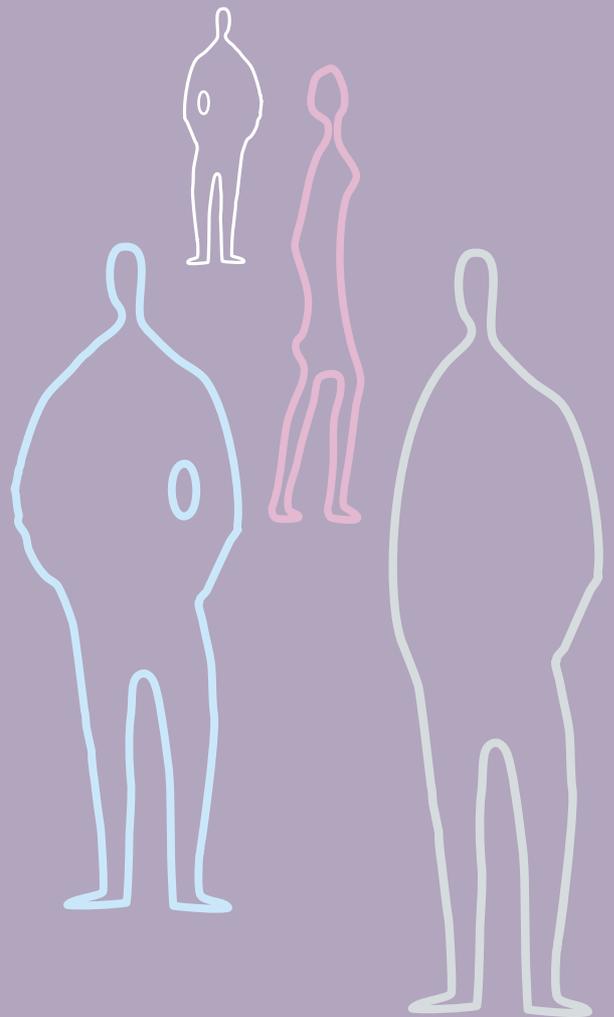


An Introduction to Financial Services Compliance



Barclay Simpson
Recruitment Consultants

Contents

1. Overview

- 1.1. Introduction
- 1.2. Purpose
- 1.3. Why regulate?
- 1.4. What is compliance?
- 1.5. Terminology

2. Regulation past and present

- 2.1. The Gower report
- 2.2. The Financial Services Act 1986
- 2.3. The Financial Services and Markets Act 2000

3. The regulatory structure within the UK

- 3.1. The Financial Services Authority
- 3.2. The Financial Ombudsman Service
- 3.3. The Financial Services Compensation Scheme
- 3.4. The Financial Services and Markets Tribunal
- 3.5. The UK Listing Authority
- 3.6. Recognised Investment Exchanges and Recognised Clearing Houses
- 3.7. The Bank of England
- 3.8. The Panel on Takeovers and Mergers
- 3.9. The Government
- 3.10. Europe
- 3.11. Voluntary codes of conduct

4. Key areas of regulation

- 4.1. High level standards
- 4.2. Business standards
- 4.3. Redress

5. The compliance function within financial services organisations

- 5.1. The compliance department
- 5.2. The compliance officer
- 5.3. The location of the compliance department in the organisational structure
- 5.4. The consequences of a regulatory breach

6. Recent developments in financial services regulation

- 6.1. Mortgages and general insurance regulation
- 6.2. Polarisation
- 6.3. Examinations review
- 6.4. The Sandler Report

7. Summary of relevant legislation

8. Further references

9. Glossary



Abbreviations used

ABI	Association of British Insurers
BBA	British Bankers' Association
DTI	Department of Trade and Industry
GISC	General Insurance Standards Council
FOS	Financial Ombudsman Service
FSAct	Financial Services Act 1986
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
IFA	Independent Financial Adviser
ISA	Individual Savings Account
MCCB	Mortgage Code Compliance Board
MLRO	Money Laundering Reporting Officer
NCIS	National Criminal Intelligence Service
PEP	Personal Equity Plan
RCH	Recognised Clearing House
RIE	Recognised Investment Exchange
RPB	Recognised Professional Body
SEAQ	Stock Exchange Automated Quotes system
SIB	Securities and Investments Board
SRO	Self-Regulatory Organisation
SYSC	Systems and Controls
T&C	Training and Competency
UKLA	UK Listing Authority

1 Overview

1.1 Introduction

Over the last two decades, compliance has increasingly become a fundamental component of financial services firms. As regulation for the industry has grown, so too has the size of compliance departments, to ensure that regulatory requirements are met. This is not simply because these requirements are based in legal statute, but also to preserve the reputation of the firm, as, with strong competition across the industry, firms cannot afford to be associated with poor compliance. Overall, this has led to the growth of the compliance profession, comprising experts in the field of regulation and its practical application in businesses.

1.2 Purpose

The aim of this guide is to provide an overview of the regulatory system operating in the UK financial services industry and to explain the role of the compliance department in firms, which works to ensure regulatory requirements are fulfilled. This guide has been written to assist candidates planning to attend interviews for compliance-related roles, who to date have only limited exposure to this industry and the regulations with which firms must abide.

1.3 Why regulate?

Many industries have standards with which firms must comply. Examples range from the utilities sector through to the food industry. The case for regulation of financial services is similar to that for these other industries and is based on consumer protection. Regulation aims to address the problem of information asymmetry between experts who sell products and less informed consumers who buy them. It is difficult for consumers to know the financial position of those firms in which they invest their money as not only do they have limited information available to interpret, but also they do not necessarily possess the requisite experience to do so. Moreover, many financial products are long-term in nature, meaning that consumers would need to give consideration to after sales service for the duration of the product before 'signing on the dotted line'.

Other considerations relevant to the financial services industry in particular include its vulnerability to financial crime and the implications of systemic failure of the economy, should one firm fail and cause a contagion effect, resulting in other failures. This is a concern that is particularly relevant for banks. The size of some well-established firms can also act as a barrier to entry to the industry for smaller firms, as these larger firms enjoy significant economies of scale, stifling competition and choice for the consumer, and leading to high prices. Regulation acts to minimise these anti-competitive and monopolistic behaviours.

It should be noted, however, that while regulation is in place to protect the consumer, the costs of compliance are passed onto the consumer in the form of higher prices.

1.4 What is compliance?

There are many different sectors within the financial services industry, including banking, insurance, investment management and securities, containing a vast network of firms, which offer a multitude of financial services and products. These sectors combine to form the UK financial system, facilitating the movement of capital and currency around the economy, channelling money from savers to borrowers. Compliance is a term familiar to all firms within these sectors.

The word compliance is derived from the verb 'to comply', which literally means, 'to act in accordance with the rules'. In the context of financial services, it therefore refers to the need for those firms that transact regulated activities to abide by the terms of the Financial Services and Markets Act 2000 (section 2.3 refers) and to act in accordance with the rules of the Financial Services Authority ("the FSA"), the independent supervisory body established under the 2000 Act as the sole regulator of the financial services industry (section 3.1 refers). Commonly, the function that is responsible for ensuring adherence to these rules is known as the compliance department.

Each compliance department has a compliance officer overseeing the function. The role of the compliance officer is to ensure that no conflicts of interest arise within the firm and to develop policy and practices that ensure all obligations and regulations are adhered to. This person, too, is responsible for maintaining the firm's relationship with the FSA.

For some firms, there are also the rules of other regulatory bodies to be complied with. These include bodies that have had regulatory powers conferred on them by the FSA, for example the London Stock Exchange, in its role as a Recognised Investment Exchange ("RIE"), and other voluntary associations, whose members agree to comply with a self-prescribed code of conduct. These bodies are discussed in more detail in section 3.

1.5 Terminology

The financial services industry abounds with its own language of phrases and expressions. While a candidate would not be expected to understand some of the more complex issues, a basic awareness of the key terms used is important. The reader can therefore refer to the glossary at the back of this guide, where they will find a concise explanation for many of the more common terms that may be raised during an interview. Each of these terms has been emboldened when it is first used within the guide for ease of reference.

2 Regulation past and present

2.1 The Gower Report

Prior to introduction of the Financial Services Act 1986 (“the FSAct”), a self-regulatory system was in place across the industry. It was entirely voluntary and members followed their own codes of conduct.

However, the gradual growth in disposable income, the globalisation of the industry and a number of highly publicised ‘scandals’ during the late 1970s and early 1980s forced the government to recruit Professor Gower in 1981 to review investor protection and consider new legislation. Gower was concerned about the dangers of over-regulation and looked to introduce a comprehensive regulatory framework based on self-regulation within a statutory framework, to be overseen by the government. He recommended that industry practitioners should register with ‘self-regulatory organisations’ (“SROs”) that would carry out the day-to-day regulation, which would in turn be overseen by a designated government agency.

The government adopted many of Gower’s proposals in its White Paper of January 1985, which preceded the FSAct.

2.2 The Financial Services Act 1986

Following the White Paper, the FSAct received royal assent in November 1986, delegating many of the government’s statutory and regulatory powers to the Securities and Investments Board (“the SIB”), which became the designated agency for the supervision of investment business within the UK. The SIB recognised a number of SROs, each responsible for the regulation of a particular arena of investment business: the Personal Investment Authority, the Investment Management Regulatory Organisation, and the Securities and Futures Authority. Members of such professions as law and accountancy, who transacted some investment business as part of their business, were able to apply for authorisation from one of the nine Recognised Professional Bodies (“RPBs”), for example, the Law Society of England and Wales, rather than join a SRO.

The regulations focused primarily on consumer protection through the authorisation of persons wishing to undertake investment business and the establishment of conduct of business rules, introducing the concept of polarisation as a key means of protecting investors. All advisers had to be informed about the products they were able to sell, and this was vital to ensure compliance with the requirement to provide customers with best advice, ensuring the suitability, sustainability and affordability of all sales made.

However, the Act attracted much criticism. By the mid-1990’s it was argued that the system was failing due to the massive compliance burden on firms and the failure to adequately protect investors, perhaps most clearly evidenced by the pensions mis-selling scandal of the late 1980s and early 1990s, and more recently, the sale of low-cost endowment plans. Despite this, it is generally agreed that rather than being an outright failure, the system simply became outdated, and the decision was taken to introduce a new regulatory regime.

- **Regulatory authorities with jurisdiction outside of the FSAct**

The scope of the FSAct did not cover banking regulation, which was separately supervised by the Bank of England under the Banking Act 1987, friendly societies by the Friendly Societies Commission under the Friendly Societies Act 1992, building societies by the Building Societies Commission under the Building Societies Act 1986, and the prudential regulation and oversight of standards of corporate behaviour within insurance companies by the Treasury under the Insurance Companies Act 1982.

2.3 The Financial Services and Markets Act 2000

The decision to reform financial services regulation was announced in 1997 with the aim of bringing all parts of the industry together under one regulatory regime. The SIB was renamed the FSA and the first stage of the merger was completed the following year when it took over responsibility for banking supervision from the Bank of England. The Financial Services and Markets Act 2000 ("the FSMA") finally received royal assent in June 2000 and was implemented on 1 December 2001, a date commonly known as "N2". It established the FSA as the sole regulator of the industry, withdrawing the previous structure of SROs and RPBs.

Persons falling under the jurisdiction of the FSMA, who therefore require authorisation from the FSA to transact business include banks, building societies, insurance companies, investment and pensions advisers, friendly societies, credit unions, Lloyd's, stockbrokers, fund managers, derivatives traders and professional firms offering specific investment services. As the FSMA came into force, much of the financial services legislation previously in place was repealed, including the FSAct. A small number of bodies are exempt from authorisation: the Bank of England, the European Central Bank, the central banks of the European Economic Area countries and various government bodies.

Virtually all financial products are regulated under the FSMA including deposit taking, debentures, futures, stocks and shares, unit trusts, investment trusts, collective investment schemes, open-ended investment contracts, gilts, individual savings accounts ("ISAs"), life assurance, pensions, disability insurance and funeral plan contracts. Mortgages and general insurance (for example, home and motor insurance) will be included under FSMA with effect from mid-2004 (section 6 refers).

The FSMA has provided the FSA with a full range of statutory power. These include the power to authorise, supervise, investigate and discipline authorised persons, prosecute unauthorised market participants under civil law, and the right to 'recognise' investment exchanges and clearing houses. It has also made provision for the control of financial promotions by the FSA and the regulation and marketing of collective investment schemes, and has introduced a new market abuse regime. The Act established the Financial Services and Markets Tribunal and laid down the framework for the Financial Ombudsman Service ("the FOS") and the Financial Services Compensation Scheme ("the FSCS").

3 The regulatory structure within the UK

3.1 The Financial Services Authority

The FSA is an independent, non-governmental organisation, established under the FSMA as the single regulator of financial services in the UK from 1 December 2001. It is limited by guarantee and funded by the firms that make up the industry. It has four main objectives:

- to maintain confidence in the UK financial system, achieved through the supervision of RIEs, and Recognised Clearing Houses ("RCHs"), and through a programme of market surveillance and transaction monitoring to identify cases of market abuse;
- to promote public understanding of the financial system, through, for example, the provision of plain English publications;
- to secure the right degree of protection for consumers, by developing regulations with which those conducting investment business must comply; and
- to contribute to the reduction in financial crime, particularly money laundering, fraud and dishonesty, and criminal market misconduct such as insider dealing.

In working towards these objectives, the FSA must take into consideration the most appropriate use of resources and the need for a sound balance between the cost of regulation for firms and its benefits for consumers, recognising the value of competition as a regulator in its own right. It is also required under the terms of the FSMA to consult with industry practitioners on proposed changes to its rules.

The FSA is accountable to the Treasury for its actions, which measures the success of the FSA in achieving its objectives. The FSA is also held accountable to consumers and industry practitioners through the Consumer Panel and Practitioner Panel respectively. Both of these panels, whilst set up by the FSA, have a statutory basis in the FSMA.

The FSA has a number of powers conferred on it by the FSMA. Amongst these is its ability to authorise and supervise firms carrying on regulated activities, and enforce compliance by these firms with provisions of the FSMA and its own rules.

● **Authorisation**

The FSA is responsible for the authorisation of all applicants wishing to carry on regulated activities, unless that person is exempt from authorisation (for example, an RIE). Persons must meet with the threshold conditions, detailed within the High Level Standards Sourcebook (section 4.1 refers) to engage in a regulated activity. The purpose of authorisation is also to recognise approved persons as being fit and proper to undertake a controlled function.

● **Supervision**

The FSMA requires the FSA to monitor for compliance with the conditions set down in the Act. The FSA therefore supervises the prudential soundness of firms undertaking regulated activities, as well as the fulfilment of conduct of business regulations by firms. It also supervises the RIEs and RCHs to ensure the integrity of the UK investment markets, and conducts market surveillance and transaction monitoring.

The FSA operates a risk-based supervision programme to review compliance with its rules, whereby the level of scrutiny a firm is placed under is dependent upon its priority rating. All firms are allocated a rating according to the risk that their failure to meet with regulatory requirements would pose to the ability of the FSA to meet its objectives and the likelihood of that risk being realised.

One component of the FSA's supervisory toolkit is mystery shopping. This is where a representative of the regulator approaches an authorised person as a potential customer to assess compliance with conduct of business rules during the sales process. This is an extremely useful tool, enabling the regulator to witness first hand actual discussions that take place with a customer and advice provided, rather than relying on the paperwork associated with the sale alone.

● **Enforcement**

Where a firm is in breach of its rules, or the requirements of the FSMA, the FSA has the statutory power to investigate and discipline firms. It can discipline those firms where breaches are proven by withdrawing authorisation, issuing a public censure or a fine, seeking injunctions or requiring compensation to be paid to disadvantaged consumers. It has criminal prosecution powers to prosecute those who undertake regulated activities without appropriate authorisation. The Regulatory Decisions Committee determines sanctions for the most serious of cases.

3.2 The Financial Ombudsman Service

The FOS was established under the terms of the FSMA, and falls under the jurisdiction of the FSA, with compulsory membership for authorised firms. It offers consumers a free and independent service for dispute resolution. Decisions taken by the FOS are not binding on consumers, who can proceed to the courts with their claim if they so wish. However, before the FOS will review a case, the complaint must have been made to the firm, which has provided either an unsatisfactory response or has failed to respond within eight weeks of the complaint being made. The maximum award that the FOS can require a firm to make to a complainant is £100,000.

The remit of the FOS covers most financial products and services, with the exception of general insurance and mortgage brokers (although these will fall under its jurisdiction with the introduction of statutory regulation for these areas from mid-2004), the investment performance of a product and firms dealing in loans and credit that are not banks or building societies.

3.3 The Financial Services Compensation Scheme

The FSCS was established under the FSMA and came into effect 1 December 2001, replacing a multitude of other compensatory arrangements in place at that time. It is a scheme that provides consumers with compensation when an authorised firm cannot pay claims made against it, perhaps as a result of insolvency. It covers business conducted by all firms regulated by the FSA and is funded by these firms via a levy. However, it will not generally compensate 100% of any loss incurred.

3.4 The Financial Services and Markets Tribunal

Run by the Lord Chancellor's department, the Financial Services and Markets Tribunal was established under the

FSMA and came into force at N2. Authorised persons can request that the Tribunal conducts an independent review, usually in public, of an FSA decision affecting them, as can anyone who stands accused of offences under the market abuse code.

The Tribunal has the power to overrule a decision made by the FSA in favour of its own determination. Its decisions are binding.

3.5 The UK Listing Authority (“the UKLA”)

As part of the powers conferred to it under the FSMA, the FSA acts as the competent authority for listing to formulate and enforce the Listing Rules, and maintain the Official List. It took over this responsibility from the London Stock Exchange, after the Exchange demutualised in 1998.

The UKLA is responsible for the admission of securities to trading, approving prospectuses before they are published and ensuring that issuers have met the relevant conditions for listing. It also suspends and cancels listings, where appropriate. It has the power to enforce compliance with the Listing Rules, with the ability to sanction issuers and company directors who are in breach of them.

The Listing Rules include numerous continuing obligations that require full, timely and accurate disclosure to the market of price sensitive information in relation to a listed company. Prior to 15 April 2002, this disclosure was made via the Company Announcement Office of the London Stock Exchange. However, with effect from this date, dissemination of regulatory information to the market can be done via any Regulatory Information Service approved by the FSA as a Primary Information Provider.

3.6 Recognised Investment Exchanges and Recognised Clearing Houses

Under the FSMA, the FSA has the power to recognise and supervise RIEs and RCHs. The recognition gives the Exchange or Clearing House an exemption from the need to be authorised to carry on regulated activities in the UK.

Each RIE is responsible for ensuring that the operation of its markets is orderly, ensuring fair dealing for investors, in order to maintain confidence in its markets. The FSA requires that RIEs have in place effective arrangements for the monitoring and regulation of their markets. These arrangements include activities such as screening membership applications, monitoring and enforcing compliance with rules and regulations in place, monitoring trading activity and investigating where appropriate potential cases of market abuse for referral to the FSA. There are currently six RIEs recognised by the FSA:

- LIFFE Administration and Management;
- London Stock Exchange plc;
- OM London Exchange Ltd;
- The International Petroleum Exchange of London Ltd;
- The London Metal Exchange Ltd; and
- virt-x Ltd.

There are currently two RCHs recognised by the FSA:

- CrestCo Ltd; and
- The London Clearing House Ltd.

3.7 The Bank of England

The Bank of England is the central bank of the UK. Founded in 1694, it gained independence from the government in 1997, empowering the Bank to self-determine monetary policy and interest rates for the UK economy.

One of the Bank's main responsibilities is to set monetary policy in order to maintain the integrity and value of sterling. It achieves this by setting interest rates to meet government inflation targets.

The Bank is also responsible for maintaining the stability of the financial system. Prior to 1997, this role included the supervision of banks and other financial services firms; however, this function was taken over by the FSA, as part of the consolidation of UK financial services regulation at this time (section 3.1 refers). A Memorandum of Understanding was put in place between the Bank, the FSA and the Treasury to formalise the allocation of responsibilities between the different bodies. Provisions were made within this memorandum for the establishment of a Standing Committee, which meets periodically to discuss individual cases of significance and developments relating to the stability of the economy.

Finally, the Bank has a significant position within the economy as the Lender of Last Resort. This is an option only used in exceptional circumstances in a bid to protect the overall stability of the UK economy, and not the customers and shareholders of those institutions in financial difficulty.

3.8 The Panel on Takeovers and Mergers

The Panel is a non-statutory body established in 1968 with responsibility for administering the City Code on Takeovers and Mergers, ensuring equality of treatment and opportunity for all shareholders in takeover bids. Its membership consists of representatives from major financial institutions and trade associations, and has the backing of the Bank of England.

3.9 The Government

A number of government departments are involved in the regulation of financial services:

- HM Treasury

The Treasury is tasked with securing an innovative, competitive and efficient financial services market, with a sound balance of regulation in the public interest. It is responsible for the FSMA legislation and the regulatory framework within the UK, overseeing the actions of the FSA.

The Treasury receives an annual report from the regulator, reporting on how it has achieved its statutory objectives. Treasury Ministers then present the report before Parliament. The Treasury can also require the FSA to give evidence at Treasury Select Committee hearings, a recent example of this being in relation to the FSA's role in the Equitable Life case.

The Treasury also attends meetings of the Standing Committee, comprising representatives from the Bank of

England and the FSA (section 3.7 refers).

- **Department of Trade and Industry**
The DTI is responsible for company law and insolvency matters. It leads the majority of investigations and prosecutions under the Companies Acts.
- **Department for Work and Pensions**
This department liaises with the FSA and other pensions bodies such as the Occupational Pensions Regulatory Authority (the independent regulator established under the Pensions Act 1995 to regulate the operation of UK occupational pension schemes) in relation to its responsibilities for UK pensions policy and the regulation of occupational pensions schemes.
- **Office of Fair Trading ("the OFT")**
The OFT has a wide remit in identifying trading practices against the public interest, regulating the provision of consumer credit and investigating instances of anti-competitive practice.
- **Serious Fraud Office**
This office is responsible for the investigation and prosecution of serious fraud cases, and may become involved in complex cases of market abuse and insider dealing.
- **National Criminal Intelligence Service ("the NCIS")**
The NCIS is an intelligence gathering service focused on combating serious and organised crime. Potential cases of money laundering are reported to this service for further investigation.

3.10 Europe

The issuance of numerous EC directives over the years has led to a convergence in many areas of regulation across Europe in a drive to establish a truly single market in financial services for all member states. As a member of the European Union, the UK must comply with any European Directives that are approved by the European Parliament and the Council of the European Union. Some of the most significant directives in relation to financial services are listed in section 7 of this guide.

3.11 Voluntary codes

- **The General Insurance Standards Council ("the GISC")**

The GISC was launched in July 2000 to regulate the selling, advising and servicing standards of its members in relation to general insurance business conducted. It is an independent, non-statutory organisation, funded by the subscriptions of its 6,500 members who include general insurers, intermediaries, agents and those acting for them.

The main purpose of the GISC is to ensure that general insurance customers are treated fairly. General insurance includes within its scope:

- home insurance (buildings and contents)
- pet insurance
- private medical and dental insurance
- extended warranty and breakdown insurance
- payment protection insurance for mortgages and other loans
- motor, boat and caravan insurance
- travel insurance
- personal accident insurance
- legal expenses insurance
- insurance for businesses (property, key man insurance, goods under transit, employer's liability, legal expenses and business interruption cover)

The GISC has established two codes of conduct that its members must follow: the Private Customer Code and the Commercial Code. The GISC regulates and monitors adherence to the codes by its members.

● **The Association of British Insurers ("the ABI")**

Insurance practitioners have the option to join the ABI, whose voluntary members represent around 400 insurance companies in the industry. The ABI has established numerous codes of conduct, covering both general insurance and life insurance, which, upon joining, members are required to observe. The codes are developed and enforced by the members themselves, with some input from the government and consumer bodies. Members undertake to use all reasonable efforts to ensure that they, and those who sell their products, comply with the codes in place.

● **The British Bankers' Association ("the BBA")**

The BBA is a trade association founded in 1919, with approximately 295 members, plus many associate-members, who account for approximately 95% of UK employment in the banking sector. Its membership is truly international, with over 60 countries represented.

The work of the BBA covers both domestic and international banking policy, with an aim of promoting sound competition that benefits both members and consumers. The BBA Banking Code lays down the industry standard on good practice for banks and building societies in their dealings with private customers in the UK. The Independent Review Body for the Banking and Mortgage Codes monitors compliance with the Code.

● **The Mortgage Code Compliance Board ("the MCCB")**

The MCCB is a non-statutory organisation established to regulate the provision of mortgage information and advice in the UK by mortgage lenders and intermediaries. It developed the Mortgage Code, which lays down the minimum standards of good lending practice. Over 150 lenders and 13,000 intermediary firms have voluntarily subscribed to the Code, representing all the major mortgage lending institutions.

The MCCB monitors compliance with the Code by members through a programme of annual compliance visits and mystery shopping exercises. It has the power to conduct investigations in cases of suspected Code breaches and, where proven, can fine, suspend or de-register firms.

- **Advertising codes**

The Advertising Standards Agency monitors compliance with the two main codes of conduct for advertising in the UK, which also cover advertisements in financial service products:

- British Code of Advertising Practice - requires that all advertisements should be legal, decent, honest and truthful, prepared with a sense of responsibility to the consumer, conforming to the principles of fair competition; and
- British Code of Sales Promotion Practice - requires that any free offers, vouchers or any other inducements to buy (other than the own merits of the product) should not offend, mislead or provoke people into offensive or dangerous behaviour.

4 Key areas of regulation

4.1 High level standards

● Principles for businesses

The FSA principles are a general statement of the fundamental obligations of firms under the regulatory system and act as the foundation on which other rules are based. Breaching a principle makes a firm liable to disciplinary sanctions.

There are 11 principles:

Principle 1	Integrity	A firm must conduct its business with integrity.
Principle 2	Skill, care and diligence	A firm must conduct its business with due skill, care and diligence.
Principle 3	Management and control	A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
Principle 4	Financial prudence	A firm must maintain adequate financial resources.
Principle 5	Market conduct	A firm must observe proper standards of market conduct.
Principle 6	Customers' interests	A firm must pay due regard to the interests of its customers and treat them fairly.
Principle 7	Communications with clients	A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
Principle 8	Conflicts of interest	A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
Principle 9	Customers' relationships of trust	A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
Principle 10	Clients' assets	A firm must arrange adequate protection for clients' assets when it is responsible for them.
Principle 11	Relations with regulators	A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

● Senior management arrangements, systems and controls ("SYSC")

The purpose of SYSC is to encourage directors and senior management of firms to take appropriate responsibility for the firm's arrangements on matters likely to be of interest to the FSA, making them accountable for the control of the firm's affairs.

The FSA has stated that when things go wrong, it will hold senior management accountable for those failures. As such, the FSA has introduced the approved persons regime: a system of individual registration to include those persons who perform significant functions within an organisation, ensuring that specified individuals take on clearly defined responsibilities for risk management and compliance. These functions are known as controlled functions (of which there are 27) and persons who the FSA are satisfied are fit and proper to undertake those roles are known as approved persons.

- **Threshold conditions**

This sourcebook contains details of the minimum conditions that a firm must satisfy, and continue to satisfy, in order to be given and retain authorisation under the FSMA to undertake regulated activities.

- **Statements of principle and code of practice for approved persons**

The FSA has set out the standards of behaviour expected of approved persons in carrying out controlled functions. The seven statements of principle are supported by a code of practice, issued by the FSA to help determine whether the conduct of an approved person complies with the principles. Failure to do so could result in disciplinary action being taken against the individual and their approved status being withdrawn.

- **The fit and proper test for approved persons**

This test assesses the fitness and propriety of a candidate to undertake a controlled function. It covers the criteria against which the individual would be assessed, both to be awarded approved person status and on an ongoing basis to ensure the continuing suitability of that individual for the role.

4.2 Business standards

- **Prudential regulation**

Prudential regulation deals with the financial management and viability of a firm. It is not aimed at preventing the financial collapse of poorly run companies, but at ensuring that such failures do not endanger the stability of the financial markets or give rise to financial loss for the customers of that firm. It sets the standards for the maintenance of capital resources proportionate to a firm's risks. There is currently an Interim Prudential Sourcebook for each sector of the financial services. These are shortly to be incorporated into a single Prudential Sourcebook for the industry.

- **Conduct of business regulation**

This regulation includes rules in relation to how a firm should interact with, and conduct business with, its customers. It applies to firms undertaking designated investment business. The rules relate primarily to the marketing of products and the advice that financial advisers give to customers concerning financial products. Specifically, it covers such areas as communications, commission, Chinese walls, financial promotions, terms of business, customer types, advising and selling standards, product disclosure and the customers right to withdraw or cancel, dealing and managing investments, reporting to customers, handling of client assets, operators of collective investment schemes, trustee and depositary activity and Lloyd's.

● **Market conduct**

The FSMA increased the scope of FSA responsibilities to include oversight of the new Code of Market Conduct, aimed at tackling market abuse. The objective of this regime is to ensure the ongoing transparency of the markets and that dealing on these markets is open and fair. The Code sets out the standards of market conduct expected of those trading in qualifying instruments on prescribed markets within the UK based on the reasonable expectations of a regular user of that market, giving guidance on what behaviour does and does not amount to market abuse. It introduces the three market abuse offences of misuse of information not publicly available; giving a false or misleading impression of the demand, supply, price or value of an investment to the market; and market distortion.

● **Training and Competency (“T&C”)**

The T&C Sourcebook requires that proper arrangements be made for all those employees associated with a regulated activity to ensure they achieve and maintain competence. There are a number of commitments in relation to T&C, with which a firm must comply. These include that employees are competent to perform their respective roles and retain this competency, confirmed through regular review, that they are appropriately supervised and that the level of competency is appropriate to the nature of the business undertaken.

● **Money laundering**

Firms must have in place effective anti-money laundering controls to prevent would-be money launderers from successfully integrating dirty money into the financial system. This sourcebook relates directly to the fourth objective of the FSA, which requires it to work to reduce financial crime.

All firms must appoint a Money Laundering Reporting Officer (“MLRO”). It is the duty of the MLRO to report any suspicions of money laundering to the NCIS. Therefore, firms must include in their sales procedures appropriate steps for confirming the identity of clients, and where potential money laundering is suspected, procedures for reporting that suspicion to the MLRO.

All staff must have regular training on the firm’s money laundering procedures and individual legal obligations under the Money Laundering Regulations 1993 for reporting suspicious transactions. Failure to do so can result in imprisonment, a fine or both under these regulations, which set out the statutory responsibilities for individuals and firms for counteracting money laundering. Giving assistance to, or tipping off, money launderers are also criminal offences.

4.3 Redress

This sourcebook outlines requirements in relation to complaint handling by firms. Firms must have in place appropriate arrangements for dealing with complaints received from their customers, and ensure that all staff are familiar with these procedures. Complaints should be handled consistently, fairly and promptly, acknowledged within five business days of receipt, and then ultimately resolved within eight weeks, after which time the complainant must be notified of their right to contact the FOS if they are unhappy with the delay in addressing their concerns.

Also covered in this sourcebook are details of the jurisdiction and procedures of the FOS, and a compensation section covering the function and responsibilities of the FSCS. Finally the rules with which the FSA itself must comply in relation to complaints made against it is covered, including the requirement to appoint an independent complaints commissioner to annually inspect complaints records.

5 The compliance function within financial service organisations

Over the last two decades, compliance has become a fundamental component of financial services firms. All firms now have compliance departments, although where and how these fit into the overall company structure is likely to vary considerably.

5.1 The compliance department

The compliance department is responsible for overseeing the activities of the firm to ensure that these are being undertaken in accordance with, and paying due regard to, the regulations set by the FSA and other voluntary codes to which that firm subscribes. The department is tasked with providing guidance in relation to these regulations to other parts of the business, and for developing appropriate procedures and policies with which the firm, in carrying on a regulated activity, must adhere.

The FSA has laid down rules that require a firm to take reasonable care to establish and maintain effective systems and controls for compliance and for countering the risk that the firm might be used to further financial crime. The compliance function therefore frequently includes within its remit an anti-money laundering team, which monitors sales and transactions to identify potential cases for referral to the NCIS.

A number of other sub-departments, or teams, will form part of the overall function. These may include a T&C department, which oversees the competence of appropriate staff and the records that demonstrate this. For sufficiently large firms there may be a separate complaints section, investigations team, or business review team. There are also likely to be monitoring teams, who undertake regular programmes to review samples of business transacted and ensure appropriate and valid audit trails are in place. A policy department is also common, which has responsibility for understanding changes in regulation and helping to incorporate these into company procedures. This team may also be involved in the formulation of responses to FSA consultation papers, feeding back to the FSA the company's views and recommendations on proposed regulatory changes. Specific departments may also be established to focus on one particular aspect of compliance, for example work on the pensions review or the low-cost endowments review.

The compliance function should be staffed by an appropriate level of staff for the nature, size and complexity of the business, and who are sufficiently independent (especially from any revenue generating areas) to perform their duties objectively. The T&C Sourcebook requires that proper arrangements be made for all those employees associated with a regulated activity to ensure they achieve and maintain competence. This includes compliance staff, all of whom must be considered competent to undertake the activities for which they are responsible.

5.2 The compliance officer

The rules stipulate that the responsibility for the oversight of a firm's compliance should be allocated to a director or senior manager, usually the compliance officer. This person is required to be an approved person under the FSA approved person regime, and therefore must have passed the fitness and propriety test requirements laid down in the FSA Handbook.

The role of the compliance officer is extensive. Operationally, they have the responsibility to organise the compliance function in an efficient and effective way, taking into account the need to be able to demonstrate adherence to regulations through the maintenance of appropriate records, which must be readily available should

they be required by the FSA, perhaps during a regulatory visit to the company. However, they also need to be able to justify spend and costs associated with compliance, something that is becoming increasingly important in light of the current UK economic position.

The compliance officer must put in place measures to ensure that the department is up to date with regulatory events and changes to rules that are introduced, so that the relevant staff can incorporate changes where necessary into the firm's own compliance manual. These changes also need to be communicated quickly and clearly to the other areas of the business that may be affected, for example, changes to the conduct of business rules are likely to have an impact on the sales process followed by the company sales force, which must be updated quickly to ensure that future sales made are compliant. Often the compliance officer is also given other responsibilities, which can include acting as the MLRO or as the Data Protection Officer for the organisation.

Perhaps one of the most important aspects of the compliance officer's role is to develop and nurture the firm's relationship with the FSA. A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA anything relating to the firm of which the FSA would reasonably expect notice. This is principle 11 of the FSA's Statements of Principle (section 4.1 refers). While the FSA has adopted a risk-based approach to supervision, the priority rating awarded to a firm by the FSA is in no small part influenced by its historical relationship with that firm.

The relationship with the regulator can be greatly facilitated by clear evidence of a strong compliance culture within the firm. Effective senior management, internal systems and controls (as required by the rules) help to engender such a culture as management has to lead by example. It is not just sufficient to comply with the rules in place, it is expected that members of staff comply with the spirit of the regulations. This is perhaps a question of ethics, something which is very much on the FSA's agenda.

Not only should such a culture be in place to facilitate regulatory relationships, but also to enhance commercial ones. Firms associated with poor compliance, especially those who have been publicly censured by the regulator for rule breaches, may find this impacts negatively on reputation, which in turn may result in decreased sales as consumers 'vote with their feet'.

5.3 The location of the compliance department in the organisational structure

The size, structure and location of the compliance department will vary from firm to firm, depending upon the nature, scale and complexity of the business. In many large firms, the compliance department is usually a separate line function, with the compliance officer either reporting into the company's Board of Directors, or as is increasingly the case, actually having a seat on the Board. Some smaller firms may choose to incorporate the department into the Internal Audit function, which has responsibility for assessing the appropriateness and effectiveness of organisational systems and controls, or alternatively with the Legal department, although more commonly these functions are kept separate, especially within larger organisations.

Smaller firms will not have such an extensive department structure, and may have only a handful of staff working on compliance. Indeed, small IFAs may have only one person responsible for compliance overall. For one-man bands, this means that compliance forms only a part of the overall responsibilities for an individual. This is a considerable task, and many choose to outsource their compliance activities to a larger firm, a network, which undertakes these activities on their behalf.

5.4 The consequences of a regulatory breach

Where the FSA identifies breaches with its rules, it is empowered to take disciplinary action against authorised persons. The following recent examples illustrate the consequences of breaching the regulations in place, but show how a good relationship with the regulator can help to minimise the effect on business reputation and the level of fine awarded:

● **Bank of Scotland**

In February 2003, the Bank of Scotland was fined £750,000 for failures in its administration of PEPs and ISAs, resulting from poor staff training and controls. It also had to provide customers affected with compensation. It was reported that the Bank had failed to inform the FSA of any system problems and did not provide the regulator with relevant documentation over one year after it had been requested.

● **Abbey Life Assurance**

In December 2002, Abbey Life Assurance was fined £1million by the FSA for mortgage endowment mis-selling and failures in its compliance procedures and controls. This was especially in relation to poor record keeping and inadequate reasons why letters (part of the conduct of business rules) between 1995 and 1999. Abbey Life was also required to compensate customers for their loss. However, while publicly censured, the FSA indicated that the penalty imposed reflected very considerable credit on the part of Abbey Life for the model way in which it dealt with the investigation. If it had not been for this proactive and cooperative manner, the fine would have been much higher.

● **Royal Bank of Scotland**

The Royal Bank of Scotland was fined £750,000 in December 2002 for breaches of the rules of the money laundering sourcebook. Weaknesses were found in anti-money laundering controls and a failure to request sufficient documentation to identify customers or retain copies of this documentation during early 2002. Again, the FSA commended the Bank for its quick and effective resolution of these problems, and noted that this had resulted in a much lower level of fine than would otherwise have been the case.

6 Recent developments in financial services regulation

6.1 Mortgage and general insurance regulation

Sales and advice on mortgages and general insurance are currently regulated on a voluntary basis by the GISC and the MCCB respectively (section 3.11 refers). However, from mid-2004 general insurance, together with mortgages, will come under the provinces of the FSA, which is currently in consultation with the industry to determine the details of the regulation to be put in place.

6.2 Polarisation

The issue of polarisation is currently under debate. The polarisation of independent and tied agents was introduced following the FSAct on consumer protection grounds. However, the FSA has concluded that these reasons no longer apply and is concerned that the existing regime is outdated and anti-competitive. An extensive review is underway during 2003 looking at de-polarisation and options for an alternative regime. Ideas range from the abolition of commission-based remuneration and introduction of fee-based advice, to changes in the accepted views of independent vs tied advice.

6.3 Examinations review

The FSA is looking to develop a single examinations framework across financial services, to improve consistency and raise competency standards. There is currently a confusing array of different examinations (many for the same activity) that can be undertaken to demonstrate competence in carrying on designated investment business, but the standards of these vary considerably and are not necessarily transferable from one employer to another, or indeed one sector to another. It is also confusing for consumers when trying to judge whether or not an adviser is suitably qualified. The FSA is proposing to rationalise examinations available, introducing a simpler structure of exams and associated designatory letters.

6.4 The Sandler Report

A report was commissioned by the Treasury to review retail saving in the UK. The findings of the Sandler Report were published in 2002 and included that products available to consumers are overly complex, with poor disclosure and communication from firms, noting that compliance has been focused on paperwork rather than giving best advice. Recommendations for the simplification of financial products and improved product disclosure have been taken on board by the FSA, which is now consulting with the industry on these areas, with a view to introducing a suite of stakeholder-like products. It is proposed that such products would not require the provision of detailed advice, nor the need to establish suitability of the product for the customer and would therefore be subject to much lighter regulation.

7 Legislation

The table below provides a summary of all statutory legislation relevant to financial services. Recently repealed legislation has also been included for reference.

Statutory Instrument	Comments
Financial Services and Markets Act 2000	Received royal assent June 2000. Came into effect December 1 2001. Act in force.
Financial Services Act 1986	Act repealed under FSMA.
Money Laundering Regulations 1993	Regulations in force.
Banking Act 1987	Act repealed under FSMA.
Building Societies Act 1986	Part of Act repealed under FSMA.
Friendly Societies Act 1974	Part of Act repealed under FSMA.
Friendly Societies Act 1992	Part of Act repealed under FSMA.
Insurance Companies Act 1982	Act repealed under FSMA.
Consumer Credit Act 1974	Act in force.
Investment Services Directive 1993	Council Directive 93/22/EEC 10 May 1993.
Insurance Brokers (Registration) Act 1977	Act repealed under FSMA.
Non-Life Establishment Directive 1973	Council Directive 73/239/EEC.
Life Establishment Directive 1979	Council Directive 79/267/EEC.
Capital Adequacy Directive 1993	Council Directive 93/6/EEC 15 March 1993
Electronic Commerce Directive 2000	Council Directive 2000/31/EC.
Insurance Mediation Directive 2002	Council Directive 2002/92/EC.
Data Protection Act 1998	Act in force. Widens the definition of data in the 1984 Data Protection Act to include some manual records as well as computer-based records.
Policyholders Protection Act 1975	Substantially repealed under FSMA. Terms now only apply to claims against insurance companies that failed before 1 December 2001.

As noted earlier in this guide, provisions are currently being made to introduce statutory regulation for selling and advising on mortgage and general insurance products. This was announced in December 2001 by the government, to comply with the EU Insurance Mediation Directive. This directive must be implemented within two years and therefore it is anticipated that these changes will be effective from mid-2004. The GISC, ABI and MCCB are actively involved in the development of transitional arrangements for the transfer of oversight responsibilities to the FSA.

8 Further references

While this guide provides a comprehensive overview of compliance in financial services, there may be some areas that you wish to understand in more detail. The following references are recommended for further reading.

Regulator (or related) websites:

www.fsa.gov.uk

www.gisc.co.uk

www.abi.org.uk

www.mortgagecode.com

www.londonstockexchange.com

www.bba.org.uk

www.bankofengland.co.uk

www.fscs.org.uk

www.financial-ombudsman.org.uk

Compliance and financial services news:

www.complinet.com

www.ft.com

Information on relevant qualifications:

www.cii.co.uk

www.ifslearning.com

www.securities-institute.org.uk

www.londonmet.ac.uk (for information on MSc Financial Regulation and Compliance)

Financial services legislation

www.hms0.gov.uk

9 Glossary of terms

Approved person	A person upon whom the FSA has conferred approved person status, allowing them to undertake a controlled function, having passed the Fitness and Propriety test (FIT).
Authorised person	A person who has been authorised by the FSA to have a part IV permission of the FSMA to undertake one or more regulated activities.
Chinese wall	An arrangement that requires the separation of key functions of a business to ensure that no conflicts of interest arise and to prevent the inappropriate transfer of sensitive or regulatory information to another part of the business.
Compliance	A controlled function within all financial services firms charged with ensuring that the firm acts in accordance with the rules of the FSA and the provisions of the FSMA.
Compliance officer	The person who is usually responsible for the compliance department, who must be an approved person by the FSA.
Conduct of business rules	FSA rules that relate primarily to the marketing of products and the advice that financial advisers give to customers concerning financial products.
Controlled function	A function that is related to the carrying out of a regulated activity, which must be overseen by an approved person.
Contagion	A situation where problems in any one financial institution or market may spread, endangering the stability of the entire financial system.
Financial Ombudsman Service	The service provided for by the FSMA and established by the FSA offering consumers a free and independent service for dispute resolution with firms in the financial services industry.
Financial Services Compensation Scheme	The scheme that provides consumers with compensation when an authorised person cannot pay claims made against it, perhaps as a result of insolvency. It covers business conducted by all firms regulated by the FSA.
Financial Services and Markets Tribunal	The Tribunal provided for by the FSMA and run by the Lord Chancellor's Department to review at the request of an authorised person an FSA decision affecting them. This request can also be made by anyone who stands accused of offences under the Code of Market Conduct.
FSA Handbook	The FSA rulebook, comprising a number of Sourcebooks, detailing regulations with which authorised persons must comply.
Information asymmetry	The gap between information held by two distinct groups, often used to refer to the difference in information held by consumers and suppliers (experts).

Lender of Last Resort	The role undertaken by the Bank of England enabling it to intervene and provide emergency support to failing financial firms whose failure would jeopardise the stability of other viable institutions.
Listing Rules	The rules made by the Listing Authority (part of the FSA) governing admission to listing, the continuing obligations of issuers, the enforcement of these obligations and, where appropriate, the suspension and cancellation of listing.
Market abuse	Behaviour in relation to qualifying investments which is likely to be regarded by a regular user as abusive, particularly: <ul style="list-style-type: none"> • the behaviour is considered to be based on information that is not generally available (mis-use of information); • the behaviour is considered to give a false or mis-leading impression of the supply, demand, price or value of investments; or • the behaviour is likely to distort the market in investments in question.
Money laundering	The process of making dirty money (obtained via illegal means) clean (i.e. legitimate), through a process of placing, layering and integrating that money into the financial system.
Mystery shopping	A tool used by the FSA in the supervision of conduct of business rules by firms, where a representative of the FSA meets with an authorised person as a potential customer and runs through the sale process.
N2	The name given to represent the date on which the FSMA came into force – 1 December 2001.
Official list	The details held and maintained by the UKLA (FSA) of all listed companies.
Polarisation	The requirement for advisers on life assurance, personal pensions and unit trusts either to be independent and advise on all available products in the marketplace, or to be tied and represent the products of one company.
Primary information provider	A firm approved by the FSA to disseminate regulatory information to the market, via a Secondary Information Provider.
Prudential regulation	The supervision of firms, undertaken by the FSA, to ensure they are financially sound.
Recognised clearing house	A clearing house, which has been recognised by the FSA, through which transactions on an Exchange may be cleared.

Regulated activity

Activities deemed to be regulated activities (under the FSMA) include: accepting deposits; issuing electronic money; effecting or carrying out contracts of insurance; dealing in investments as principal or as agent; arranging deals in investments, making arrangements with a view to transactions in investments; managing, safeguarding and administering investments; sending or causing dematerialised instructions to be sent; establishing operating or winding up a collective investment scheme; acting as trustee of an authorised unit trust scheme; acting as a depositary or sole director of an open-ended investment company; establishing, operating or winding up a stakeholder pension scheme; advising on investments; advising on syndicate participation at Lloyd's; managing the underwriting capacity of a Lloyd's syndicate as a managing agent at Lloyd's; arranging deals in contracts of insurance written at Lloyd's; entering as provider into a funeral plan contract; agreeing to carry on a regulated activity, which is carried on by way of business.

Regulatory information service

A service that disseminates regulatory information to the market.

Recognised investment exchange

An investment exchange, which has been recognised by the FSA, on which trading in designated investment business may take place.

Systemic failure

A situation where problems in any one financial institution or market may spread, endangering the stability of the entire financial system.