UK local authority which can be withdrawn within 90 days;</p> <p>(c) money <i>deposited</i> and evidenced by a certificate of tax <i>deposit</i>.</p>

(12) Other amounts due from Government bodies or local authorities	Include other amounts due from UK Government bodies or local authorities if they are agreed and due within 90 days.
(13) All other assets	Exclude in full.

Table 13.12.3(2) Part II

This table forms part of *rule 13.12.3*

<i>FIRMS IN CATEGORIES B2 AND B3 (except low resource firms)</i>	
CALCULATION OF LIABILITIES	
LIABILITIES	CALCULATIONS
(14) Secured Liabilities	<p>Include in full, except the amount of the liabilities secured by a charge on land and buildings which may be reduced as follows:</p> <p>(a) If the liabilities secured exceed 85% of the value of the land and buildings, then the excess is treated as a liability;</p> <p>(b) If the land and buildings have been valued by an independent professional valuer within the past three years, the value of the land and buildings is the amount certified by the valuer as their market value; otherwise it is their net book value.</p> <p>(If 60% of the value of the land and buildings which are subject to a charge exceeds the liabilities secured, then the amount of that excess may be treated as an asset.)</p>
(15) Subordinated loans	<p>Include in full, except any short term subordinated loan in the standard form prescribed by the <i>FSA</i> for such loans which may be treated as capital up to the limits specified in <i>rules 13.12.5 and 13.12.5A</i>.</p>

<p>(16) Commission on indemnity terms from the sale of <i>life policies</i> or pension contracts</p>	<p>Include as a liability a provision for repayment, in the event that premiums cease within the indemnity period, which must equal or exceed 2.5% of the commissions the <i>firm</i> has received on indemnity terms during the previous twelve months. This provision must be reasonable having regard to its circumstances and, in particular, its previous lapse ratio.</p>
<p>(17) Short Positions</p>	<p>Include a <i>net short position</i></p> <p>(a) valued at its offer price, and</p> <p>(b) increased using the applicable percentage rate in table 13.12.3A.</p>
<p>(18) Deficiency in <i>subsidiary</i></p>	<p>Include as a liability the amount by which the liabilities of any <i>subsidiary</i> (excluding its capital and reserves) exceed its tangible assets. This requirement applies only to the extent that the <i>firm</i> has not already made such a provision elsewhere in its financial statements.</p>
<p>(19) Liability for tax</p>	<p>Include as a liability a provision for taxation on the whole of the profits of its business up to its balance sheet date.</p>
<p>(20) Unsettled <i>Securities</i> Transactions –Cash against Documents</p>	<p>Include creditors where the <i>firm</i> has entered into a transaction on its behalf in <i>securities</i> or <i>units in collective investment schemes</i> on a cash against documents basis, and the transaction remains unsettled, after adding an amount calculated by</p> <p>(a) computing the difference between the agreed settlement price for those investments and their current <i>market value</i>, and</p> <p>(b) multiplying that difference by the applicable percentage specified in table 13.12.3B.</p>

(21) Creditors relating to Unsettled Securities Transactions—Free Deliveries	<p>Include an amount for creditors where (acting on its behalf) the <i>firm</i> has delivered certificates of title for <i>securities</i> or <i>units</i> in <i>collective investment schemes</i> before receiving payment for them, or where the <i>firm</i> has bought such investments before receiving certificates of good title for them, as follows:</p> <p>(a) (if the <i>firm</i> has paid for them and not more than 3 days have passed since the payment was made) include in full;</p> <p>(b) (if more than 3 days have passed since the payment was made) include the full value of the <i>securities</i> at the current offer price.</p>
(22) <i>Over the counter derivatives</i>	<p>Include as a liability an amount for any positions the <i>firm</i> holds on its own behalf in such <i>derivatives</i> calculated by computing the credit equivalent of those positions in accordance with table 13.12.3C. In addition, bought <i>OTC derivatives</i> and covered <i>warrants</i> will be subject to table 13.12.3D.</p>
(23) Contingent Liabilities	<p>A <i>firm</i> must include a provision for any contingent liabilities which exist at its balance sheet date that must be made.</p>
(24) Long term liabilities	<p>Include as a liability any amount which falls due more than 3 years from the balance sheet date and is due to connected persons, in accordance with <i>rules</i> 13.12.5 and 13.12.5A.</p>
(25) Redeemable Preference <i>Shares</i>	<p>Include as a liability any redeemable preference <i>shares</i> which fall due within two years. If <i>shares</i> are not redeemable by the shareholder within two years, they must be treated in accordance with <i>rules</i> 13.12.5 and 13.12.5A.</p>
(26) <i>Net open foreign currency position</i>	<p>A <i>firm</i> must calculate its foreign exchange risk requirement in accordance with table 13.12.3D and include the amount as a liability.</p>
(27) All other liabilities	<p>Include in full.</p>

Table 13.12.3A3.10 Part II

This table forms part of *rule* 13.12.33.10

DISCOUNTS FOR INVESTMENTS

The percentages in the table are applied to the *market value* (unless otherwise stated) ~~or of~~ gross positions, i.e. both longs and shorts in each category; netting and offsetting are prohibited. The long or short position in a particular ~~investment~~ *investment* is the net of any long or short positions held in that same investment.

Investment	Discount
<p>A.. Debt</p> <p>UK Government or local authority stocks:</p> <ul style="list-style-type: none"> - with less than one year to final redemption 2% - with more than one year but less than five years to final redemption 5% - with five years or more to final redemption 10% 	
<p>Debt security:</p> <ul style="list-style-type: none"> - debt instruments issued or accepted by an <i>approved bank</i> with less than 90 days to final redemption 2% 	
<ul style="list-style-type: none"> - other debt instruments which are <i>marketable investments</i> with less than one year to final redemption 5% - other debt instruments which are <i>marketable investments</i> with less than five years to final redemption 10% - other debt instruments which are <i>marketable investments</i> 15% - floating rate notes which are <i>marketable investments</i>: - with no more than 20 years to final redemption 5% - with more than 20 years to final redemption 10% 	
<p>B. Equities</p> <ul style="list-style-type: none"> - other <i>investments</i> listed on a recognised <i>recognised</i> or designated investment exchange <i>designated investment exchange</i> 25% 	

<ul style="list-style-type: none"> - shares traded on a recognised investment exchange <u>shares traded on a recognised investment exchange</u> - other <i>shares</i> for which there is a <i>market maker</i> in the UK 	<p style="text-align: right;">35%</p> <p style="text-align: right;">35%</p>
<p>C. Derivatives</p> <ul style="list-style-type: none"> - exchange traded futures - OTC futures - Purchased options - Contracts for differences 	<p>4 x initial margin requirement</p> <p>Apply the appropriate percentage shown in A and B to the <i>market value</i> of the underlying position</p> <p>Apply the appropriate percentage shown in A and B to the <i>market value</i> of the underlying position but the result may be limited to the <i>market value</i> of the option</p> <p>20% of the <i>market value</i> of the contract</p>
<p><u>DC.</u> Other <i>Investments</i></p> <ul style="list-style-type: none"> - Unit linked bonds and units in authorised unit trust schemes (other than higher volatility funds and property funds) or regulated collective investment schemes <u>Unit linked bonds and units in authorised unit trust schemes (other than higher volatility funds and property funds) or regulated collective investment schemes</u> - units in higher volatility funds and property funds - with profit life policies (only applicable to firms other than traded life policy market makers) - shares in subsidiary companies and shares which are not readily realisable securities in connected companies 	<p style="text-align: right;">25%</p> <p style="text-align: right;">50%</p> <p style="text-align: right;">20%</p> <p style="text-align: right;">of the <i>surrender value</i> of the <i>policy</i></p> <p style="text-align: right;">100%</p>

-	<i>traded endowment policies</i> (Note 1): where a <i>traded life policy</i> is held for resale by a <i>firm</i> which is a <i>traded life policy market maker</i> :	
	(a) for 3 months or less	0% of the <i>surrender value</i> of the <i>policy</i>
	(b) for more than 3 months	10% of the <i>surrender value</i> of the <i>policy</i>
	when a <i>traded life policy</i> is held by a <i>firm</i> which is a <i>traded life policy market maker</i> for investment	10% of the <i>surrender value</i> of the <i>policy</i>
-	other	100%

Note 1 - A *traded life policy market maker* must:

- (1) include such a policy valued at its surrender value at the date on which the *firm* acquired it, or its latest available surrender value if different; and
- (2) where a life office whose policy is held by the *firm* has altered adversely the basis on which it calculates surrender values, revise its valuation of the *traded life policy* as soon as practicable after becoming aware of the alteration.

Table 13.12.3B—

This table forms part of *rule* 13.12.3

UNSETTLED SECURITIES TRANSACTIONS		
Number of <i>business days</i> after due settlement date	A %	B %
0 — 15	0	0
16 — 30	25	0
31 — 45	50	25
46 — 60	75	50
61 — or more	100	75
over 90	100	100

Note 1-	Column A applies to a transaction in a debt or debt-related instrument (unless the debt instrument is settled through the appropriate UK settlement system), and
Note 2-	Column B applies in all other cases (and, in particular, applies to equity and equity related instruments).

Table 13.12.3C

This table forms part of *rule 13.12.3*

OVER THE COUNTER DERIVATIVES		
a. By attaching current market values to contracts (marking to market), obtain the current replacement cost of all contracts with positive values.		
b. To obtain a figure for potential future credit exposure (except in the case of single currency “floating/floating interest rate swaps” in which only the current replacement costs will be calculated), the notional principal amounts or values underlying the <i>firm's</i> aggregate positions are multiplied by the following percentages:		
Residual Maturity	Interest Rate Contracts	Foreign Exchange Contracts
One year or less	Nil	1%
More than 1 year	0.5%	5%
c. The credit equivalent is the sum of current replacement cost and potential future credit exposure.		

Table 13.12.3D

This table forms part of *rule 13.12.3*

FOREIGN EXCHANGE RISK

- ~~(a) A firm must deduct a foreign exchange risk requirement for all the following items which are denominated in a foreign currency:~~
- ~~(i) all assets and liabilities, including accrued interest, denominated in the currency (all investments at market or realisable value);~~
 - ~~(ii) any currency future, at the nominal value of the contract;~~
 - ~~(iii) any forward contract for the purchase or sale of the currency, at the contract value, including any future exchange of principal associated with currency swaps;~~
 - ~~(iv) any foreign currency options at the net delta (or delta based) equivalent of the total book of such options;~~
 - ~~(v) any non-currency option, at market value;~~
 - ~~(vi) any irrevocable guarantee;~~
 - ~~(vii) any other off-balance sheet commitment to purchase or sell an asset denominated in that currency.~~
- ~~(b) The requirement must be calculated as follows:~~
- ~~(i) using the spot rate, convert the net long position and net short position in each foreign currency into the currency in which the firm's annual financial statements are reported;~~
 - ~~(ii) total the net open long positions and the net open short positions;~~
 - ~~(iii) the higher of (i) and (ii) above is its net open foreign currency position;~~
 - ~~(iv) multiply its net open foreign currency position by 10%;~~
- ~~(c) A firm may not include any future income or expense not yet accrued but fully hedged (subject to deduction of an appropriate risk requirement).~~

13.12.4 SHORT TERM SUBORDINATED LOANS

13.12.4 R A Category B firm may treat a subordinated loan as a financial capital resource, as specified in rules 13.12.53.13R to 5A and 13.3.14R, if the short term subordinated loan is eligible for such treatment in accordance with rule 13.12.4A3.12R;

13.12.4A R A short term subordinated loan is eligible for such treatment if:

- (1) it has an original maturity of at least two years or, if it has no fixed term, it is subject to two years' notice of repayment;

- (2) payment of interest is not permitted under the loan agreement unless after such payment a *firm* meets 120% of its ~~financial~~ capital resources requirement;
- (3) repayment, prepayment or termination is only permitted under the loan agreement:
 - (a) on maturity, or on expiration of the period of notice, if after such payment or termination a *firm* meets 120% of its ~~financial~~ capital resources requirement; or
 - (b) on winding up after the claims of all other creditors and all outstanding debts have been settled;
- (4) it is in the standard form for short term subordinated loans prescribed by the *FSA*.

RESTRICTIONS

13.12.5 R A ~~C~~category B *firm* must calculate:
3.13

- (1) the aggregate amount of its short term subordinated loans; and its preference *shares* which are not redeemable within two years; ~~and for a *Category B firm* other than a *Category B1 firm* its long term liabilities which are not secured on its assets, if they do not fall due more than three years from the balance sheet date, and are not due to *connected persons*; and~~
- (2) the amount of the *firm's* total capital and reserves excluding preference *share* capital, less the amount of its intangible assets, multiplied by ~~400~~200%.

13.12.5A R A ~~C~~category B *firm* must treat as a liability in the calculation ~~of~~ of its ~~financial~~ capital resource any amount by which the sum of ~~13.12.5(1)~~3.13R(1) exceeds the product of ~~13.12.5(2)~~3.13R(2).
3.14

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The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: <http://www.fsa.gov.uk>

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