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Financial Services Authority

Review of the
prudential rules for
Personal Investment
Firms (PIFs)

Feedback to CP08/20 and
CP09/20 (Chapter 11)

November 2009



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This policy statement reports on the issues arising from consultation papers 08/20 and 09/20 (Chapter 11) and publishes final rules.

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1 Overview

Introduction

- 1.1 In this Policy Statement (PS), we set out the rule changes we will make following our consultation on the prudential rules for Personal Investment Firms. We summarise the feedback we received to that consultation and give our response to it.

Background

- 1.2 On 27 November 2008 we published Consultation Paper 08/20 (the CP) on the review of the prudential rules for Personal Investment Firms¹ (PIFs) outside the scope of the MiFID² (the PIFs review). The consultation period closed on 31 March 2009. A related publication is the Discussion Paper (DP) DP07/4,³ which was followed up with a Feedback Statement (FS08/2)⁴ in April 2008.
- 1.3 Internal and external stakeholders have expressed concern that the current prudential⁵ requirements for PIFs are no longer fit for purpose. There have been high-profile failures in the sector in recent years, and one of the main recommendations from the early stages of the Retail Distribution Review (RDR) was that increased and risk-based capital resources requirements for PIFs be explored. Our previous work indicated that we are not able to identify drivers of unsuitable advice but that prudential requirements (in the form of professional indemnity insurance, capital resources and requirements) could mitigate the impact of such unsuitable advice. We also consider that the expenditure-based requirement is the best method we have to reflect operational risk in a Personal Investment Firm.
- 1.4 The intended outcome of the PIFs review is to improve the effectiveness of the prudential rules. We would like to see a reduction in the level of consumer detriment and the costs to the levy payers contributing to the Financial Services Compensation Scheme (FSCS)

1 For the most part PIFs are independent financial adviser (IFA) firms.

2 The Markets in Financial Instruments Directive.

3 DP07/4: *Review of the Prudential Rules for Personal Investment Firms* (July 2007).

4 FS08/2: *Review of the Prudential Rules for Personal Investment Firms* (April 2008).

5 Prudential rules requirements here comprise capital resources and professional indemnity insurance (PII) requirements.

from unsuitable advice on investment products. It is clear that stakeholders expect us to develop prudential rules that deliver a more proportionate and effective set of regulatory requirements.

- 1.5 Given the overlap between the PIFs review and the RDR, we aired our early thinking and links to the RDR through DP07/4 (the DP), which was published in parallel with the RDR DP⁶ in mid-2007. We used the DP to set out our early analysis and findings, drawing 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; to accept radical new proposals such as exit arrangements; and to consider risk-based capital resources requirements.
- 1.6 The DP was followed by the CP, which consulted on proposed changes to the PII requirements; the capital resources and connected requirements; and discussed the concept of departing firms being required to leave adequate resources behind (when authorisation ceases) to deal with the costs of subsequent consumer complaints.
- 1.7 We received 93 responses to the CP from regulated firms, trade associations and consultants.
- 1.8 We also consulted in Chapter 11 of CP09/20⁷ on the consequential changes necessary to the professional indemnity insurance (PII) guidance in the Retail Mediation Activities Return (RMAR).
- 1.9 The European Commission has announced plans to update the Insurance Mediation directive (IMD) over the next three years. Many PIFs are insurance intermediaries within the scope of the IMD, which includes a minimum PII requirement and an optional capital resources requirement (which we previously chose not to implement). So the outcome from the IMD review could affect our PII and capital resources requirements for insurance intermediaries, including those also subject to the PIFs regime. We will monitor the situation.

Structure of this Policy Statement

- 1.10 The PS is set out as follows:
 - *Chapter 2*: The changes we have made to the proposals in the CP based on the comments we received to the consultation.
 - *Chapter 3*: A summary of the feedback to the questions in the CP.
 - *Chapter 4*: Details of the feedback to the consultation on consequential amendments to the PII guidance in the RMAR.

⁶ DP07/1: *A Review of Retail Distribution* (June 2007).

⁷ CP09/20: *Quarterly Consultation Paper (No 21)* (July 2009).

- *Chapter 5*: An update on the market failure analysis and cost benefit analysis based on the changes to the proposed policy as discussed in Chapter 2.
- *Annex 1*: List of non-confidential respondents.
- *Annex 2*: Capital resources calculation.
- *Annex 3*: Transitional arrangements.
- *Appendix 1*: Handbook text: Capital resources and professional indemnity insurance requirements for Personal Investment Firms Instrument 2009
- *Appendix 2*: Handbook text: Supervision manual (Retail Mediation Activities Return) (amendment) Instrument 2009

Who should read this Policy Statement?

- 1.11 This PS will primarily be of interest to non-MiFID PIFs, as it sets out the changes to the prudential rules for 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. The PS will also be of interest to consumers.

Our changes in summary

- 1.12 Our changes are:
- *Capital resources*: to implement the proposed policy from the CP to simplify the calculation and make it consistent for all firms.
 - *Capital resources requirement*: to extend the expenditure-based requirement (EBR) to all firms based on three months of relevant annual expenditure and to increase the minimum capital resources floor to £20,000.
 - *Own funds requirement*: to remove the minimum requirement of £10,000.
 - *PII*: to set out more specific requirements as to the level of additional capital resources needed where firms have any type of exclusion in their PII policy.
 - *PII guidance in the RMAR*: to make the consequential amendments to the PII guidance in the RMAR.
- 1.13 *Expenditure-based requirement*: as a result of the feedback we received to the CP, we will consider how we can apply a consistent approach to the expenditure-based requirement (EBR) to all firms so that it will deliver a level outcome irrespective of the firm's business model. We will also consider the capital resources requirements for pension and third-party administrators. We expect to consult separately on these issues in 2010.
- 1.14 *Leaving resources behind*: we have deferred our work at this stage for various reasons, including our review of the FSCS funding model. In any case, we will review the position in 12 months time.

Effect on reporting requirements

- 1.15 The amendments to the Handbook relating to the capital resources regime, and connected requirements, will have a consequential effect on reporting requirements, in particular sections D1 and D2 of the RMAR. We will consult on these consequential amendments in 2010. Amending the reporting requirements would also necessitate changes to our electronic data collection, analysis and risk alert systems. So firms will need to ensure that they amend their own systems where necessary. These system changes will need to be effective from 2011.

Next steps

- 1.16 The changes to the PII requirements come into effect on 31 December 2009.
- 1.17 We expect to consult on the issues set out in paragraphs 1.13 and 1.15 above in 2010.
- 1.18 The changes to the capital resources and connected requirements start on 31 December 2011 with a transitional period lasting until 31 December 2013, when the full requirements come into effect.

SMALLER FIRMS

This PS 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 changes for capital resources and the connected requirements and PII. We have carefully considered the implications for smaller firms to ensure that any requirements are proportionate for them.

CONSUMERS

This PS is important for consumers because the prudential requirements for non-MiFID PIFs may affect the ability to pay redress should the PIF provide unsuitable advice on investment products. Any changes to these requirements may also affect the cost and supply of advice to consumers.

2 Changes to our CP proposals

- 2.1 As a result of feedback to the CP we are making two changes to our proposals and consulting on a third change in a later paper. These are on: the expenditure-based requirement; the transitional arrangements for capital resources and connected requirements; and our approach to PII exclusions.

Expenditure-based requirement (EBR)

- 2.2 Currently, PIFs are subject to different requirements depending on the size of the firm. We do not want our rules to create opportunities for regulatory arbitrage amongst the various business models. Applying a three-month EBR would deliver an outcome that is relatively simple to calculate and likely to be proportional to the size of the firm. In the CP, we proposed a consistent EBR for all firms, regardless of their size and business model.
- 2.3 The substantive responses to the consultation focused on the proposed amendments to the EBR calculation. The main issue arising was the perception that the suggested approach allowed a potential favouring of the ‘network’⁸ business model (also firms with non-salaried staff or advisers) as the mechanics of the calculation exclude commission payments but include the salary costs of employed advisers. We consider the prudential risk issues to be similar across the different business models.
- 2.4 We have stated clearly that our objective is to provide clear and consistent capital resources requirements across the industry and eliminate any arbitrage opportunities available to firms.
- 2.5 We are reviewing how we can apply a consistent method for the EBR calculation that will deliver a level outcome for all PIFs. We intend to consult on this issue in the near future. In the meantime the rules on the EBR calculation remain as we consulted on in the CP.

⁸ Broadly, for the purpose of the prudential rules a network is a firm: (a) which has five or more appointed representatives; or (b) whose appointed representatives, not counting introducer appointed representatives (and being fewer than five) have, between them, 26 or more representatives.

Transitional arrangements for capital resources and connected requirements

- 2.6 We proposed that the amendments to IPRU (INV) Chapter 13 should come into force for PII exclusions from 31 December 2009 and for capital resources and connected requirements from 31 December 2010. We put forward a phased transitional provision for the capital resources and connected requirements until 31 December 2012.⁹ We asked respondents to comment on the proposed implementation date and the transitional provisions.
- 2.7 There was general agreement from respondents that the proposed changes should not come fully into force before 2012. In fact, there were suggestions that they should be deferred until either 2014 or 2015.
- 2.8 We recognise that most medium-sized firms would face a significant increase in their capital resources requirement and may not be in a position to generate the required additional capital resources in a short time period. So we will extend the transitional period by an extra year to end on 31 December 2013 to allow those firms in particular additional time to ensure they are in compliance with the new rules. Details are set out in Table 1 below.
- 2.9 Although the RDR's proposed transitional arrangements end on 31 December 2012, the additional year will allow firms to finalise their capital structures under the new prudential regime after taking account of business-model and other necessary changes arising from the RDR implementation.

Table 1

Deadline	EBR	£20k requirement	Subordinated debt
31 December 2011	1 month (4 weeks)	£15k	Existing limit
31 December 2012	2 months (8 weeks)	£15k	400% limit
31 December 2013	3 months (13 weeks)	£20k	200% limit

PII exclusions

- 2.10 In the CP we proposed changes to enhance our regulatory approach to PII policy exclusions.¹⁰ Our current rules do not specify the amount of additional capital resources that firms need to hold to cover the exposure created by PII exclusions and so we proposed to introduce a Table using the current additional capital resources trade-off applied by IPRU (INV) to PII policies with a £20,000 excess.

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- Firms would need to meet a minimum capital requirement of £15k by end 2010 and £20k by end 2012.
- Firms on less than three months EBR would need to meet one month's EBR by end 2010, two months by end 2011 and three month's EBR by end 2012.
- Firms would be restricted to a 400% limit of subordinated debt by end 2011 and 200% by end 2012.

10 Policy exclusions that are not relevant to the business conducted by a particular PIF would not be caught by this requirement.

- 2.11 The Handbook sets out, by a combination of rules, evidential provisions and guidance that PIFs should hold a reasonable amount of additional capital resources to cover liabilities arising from an excluded business line or activity. We proposed in the CP that one way to tighten the requirement to hold adequate additional capital resources in this respect would be to convert evidential provisions and guidance into rules: thus removing any doubt about the current application of our requirements.

Exclusion of claims arising from FSA-instigated action

- 2.12 We are aware that many insurers now include clauses in their PII policies to exclude claims that may arise as a result of a review of past business under section 404 of FSMA.¹¹ These clauses could also be used to exclude claims arising as a result of FSA-instigated action e.g. thematic work, a section 166 skilled persons report or enforcement action. Because of the way the exclusion rules are drafted, it is possible that a firm that holds a PII policy including this type of exclusion could be in breach of our minimum PII requirements.
- 2.13 In a hardening PII market, the increased use of skilled persons reports and actions to mitigate risks arising from our thematic work could cause insurers to apply the wider interpretation of this type of exclusion in future. If the insurer refuses to pay such claims and the PIF cannot pay and is declared in default, the FSCS will limit the consumer detriment arising but, as claims increase, it is expected that the remaining PIFs in the industry will bear more costs as FSCS levies increase due to the failure of other firms.
- 2.14 We will implement the amendments to the PII exclusion rules as proposed in the CP. However, in response to the point discussed in paragraphs 2.12 and 2.13 above we have amended our proposals. We will allow firms to have policy exclusion clauses but only if they hold sufficient additional capital resources to cover the likely liabilities arising from such exclusions e.g. for thematic events instigated by the FSA. This reflects our approach to the PII requirement whereby we allow a firm to have flexibility in the PII cover it purchases as long as it holds adequate additional capital resources to cover the expected liabilities arising from any exclusion.

11 FSMA is the Financial Services and Markets Act 2000.

3 Feedback on our consultation (CP08/20)

Capital resources requirements

Expenditure-based requirement (EBR)

- 3.1 In the CP, we proposed to extend the EBR to all firms and to streamline the calculation to apply the same method for all firms. All firms, regardless of size and number of advisers, would be subject to an EBR of three months i.e. one quarter of the fixed annual expenditure. Fixed expenditure is the amount of expenditure that a firm is committed to pay out regardless of its income level.
- 3.2 We also proposed to amend the EBR rules to clarify the language and make the terminology consistent, thereby eliminating any ambiguities.
 - Q1: Do you agree with our proposal, to apply a three-month EBR for all PIFs?
- 3.3 Some respondents highlighted the inconsistent treatment of staff emoluments depending on whether the business paid out a fixed salary or commission to advisers. In particular they argued the proposal does not support the desired move away from the ‘up-front’ commission remuneration model and discourages the move towards the ‘new model’ of fee-based advisers. Two respondents commented that the ‘old fashioned’, high commission paying PIFs that strip everything out of their business appeared to benefit from a lower requirement than a similarly sized ‘high quality’ firm that invests in technology and training.
- 3.4 Some respondents stated there is no need to extend the three months EBR to all firms. They commented that the resulting increase in the requirement for some firms will force them to leave the industry or reduce costs, neither of which would benefit consumers. Others stated that the increase in the requirement would not necessarily improve the performance or security of the firm and that lower risk firms should still be subject to a lower requirement. Some commented that it makes good business sense to keep in reserve capital resources equivalent to three months of expenditure.

- 3.5 Two respondents stated that a one-size-fits-all approach was not the right answer because it does not build in any form of risk assessment of the type of business undertaken.

Our response: We did not intend to create different capital resources requirements for firms with different business models and different sizes. We are currently reviewing this issue and intend to consult on a proposed solution in 2010. Please see Chapter 2 for further details.

- 3.6 A few respondents stated that some PIFs operate on a composite basis where regulated investment business is only one component of their activities. For these firms the EBR will be based on the total fixed expenditure of their business i.e. including that relating to any non-regulated activities. Applying the three-month EBR to these firms would create an incentive for them to divide into separate entities.

Our response: This issue does not arise as a consequence of our proposed rule amendments but rather through the existing structure of the firm. We recognise that firms may need to review their business structure to identify the optimal set-up to resolve any problems arising.

- 3.7 Some respondents were not convinced a case has been made that the proposed amendments will generate clear consumer benefits and, on the contrary, said they could hinder market developments that would benefit consumers. Other respondents suggested that we should consider a risk-based requirement or one that would be better suited to the current economic climate.

Our response: As we set out in the CP, the aim of the proposals is to complement the RDR in addressing the market failures identified in the sector. We aim to do this by requiring PIFs to bear directly more of the costs of redress claims for unsuitable advice. As we set out in the Feedback Statement to the DP, the EBR is the best risk-based approach that we have available to us.

- 3.8 One respondent suggested removing the 'other variable expenditure' deduction from the EBR calculation and maintain the current policy of firms applying for a waiver to allow any other expenditure to be excluded from the calculation.

Our response: We expect firms to be able to determine the expenditure that is variable i.e. not fixed. Other variable expenditure includes any that could be stopped immediately when the firm's income stops and do not have a contractual cost of termination.

- 3.9 Some respondents that commented on the amendments to the EBR calculation helpfully provided us with examples of the impact it would have on their particular firms.

Our response: The impact on individual firms reflects our expectation of the policy intention. Where firms have concerns about meeting their capital resources requirements, we would encourage them to discuss their individual case with their supervision contact.

- 3.10 One trade association, Association of Private Client Investment Managers and Stockbrokers (APCIMS), highlighted that the proposed amendments to the rules did not incorporate risk management in the form of either the Pillar2/ICAAP process or stress- and scenario-testing (including reverse stress testing) as required for BIPRU investment firms such as broker-dealers.

Our response: The PIFs within the scope of this Review are non-directive firms, so fall outside the scope of the application of stress- and scenario-testing rules. The package of proposals in the CP would require most PIFs to hold more capital resources than at present and we suggest that will be sufficient to mitigate the impact of the risks they face, given the more restricted nature of their business activities compared to broker-dealers.

- 3.11 We also received the following comments:

- We should consider the better use of data to facilitate risk-based assessments of capital resources as used by larger firms. Networks would be higher risk but have a lower cost base.
- Our proposed approach could disadvantage firms that have been established for some time and which have a significant stream of ongoing income and consequently higher expenditure.
- Firms that do not handle client money and/or client assets should not be subject to the same capital resources requirement as those that do.
- The onerous EBR shifts the burden of risk towards PIFs and away from consumers, by reducing the likelihood of firm failure and providing a larger capital resources base which an administrator appointed for the firm could use if required.
- The capital resources requirement should be based on an income measurement rather than expenditure based.
- Pension administrators should not be subject to these requirements. These firms only deal with scheme trustees and/or employers and do not advise scheme members but because of the way the regime works, they are classified as PIFs.

- 3.12 We have received other similar comments in respect of third-party administrators that provide services to authorised firms in the life and pensions sector and do not deal with retail customers.

Our response: We note the comments received. In particular, we are aware that a number of firms (such as pension and third party administrators) are not typical PIFs in that they do not deal with retail customers. So we are reconsidering our approach to setting capital resources requirements for such firms and will consult on this issue in the near future. In the meantime we invite affected firms to consider applying for a rule waiver, if they believe they can meet the tests set out in section 148 of FSMA.

- 3.13 Some respondents to this question asked whether the EBR needed to be met only by holding cash.

- 3.14 We received similar comments about the minimum capital resources requirement of £20,000. Some respondents who objected to the increase in the minimum requirement thought it would need to be held as cash and said some firms would find it difficult to raise the necessary capital.

Our response: The EBR and the minimum capital resources requirement of £20,000 need not be met only by holding cash. We would expect firms to meet the requirements by using the assets which do not need to be deducted under the terms of IPRU (INV) 13.3.10R. In other words, firms could meet these requirements using assets other than cash such as trade debtors unpaid for 90 days or less and accrued income receivable within 90 days.

Minimum capital requirement

- 3.15 We asked about the components of the capital resources calculation.
- 3.16 Low resource firms¹² 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 cases the minimum is £10,000.
- 3.17 In line with our policy to align the capital resources and connected requirements for all firms, we proposed to apply a minimum capital resources requirement and extend it to all firms regardless of their size. To reflect both inflation since the £10,000 minimum requirement was set in 1994 and the minimum amount we consider a firm should be prepared to hold to demonstrate creditworthiness, substance and commitment by its owners, we proposed a minimum capital resources requirement of £20,000.

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

- 3.18 A number of respondents agreed with the proposal, stating that the minimum requirement of £10,000 is too low and a move to £20,000 is justified, thereby providing more comfort to the regulator and customers. One respondent suggested the minimum should be raised to £50,000, and, if not that, then £30,000.
- 3.19 However, other respondents disagreed. They said there was no case for an increase other than to keep up with inflation, in which case the new minimum should be about £15,000. Some respondents commented that the minimum level should reflect the risks posed by individual firms. There were also a couple of comments that raising the minimum capital resources requirement will increase the barrier for new entrants to the market.

Our response: We repeat our reasoning for increasing the minimum capital resources requirement. The requirement of £10,000, set in 1994, is out of date. We believe that £20,000 is the minimum amount we expect a firm should be prepared to hold in its business to demonstrate credit worthiness, substance and commitment by its owners and it should not represent an unreasonable barrier to entry. We will introduce a phased transitional period to allow firms until 31 December 2013 to meet the new minimum. So, any current inflation-adjusted figure based on current cost estimates is likely to be out of date by the time the proposals are fully implemented.

12 A low resource firm is one with 25 advisers or fewer.

- 3.20 One respondent commented that a sole trader who risks his personal assets has a greater incentive to run the business well. Also, our proposals will encourage a move to limited company status which will give less security to customers. Another respondent suggested that, as a result of our proposals, smaller firms might fold, merge or join a network.

Our response: Our rules recognise that a firm may choose which type of legal form it wishes to use for its business. There are many reasons, other than regulatory, why such a decision is made and we do not wish to dictate what it should be.

Adjusted net current assets test

- 3.21 We proposed to remove the net current assets test as it is broadly a solvency requirement which is underpinned by the wider requirement in the rules for a firm to be able to meet its liabilities as they fall due. So the test itself does not add any value.

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

- 3.22 Nearly all the respondents supported the proposal to remove the adjusted net current assets test, confirming that they agreed the test did not add any value to the existing requirement to meet liabilities as they fall due.
- 3.23 A couple of respondents, including the Institute of Chartered Accountants in England and Wales objected to the proposal stating the test is important and should remain. One respondent stated the test should be replaced with the requirement to implement a suite of key risk indicators.

Our response: We repeat our argument that this is broadly a solvency requirement and firms separately need to meet liabilities as they fall due. So we will remove the test.

In response to the suggestion that we should implement a suite of key risk indicators, in the Feedback Statement to the DP we concluded that we could not identify suitable risk-based parameters for the PIF population as a whole, other than the EBR.

Capital resources

Proposed adjustment to the capital resources calculation

- 3.24 The current capital resources calculation comprises two parts: one to determine the capital for a firm's own funds and the other for the adjusted capital used to meet the EBR.
- 3.25 As we are streamlining the capital resources requirement to remove the own funds test and replace it with a minimum capital resources floor as part of the EBR, we

proposed having one definition of capital resources that applies consistently for all firms. In doing so our proposals replace complex rules with straightforward principles of calculating capital resources.

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

- 3.26 Respondents generally agreed with the proposal to simplify the capital resources calculation and have one definition of capital resources that applies consistently for all firms.
- 3.27 We received a few comments to the effect that a capital adequacy requirement will not reduce the likelihood of firm failure, with one respondent emphasising that the level of capital resources available to a firm or business neither indicates nor suggests how well run it may be. One respondent stated that the proposals on Leaving Resources Behind would be a better alternative to a capital adequacy requirement.

Our response: We did not receive any substantive comments which disagreed with our proposed approach to have one definition of capital resources and one capital resources calculation. We will proceed with our proposals as set out in the CP. Please see annex 2 for the capital resources calculation.

- 3.28 The rules proposed that we should retain a prescribed standard form for subordinated loans and we asked whether firms would find this helpful.

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

- 3.29 We received overwhelming support for keeping the standard form. One respondent commented that the form was useful to ensure the terms of the loan comply with the rules.

Our response: We will retain the standard form for subordinated loans.

- 3.30 We also proposed some detailed changes to the calculation of capital resources, which included introducing a lower limit on the inclusion of subordinated loans (reduced from 400% to 200% and applied to all PIFs), clarifying the treatment of intra-group debtors and the use of personal assets by unincorporated firms.

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

- 3.31 A few respondents opposed changes to the subordinated loan restriction. One respondent did not agree that subordinated loans are a lower quality of capital than share capital and reserves. Another suggested that we should undertake further work to define the quality and appropriateness of subordinated loans that can be included in capital resources. One more respondent stated the subordinated loan restriction will not help where there is goodwill that has been transferred into a newly incorporated entity.

- 3.32 One respondent agreed that subordinated debt does not represent high quality capital and suggested that it should either be further restricted or disallowed altogether. Another respondent stated that the ability to use subordinated loans should depend on the terms and conditions of the loan.

Our response: Although we agree subordinated debt does not represent the highest quality of capital, we recognise that smaller firms are not as readily able to raise better quality capital and will be dependent on other forms of funding. We will continue to allow firms to include subordinated debt in their capital resources calculation. We will, however, implement the proposed subordinated loan gearing restriction as we do not want firms to be completely reliant on debt funding.

- 3.33 One respondent stated the definition should focus on both the quality of capital and management's ability to realise the assets should a need to obtain cash arise.

Our response: This approach forms the basis of the capital resources calculation. We require a firm to deduct assets that are not readily realisable and maintain an adequate quality of capital.

- 3.34 One respondent stated that the combined effect of all the proposed changes could have a serious impact on PIFs and delaying the end of the transitional arrangements would enable firms to prepare properly and adjust to any changes.

Our response: We have addressed this point in our response in paragraphs 2.6 – 2.9 and 3.36 – 3.38 in respect of transitional arrangements.

- 3.35 We received some specific comments on the mechanics of the proposed capital resources calculation, which we respond to in Table 2 which follows.

Table 2

Respondent's comment	FSA response
The indemnity commission claw back proposal is unclear and further guidance is required. We should either require a higher minimum level of capital resources for claw backs or limit indemnity commission income inclusion to a more realistic value of the stream of initial payments.	The current adjustment is no longer required, as the same effect would be achieved by firms applying the relevant accounting standards.
Could we define trade and non-trade debtors in the context of the proposed treatment of intra-group debtors?	These terms are self explanatory but for the avoidance of doubt, trade debtors are those in respect of trading services rendered between different group entities and non-trade debtors relate to all other types of debt.
The deduction of intra-group non-trade debtors is excessive.	As we set out in the CP, we consider that including intra-group debts could lead to some firms overstating their relative solvency, as the position of the group may not support the immediate repayment of such amounts.

Respondent's comment	FSA response
<p>The definition of intra-group debtor should be extended to include shareholders and other connected persons who are debtors of the PIF. But where the debtor is another regulated business it should not be excluded as there could be a double-counting of capital resources requirements. Allowing trade debtors can cause confusion and so these should also be deducted.</p>	<p>As we set out in the CP, we consider that including both trade and non-trade intra-group debts could lead to some firms overstating their solvency and capital resources position.</p> <p>We propose to amend the rules to clarify that intra-group debtors include other connected persons.</p>
<p>Deposits that can be withdrawn within 90 days should be included but penalty costs associated with early withdrawal should be deducted from capital resources.</p>	<p>Such balances should be deducted where there is a penalty to withdraw the deposit within 90 days.</p>
<p>Firms that model their business on recurring revenue and ongoing service to clients should be able to use their recurring revenue in some way in their capital adequacy computation.</p>	<p>The suggestion seems to be that a firm should be able to include a value for a future income stream. As we base our capital resources computation on accounts drawn up in accordance with accounting standards, and such standards would not allow any recognition of these income streams in the balance sheet, we will not allow them in the capital resources computation.</p>
<p>Definition of guarantees and contingent liabilities. There is a potential for these to be incorrectly classified by some firms, therefore guidance should be given.</p>	<p>We will rely on firms using amounts, which are derived in accordance with relevant accounting standards.</p> <p>An example of a contingent liability is where a firm has given a guarantee in respect of another group company's bank overdraft.</p>
<p>Should the calculation of the EBR expenditure include re-charges? Also what should be the treatment of non-cash items as these are deducted from capital resources but then included in the EBR calculation?</p>	<p>The treatment of expenditure items will follow accepted accounting practice. So expenditure should not be offset against income unless there is a right of set-off. If non-cash items such as depreciation are included in a firm's expenditure then they will form part of the basis of the EBR.</p>
<p>Deferred acquisition cost (DAC) and deferred income reserve (DIR). There is concern that accounting for acquisitions and deferred income will be incorrectly undertaken and this section should be deleted.</p>	<p>The DAC and DIR accounting differs from that for other assets and liabilities because they do not give rise to future cash inflows or outflows. We expect firms to follow correct accounting procedures when preparing their annual financial statements.</p> <p>This section is not likely to apply to many PIFs.</p>
<p>Guidance is required on the definition of illiquid assets, particularly for those firms unaccustomed to the terminology.</p>	<p>These are any assets that are not covered by any of the other classifications.</p>
<p>Other reserves. These should not be excluded from the capital resources calculation as all equity funds form the basis of capital resources.</p>	<p>We have clarified the capital resources calculation to show that all such reserves can be allowed.</p>
<p>Land & buildings: The discount levels should be reduced to 30% but suggest they should be increased to 40%.</p>	<p>The 30% discount level represents a mid-point for the current discounts used for those assets with mortgages and those without mortgages.</p>

Transitional provisions

3.36 The CP proposed to introduce a staged transitional provision to allow firms to raise additional capital resources over an extended period of time, which would set milestones to enable firms and others, including the FSA, to monitor the progress made towards full compliance with the new requirements. The transitional period suggested was 2010 – 2012, with full implementation to be achieved by 31 December 2012.

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

3.37 Nearly all respondents said the transitional arrangement should not end any earlier than 2012. A couple of respondents, including AIFA, suggested extending it to either 2014 or 2015.

3.38 One respondent said it should not be extended beyond 2012. Another suggested the proposals should not be implemented at all.

Our response: We have agreed to delay the phased transitional period to 2011 – 2013. Please refer to Chapter 2 paragraphs 2.6 – 2.9 for further details.

Professional indemnity insurance (PII)

3.39 We proposed changes to enhance our regulatory approach to PII policy exclusions as well as to simplify the existing PII rules.

3.40 We understand that some firms use PII policy exclusions to improve the cost effectiveness of PII. Although we do not object to this, we proposed that our rules should be clear on what minimum additional capital resources should be retained to cover such exclusions in order to ensure PIFs retain their ability to meet valid consumer claims.

3.41 In the CP, we constructed a table to show the minimum capital resources a firm should hold to cover the risk of exposure where their PII policy excludes a business line.

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

3.42 Most respondents expressed general agreement with the proposals. AIFA, however, does not believe that additional minimum capital resources requirements for policy exclusions are appropriate because there is neither FSCS levy-payer detriment nor consumer detriment.

3.43 One respondent stated that the proposals prescribe a standard which will not be relevant in all cases. Further, the table sets out a range of capital resources requirements which are unrelated to the potential liability.

3.44 Other respondents made the following comments:

- Firms with a turnover of up to £1 million would be disproportionately penalised by the proposals.
- The proposed rule change does not take into account the risks relating to or the claims potential which may attach to a particular business line. Where a PIF has properly estimated its financial liabilities then our proposal has the effect of double-counting such liabilities. Each PIF should calculate a provision for compensation payable for any potential mis-selling regardless of whether a complaint or claim has been made.
- The rules as drafted will incentivise PIFs to exclude business lines from cover rather than carry insurance where they are unable to obtain cover except with policy excesses of in excess of £20,000.
- Exclusions should only be permitted once sanctioned by the FSA.
- The provisions are not necessary in addition to the capital resources requirements.
- The proposal could impose a pro-cyclical burden on PIFs at the worst point in the economic cycle as PI insurers will then include more exclusions in their policies.

Our response: We note the comments received. The table of policy exclusions is still relevant and will impose a minimum level of additional capital resources that a firm must hold if it has PII exclusions and allow firms to use their own judgement. We will proceed with the proposals as set out in the CP. It should be noted that the rules also require a firm to hold amounts in excess of the minimum if the prescribed amounts provide insufficient cover given its circumstances.

Handbook proposals

3.45 Appendix 1 to the CP set out the new proposed rules for IPRU (INV), including drafting changes to improve their clarity. We asked firms to comment on the proposed Handbook changes.

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

3.46 We did not receive any substantive comments on the Handbook changes. A few minor amendments as suggested by some respondents have been incorporated into the Instrument.

Leaving resources behind

- 3.47 In the CP we considered options for appropriate mechanisms whereby PIFs that cease trading have arrangements in place so that they can bear more of the costs of their consumers' subsequent claims i.e. leaving resources behind (LRB).

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

- 3.48 Most respondents expressed support for the idea that a firm ceasing to be authorised should leave behind adequate resources to pay for any subsequent complaints from consumers. There were no suggestions, however, as to how a practical regime could be developed. There is recognition from some respondents of the difficult legal and administrative obstacles that would need to be overcome but no ideas to deal with them.
- 3.49 AIFA believes that elements of LRB carry merit and would actively support us in further consideration of the issue. It suggested that work on LRB is important and likely to have a positive impact on the amount of FSCS levy-payer detriment. AIFA feels further research is needed to explore how it would work in practice. It understands this is a complex area but feels it would have a positive impact on the profession. It suggests setting up a joint working group with us and other interested parties to explore these proposals further. However, AIFA does also point out that any changes would have to affect all firms contributing to the FSCS if we were to achieve a level playing field.
- 3.50 The BBA agrees with the principle of reducing the burden on the FSCS by ensuring most complaints are dealt with by PIFs by facilitating the latter's continued existence. It says that past examples of 'phoenixing'¹³ have undermined the 'polluter pays' principle. It suggested that LRB could play a role to ensure the PIF pays its fair share for future liabilities arising in respect of past business. The BBA suggested that we need to consider our approach to exit levies generally under the FSCS. It is also strongly against a pre-funded FSCS for reasons set out separately in its response to the tripartite banking reform consultation.
- 3.51 The FSA Consumer Panel responded that its primary concern is that customers have access to redress. It suggested that introducing LRB requirements may bring confusion and lead to worse outcomes for consumers. It would need to be satisfied that appropriate relationships were made with the Financial Ombudsman Service and the FSCS so that consumers are able to receive redress.
- 3.52 A few respondents specifically mentioned the concept of using PII run-off cover as a method of covering post-cessation liabilities, and some suggested that this should be priced to reflect the risks in the market. Those that have operated 'clean' business models and have low claims or compensation levels should not have to pay significant premiums for the cover.

13 A 'phoenix' firm is where a firm has ceased to be authorised, leaving uncrystallised compensation liabilities to be met by the FSCS. Before these claims crystallised its proprietors will have tried to become advisers with other authorised firms.

- 3.53 A few respondents mentioned the potential to take out a bond, built up over the life of the firm and linked to the volume and nature of the business. Any excess funds from the bond could be paid back to the principals, thereby providing an incentive to the PIF to trade in such a way as to minimise the risk of complaints.
- 3.54 There was a concern from some respondents about the need to consider some form of long stop for claims so that a firm will know when its potential liability for claims will end. Other respondents saw any regime as an alternative to capital resources and a better way to deliver a reduction in the risk of consumer detriment on the closure of a PIF.
- 3.55 One respondent suggested factors that may have a positive influence on firms exiting the industry and on the resulting liabilities. Not least would be a greater focus by us on de-authorising a firm, such as a face-to-face audit visit to assess business types written, controls and standards in place during the life of the firm, and agreeing a plan for withdrawal including adequate provisioning for any future claims.
- 3.56 The same firm also suggested that a financial product levy should be charged on every financial product at the point of purchase. They acknowledged this is an uncomfortable concept, but is the only reliable way to address what they believe is the fundamental unsustainability of the FSCS. Customers would bear the cost in a more transparent way: presently the levy cost must ultimately be borne by customers but this is obscured in overall advice or commission charges.
- 3.57 A few firms referred to the fact that it would be important to avoid arrangements which are unduly onerous, complex or legally difficult for firms to comply with. It would be critical that the market evolves to ensure customers know who will service their advice and product requirements on any existing products should a PIF cease trading. So LRB must consider how customers can be served should the PIF cease to trade. These firms believe that a risk-based approach is required. They suggested that the risks are fundamentally different where a PIF is using a range of packaged products backed by a financially strong product provider as opposed to the customer and product details being held on an in-house platform or a thinly-capitalised platform provider.
- 3.58 Some respondents recognised the need for the arrangements to be capable of dealing with the liabilities of insolvent firms otherwise the remainder of ‘good’ firms would need to pick up the resultant liabilities. They suggested we need a robust way of harnessing those who seek to ‘hit and run’, or see unimpeded exit from a business as the most financially appealing strategy, and who are currently able to burden those who remain.
- 3.59 Two respondents acknowledged that until the Treasury’s work on pre-funding is completed it would be difficult for the FSA to move forward on this issue.

Our response: We welcome the comments received which are useful contributions to the LRB debate. However, we are not putting forward any proposals at this stage.

The FSA will review the FSCS funding model and intends to consult on this in the financial year 2010 – 11. The scope of this review will include all regulated firms that contribute to the FSCS, including PIFs. The review will include, but will not be limited to, consideration of the structure and composition of the classes in the FSCS funding model, the annual amount each class can be asked to pay as well as the method of allocating levies to firms in each class including considering the case for risk-based levies.

There is also the ongoing debate in respect of pre-funding of the FSCS. The White Paper on Reforming Financial Markets that was issued on 8 July 2009 states that the Government believes that, subject to consultation, it would be appropriate to move towards the introduction of a pre-funded element in the FSCS covering the deposit-taking class, in order to provide better protection to the taxpayer.

In addition, two of the potential options that we suggested for LRB in the CP would require a firm to set aside a specified amount of resources to cover future complaints using a trust. The interplay between trust, insolvency and financial services law is complex. Expert advice would need to be considered in the development of proposals in this respect. There is some relevant litigation going through the Courts at present, and we take the view that it would be better to seek this advice when the outcome of the litigation is clear.

We propose to reconsider LRB again when the above issues have been resolved, although we will re-assess the situation in any case in twelve months time.

4 Feedback to responses to amending the PII guidance in the RMAR (CP09/20 Chapter 11)

- 4.1 CP09/20¹⁴ proposed amendments to the PII guidance on the Retail Mediation Activities Return (RMAR) in SUP 16 Annex 18BG to reflect changes to terminology and rule references.
- 4.2 The proposed amendments are primarily to update the PII guidance to reflect the Handbook changes to IPRU (INV) 13 and the change in terminology whereby we are replacing references to ‘own funds’ with ‘capital resources’. These amendments will not require consequential changes to the RMAR itself as we are not introducing or removing any data elements in the form. Nor will the type of data reported in Section E change.
- Q39: Do you agree with the proposal to update guidance on completing RMAR section E to reflect changes to the capital resources requirements in IPRU (INV)?
- 4.3 We received two responses to our consultation. Both agreed with the amendments to the guidance to reflect the Handbook changes to IPRU (INV) 13 as consulted in the CP.

Our response: We will implement the proposed amendments to the guidance for section E of the RMAR.

14 CP09/20: *Quarterly Consultation (No.21)* (July 2009).

5 Market failure and cost benefit analysis

- 5.1 In this chapter we provide an update on the market failure and cost benefit analysis based on the changes that we have made to the proposals that we consulted on in the CP. The details of the changes are set out in Chapter 2.

Market failure

- 5.2 Without regulation, the advice market would suffer from information asymmetry and divergent adviser and consumer incentives, which can create the risk of mis-selling. Conduct of Business Rules look to mitigate this risk. The changes we refer to here aim to ensure firms have adequate capital resources for complaint redress.
- 5.3 *Capital resources to supplement PII.* Without adequate capital resources held against PII insurance exclusions, a firm could face a complaint that it cannot redress. A consequence of this is that the FSCS faces having to fund this shortfall. Due to the funding structure of the FSCS, the market ultimately pays for the shortfall. This negative externality of under-provision for insurance exclusions transfers some of the cost of insolvency to the market.

Cost benefit analysis

Capital resources to supplement PII

- 5.4 *Benefits:* Holding capital resources against all PII exclusions, regardless of whether they relate to regulated business activities or other FSA-instigated events, ensures firms are in a position to redress complaints against which they are not insured.
- 5.5 *Costs:* As with the capital resources estimates above, those presented in the CP for PII costs made no allowances for different exclusion types. As such, the cost to the industry is as previously stated: £1.6 million during benign periods with an illustrative annual cost of £67,200.

Responses to CP08/20

- 5.6 A few respondents made comments about the market failure analysis and cost benefit analysis in CP08/20. The only significant comment related to the EBR calculation and, as we have discussed earlier in this paper, we will consult on this in the near future; this will include a cost benefit analysis of the EBR calculation. There were no other significant issues that need to be investigated further.

List of non-confidential respondents

CP08/20

Association of British Insurers

AEGON

A J Buckley Asset Management Ltd

Association of Independent Financial Advisers

Association of Private Client Investment Managers and Stockbrokers

Andrew Dickson Limited

Aspira Corporate Solutions LLP

Bankhall Investment Associates

British Bankers' Association

Bernard Tyler

Buckland Harvester

Cambourne Financial Planning Limited

Cameron Trinity

Castle Financial Services Limited

Central Financial Planning

Chadney Bulgin LLP

Cheltenham and Gloucester Plc

Chestergate Financial Planning Ltd

Chiltern Financial Solutions Limited

Compos Mentis (Training) Ltd

Eldon Financial Planning Limited
Executive Advisory Services
Facts and Figures Figures Planners Ltd
Fidelius
FORTIS
Foster Denovo
Financial and Taxation Advisers LLP
Financial Services Consumer Panel
Gissings Pensions
Henley Retirement Planning
HFM Columbus Wealth Management Ltd
IFAct Services Ltd
Independent Financial Strategies Ltd
Independent Life and Pensions Group
Independent Mutual Ltd
In Harmony Independent Financial Advisers
Institute of Chartered Accountants in England and Wales
Institute of Financial Planning
Investment and Life Assurance Group
Investment Quorum Ltd
John Whittenbury Financial Services
Johnstone Campbell Limited
Laurence Milbrook & Co
Liberata
London Society of Chartered Accountants
Lucas Fettes & Partners
Lupton Fawcett LLP
McParland and Partners Ltd
MGP (Employee Benefits) Ltd
Milne Wight & Company Ltd
Milsted Langdon Financial Services Ltd

Monahans
Moore Stephens Financial Services
Morton-Wilson Limited
Norwest Consultants
O'Halloran & Co
Ovation Finance Ltd
Page Russell
Paradigm Partners Ltd
Park Row Corporate and Private Clients
Paul Jones Financial Services Ltd
Pearl Group Management Services
Phillip Masters Independent Financial Advisers Limited
Premier Clients
Prosser Knowles Associates Limited
Protection and Investment Ltd
Prudential Assurance Co Ltd
P W White and Partners Limited
QS Financial Services Authority
Radcliffe 7 Co Life & Pensions Limited
Retirement and Investment Solutions
Risk Reward Limited
Scottish Widows
SFIA
Simply Biz
Stafford & Co
Standard Life Client Management
Sterling Financial Advice Limited
R J Hurst & Partners Limited
Three Sixty Services LLP
Tenet Group
Tim Brook-Dobson Brear

Tim Page

Ward Williams Financial Services Ltd

Wessex Investment Management

Whitting & Partners Financial Services Ltd

Whittaker Financial Solutions Limited

Winchester Consultancy LLP

Wishart Wealth Management Limited

Xafinity Group

Yellowtail Financial Planning

Zurich Financial Services Group

CP09/20

Association of Independent Financial Advisers

Compos Mentis (Training) Ltd

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).

Table 3

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 proprietors' 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) and other reserves	<p>These amounts do not need to be audited or verified.</p> <p>Retained profits and retained losses are subject to the following adjustments:</p> <ol style="list-style-type: none"> (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; (2) in respect of a defined benefit occupational pension scheme, the firm must derecognise any defined benefit asset; (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 (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.
Revaluation reserve	
Subordinated loans	Subject to the limits set out in rules 13.3.11R and 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
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.

Transitional arrangements

Table 4

PIFs CP transitional arrangements				
Implementation date	31 December 2009	31 December 2011	31 December 2012	31 December 2013 (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 deduction				
Subordinated debt 200%			400% limit on subordinated debt	200% limit on subordinate debt
PII requirements	For policies taken out on or after 31 December 2009, additional capital requirements			

Handbook text:

Capital resources and professional indemnity insurance requirements for Personal Investment Firms
Instrument 2009

**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 power);
 - (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) Subject to (2), this instrument comes into force on 31 December 2009.
(2) Part 2 of Annex B to this instrument comes into force on 31 December 2011.

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.

Notes

- F. In Annex B to this instrument, the “notes” (indicated by “**Note:**”) are intended for the convenience of readers but do not form part of the legislative text.

Citation

- G. 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
5 November 2009

Annex A

Amendments to the Glossary of definitions

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

Insert the following new definitions in the appropriate alphabetical place. This text 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> : <ul style="list-style-type: none"> (a) 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>; and (b) 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>	(a) 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: <ul style="list-style-type: none"> (i) giving advice on <i>investments to clients</i>; (ii) <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>;

- (iii) *managing investments*;
 - (iv) receiving or holding *client money* or other *client assets*;
 - (v) *safeguarding and administering investments*.
- (b) For the purposes of this definition, an independent intermediary is a *firm* acting as an intermediary but excluding:
- (i) a *firm* which is a member of a *marketing group*;
 - (ii) a *product provider* which *sells* its own *packaged products*.

marketing group

a group of *persons* who:

- (a) are allied together (either formally or informally) for the purposes of marketing *packaged products* of the *marketing group*; and
- (b) each of whom, if it holds itself out in the *United Kingdom* as marketing *packaged products* to *private customers*, does so only as an *investment manager* or in relation to *packaged products* of the *marketing group*.

marketing group associate a *firm* other than a *product provider* which is a member of a *marketing group*.

net long position

the situation in which a *firm* holds or will hold more *units* in an *investment* than it has contracted to *sell* or, in respect of *options*, where it has bought rights which exceed rights sold.

net open foreign currency position

(in *IPRU(INV)* 13) a *firm's net long position* or *net short position*, whichever is the higher, in a currency other than that in which the *firm's* books of account are maintained.

net short position

- (1) (except in *IPRU(INV)* 13) 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)* 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.

<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>	<ul style="list-style-type: none"> (a) a <i>regulated collective investment scheme</i> dedicated to land and interests in land; (b) a fund of funds of which one or more of the funds to which it is dedicated falls within (a); (c) a constituent part of an umbrella fund which, if it were a separate fund, would fall within (a).
<i>special adjustment</i>	(in <i>IPRU(INV) 13</i>) a <i>position</i> risk adjustment, counterparty risk adjustment and foreign exchange adjustment.
<i>verified</i>	<p>(in <i>IPRU(INV) 13</i>) 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> <ul style="list-style-type: none"> (a) satisfy himself that the figures forming the basis of the interim profits have been properly extracted from the underlying accounting records; (b) review the accounting policies 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 <i>IPRU(INV) 13</i>; (c) 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); (d) discuss with management the overall performance and financial <i>position</i> of the <i>firm</i>; (e) 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 (f) follow up problem areas of which he is already aware in the course of auditing the <i>firm's</i> financial statements, a copy of whose report asserting that the interim net profits are reasonably stated has been submitted to the <i>FSA</i> (although

this does not apply to *exempt CAD firms*).

Amend the following definitions as shown.

- adviser*
- (1) (except in IPRU(INV) 13) an individual who is: a *representative*, an *appointed representative* or a *tied agent*.
- (2) (in IPRU(INV) 13) a *financial adviser*.
- initial capital*
- ...
- (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) 13) the *initial capital* of a *firm* calculated in accordance with IPRU(INV) 13.1A.6R.
- representative*
- (1) an individual who:
- ...
- (2) (in IPRU(INV) 13 in relation to *designated investment business*) an individual appointed by a provider firm or by an *appointed representative* or *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 those products.
- (3) In (2), a provider firm is a *firm* that is:
- (a) a *product provider*; or
- (b) a *marketing group associate*.

Annex B

**Amendments to the Interim Prudential sourcebook for Investment Businesses
(IPRU(INV))**

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

Part 1: Comes into force on 31 December 2009

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
...					
<u>4</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 apply to a <i>professional indemnity policy</i> taken out, renewed or extended with effect from 31 December 2009.</u>	<u>31 December 2009 to 31 December 2010</u>	<u>31 December 2009</u>

Chapter 1: Application and General Provisions

...

1.2.1 R The ~~Glossary~~ Glossary applies to the transitional provisions, this chapter (*IPRU(INV)* 1), *IPRU(INV)* 2, *IPRU(INV)* 4 ~~and~~, *IPRU(INV)* 6 ~~and~~ *IPRU(INV)* 13.

...

Chapter 13: Financial Resource Requirements for Personal Investment Firms

APPLICATION, GENERAL REQUIREMENTS AND PROFESSIONAL INDEMNITY INSURANCE REQUIREMENTS

~~13.1~~ 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*, 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; or
- (c) if it is an *opted-in exempt CAD firm*, sections 13.9 to 13.12 (but reading references to ~~Category~~ *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~~ *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

- 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

- 13.1.2
13.1.4 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 this option (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").
- 13.1.8
- 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:
- 13.1.9
- (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~~

13.1.10 R ~~(b)~~ ~~if~~ If the *firm* is an *IMD insurance intermediary*, whether or not it is also an exempt CAD firm, 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*]

13.1.11 R ~~(ba)~~ ~~if~~ 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~~ 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 13.1A.4*)]

LIMITS OF INDEMNITY — ~~OTHER FIRMS~~

13.1.13 R ~~(d)~~ ~~if~~ 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(2A)~~ 13.1.14 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) R If a policy is denominated in any currency other than euros, ~~an *IMD*~~
13.1.15 ~~*insurance intermediary*~~ a *firm* 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 13.1.4(2)(b)~~ denominated in euros.

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 *United Kingdom* 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;
 - (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)~~ 13.1.9R to
13.1.19 R 13.1.13R, to incorporate appropriate terms, the policy should must make provision for the following:
- (1) (⊕) 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
------------------------	-------------------

more than	up to	limit of indemnity (£)
...		

- (2) (ii) full retroactive cover in respect of the kinds of liabilities described in ~~13.1.4(2)~~ 13.1.9R 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) 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; 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*);

unless the firm holds additional capital resources, in accordance with 13.1.23R.

- 13.1.4(9) G (a) The FSA considers it reasonable for a firm's policy to exclude cover
13.1.22 (1) for:
- (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) The FSA does not consider it reasonable for a firm's policy to treat (2) legal defence costs cover as part of the limits of indemnity if this reduces the cover available for any individual substantive claim.

ADDITIONAL CAPITAL RESOURCES – EXCLUSIONS

- 13.1.23 R The amount of additional capital resources that a firm must hold as a result of an exclusion under 13.1.21R 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</u> <u>£000s</u> <u>(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>
<p><u>Note 1 – For <i>firms</i> with relevant income of more than £10m but up to £100m value y is calculated by relevant income/ £10m.</u></p>		
<p><u>Note 2 – The calculation of a <i>firm</i>'s capital resources is set out in sections 13.1A to 13.12 (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>).</u></p>		

- 13.1.24 G The *firm* should hold additional capital resources in excess of those minimum amounts set out in the table in 13.1.23R 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:
- 13.1.25
- (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))~~ 13.1.27R; 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~~ 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 applicable to a type of business that has been carried out by the *firm* in the past.

13.1.26

~~ADDITIONAL OWN FUNDS CAPITAL RESOURCES – EXCESS~~

13.1.4(12) ~~E R~~ 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:

13.1.27

All amounts are shown in £000s (Notes 1 and 2)		
Relevant income is		Excess obtained, up to and including
more than	up to	...
...		
<u>Note 1 – For <i>firms</i> with relevant income of more than £10m but up to £100m value <i>y</i> is calculated by relevant income/ £10m.</u>		
<u>Note 2 – The calculation of a <i>firm</i>’s capital resources is set out in sections 13.1A to 13.12 (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>).</u>		

~~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.~~
- 13.1.9 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~~
 13.1.28 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) professional indemnity insurance cannot be obtained within 28 days of the inception or renewal date;
 - (b) (2) professional indemnity insurance is cancelled;
 - (c) (3) the amount of aggregate cover is exhausted;
 - (d) (4) the firm commences business lines for which it had 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]
- 13.1.10 R [deleted]
- 13.1.11 G [deleted]
- 13.1.12 R [deleted]
- 13.1.13 G [deleted]
- 13.1.14 R [deleted]
- [DELETED]
- 13.1.15 R [deleted]
- [DELETED]
- 13.1.16 R [deleted]
- [DELETED]
- 13.1.17 R [deleted]
- ...

Delete Appendix 13(1) (Defined terms for Chapter 13) in its entirety. The deleted text is not shown here.

Appendix 13(1) (Defined terms for Chapter 13) [deleted]

Part 2: Comes into force on 31 December 2011

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
...					
4	13.1.21 and 13.1.23 [deleted]	R	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 apply to a <i>professional indemnity policy</i> taken out, renewed or extended with effect from 31 December 2009.	31 December 2009 to 31 December 2010	31 December 2009
<u>5</u>	<u>13.3.2</u>	<u>R</u>	<u>A category B firm must meet the capital resources requirements in this transitional provision instead of those in 13.3.2 until 31 December 2013, unless the <i>firm</i> is already subject to a higher capital resources requirement, in which case this transitional provision does not apply.</u> <u>From 31 December 2011 to 31 December 2012, the <i>firm</i>'s capital resources requirement must be calculated in accordance with whichever of (1) or (2) produces the higher amount:</u>	<u>From 31 December 2011 to 31 December 2013</u>	<u>31 December 2011</u>

			<p>(1) <u>1/12 of its fixed annual expenditure, calculated in accordance with 13.3.3R to 13.3.8R; or</u></p> <p>(2) <u>£15,000.</u></p> <p><u>From 31 December 2012 to 31 December 2013, the firm's capital resources requirement must be calculated in accordance with whichever of (3) or (4) produces the higher amount:</u></p> <p>(3) <u>1/6 of its fixed annual expenditure, calculated in accordance with 13.3.3R to 13.3.8R; or</u></p> <p>(4) <u>£15,000.</u></p>		
<u>6</u>	<u>13.3.13(2)</u>	<u>R</u>	<p><u>A category B firm can calculate the amount of the firm's total capital and reserves excluding preference share capital, less the amount of its intangible assets, multiplying it by 400% until 31 December 2013.</u></p>	<u>From 31 December 2011 to 31 December 2013</u>	<u>31 December 2011</u>

...

- 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~~ section 13.2 to 13.8;
- (c) if it is an *opted-in exempt CAD firm*, ~~sections 13.9 to 13.12~~ section 13.3 (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~~ sections 13.1 and sections 13.9 to 13.12 13.3 apply.

...

ADDITIONAL CAPITAL RESOURCES – EXCLUSIONS

- 13.1.23 R The amount of additional capital resources that a *firm* must hold as a result of an exclusion under 13.1.21R 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 13.12 <u>13.3</u> (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 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	up to	...
...		
Note 2 – The calculation of a <i>firm's</i> capital resources is set out in sections 13.1A to 13.12 <u>13.3</u> (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 REQUIREMENT 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) if it is not an opted-in exempt CAD firm, the requirement that is applied by ~~sections 13.2 to 13.8~~; or
 - (b) if it is an *opted-in exempt CAD firm*, the requirement that is applied by ~~sections 13.9 to 13.12~~ 13.3 (but reading references to ~~Category~~ 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)~~ 13.1.11R and ~~13.1.4(3)~~ 13.1.15R to ~~13.1.6~~ 13.1.27R; 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) 13.1.10)]
- (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)~~ 13.1.10R and, in addition, has to have:
- (a) *initial capital* of €25,000; or
 - (b) professional indemnity insurance at least equal to the requirements of ~~13.1.4(2)(e)~~ 13.1.12R and ~~13.1.4(3)~~ 13.1.15R to ~~13.1.6~~ 13.1.27R; 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) 13.1.12)]

(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.

13.5 FINANCIAL RESOURCES TEST 2 – EXPENDITURE-BASED REQUIREMENT

REQUIREMENT

13.5.1 R [deleted]

13.5.1A R [deleted]

13.2 FINANCIAL RESOURCES REQUIREMENT FOR EXEMPT CAD FIRMS THAT HAVE NOT OPTED-IN

- 13.5.1B
13.2.1 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* ~~13.5.2~~ 13.2.3; or
 - (2) an amount equal to £400 multiplied by the number of its *advisers*.
- 13.5.1C R [deleted]
- 13.5.1D
13.2.2 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 a network~~ must have financial capital resources calculated in accordance with whichever of ~~(3), (4) or (5)~~ (1), (2) or (3) produces the highest amount-;
- ~~(3)~~ Financial capital resources which taking into account all the *special adjustments* amount to 4/52 of its ~~relevant fixed~~ relevant fixed annual expenditure calculated in accordance with ~~rules 13.5.2 13.2.3 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~~ relevant fixed annual expenditure, calculated in accordance with ~~rules 13.5.2 13.2.3 to 13.2.7~~; or
- ~~(5)~~ financial capital resources which taking into account all the *special adjustments* ~~of an amount equal to~~ £400 multiplied by the number of its *advisers*.

CALCULATION OF ~~RELEVANT~~ RELEVANT FIXED ANNUAL EXPENDITURE

~~13.5.2~~
13.2.3

- R (1) An exempt CAD firm must calculate its ~~relevant fixed~~ 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~~ 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 13.5.3 13.2.6~~, deduct from its total expenditure the items set out in table ~~13.5.2 13.2.3~~.

Table ~~13.5.2 13.2.3~~

This table forms part of ~~rule 13.5.2 13.2.3~~

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

(e)	interest charges in respect of borrowing <u>borrowings</u> 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 13.2.4 G (1) Salaries of *directors* or partners are not eligible for deduction, except to the extent that they can be demonstrated to be non-fixed costs of the *firm*.
- (2) The deduction in item (c) is intended to cover forms of remuneration, other than those set out in (b), that are fixed or guaranteed.

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

13.5.3 13.2.6 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 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.

13.2.8

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

13.5.4 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.
13.2.9 For this purpose:

(1) ~~{deleted}~~

(2) ~~An 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) ~~the assets and liabilities in the balance sheet ...~~

(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 13.5.4 13.2.9

EXEMPT CAD FIRM <u>EXEMPT CAD FIRM</u>		
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 IIThis table forms part of rule 13.5.4 13.2.9

EXEMPT CAD FIRM <u>EXEMPT CAD FIRM</u>		
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 D.</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 E, and</p> <p>(b) increasing that credit equivalent by the applicable percentage specified in table 13.5.4C D,</p> <p>(in addition to making an adjustment in accordance with item (17) of this table and (in respect of bought <i>OTC equity 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 F.</p>	A Foreign Exchange Risk Adjustment
(26) All other liabilities	...	

Table 13.5.4A B

This table forms part of rule 13.5.4 13.2.9

POSITION RISK
...

Table 13.5.4B C

This table forms part of *rule 13.5.4 13.2.9*

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

Table 13.5.4C D

This table forms part of *rule 13.5.4 13.2.9*

COUNTERPARTY RISK	
Type of Counterparty	Deduction
...	

Table 13.5.4D E

This table forms part of *rule 13.5.4 13.2.9*

OVER THE COUNTER DERIVATIVES	
a. ...	

Table 13.5.4E F

This table forms part of *rule 13.5.4 13.2.9*

FOREIGN EXCHANGE RISK	
(a) ...	

SUBORDINATED LOANS

13.5.5 R An *exempt CAD firm* may treat a subordinated loan as a ~~financial resource~~
13.2.10 capital resources as specified in ~~table 13.1A.15R~~ and subject to *rule*
~~13.5.5C 13.2.12~~, if the long term subordinated loan is eligible for such
treatment in accordance with *rule 13.5.5A 13.2.11*.

13.5.5A R A long term subordinated loan is eligible for such treatment if:
13.2.11

- (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* may include in the calculation of its financial capital resources is restricted as stipulated in 13.1A.17R and in *SUP* 16.
~~13.2.12~~

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

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

~~13.7.2B~~ R ~~An exempt CAD firm must, where it is exposed to undue risk in consequence of its membership of a group, provide against, reduce or eliminate that risk.~~

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

~~13.9 FINANCIAL TESTS 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</i> Test	Financial Resources Test 1A <i>Adjusted Net current assets</i> Test	Financial Resources Test 2 <i>Expenditure-based</i> Test	<i>Rule/section</i> Referen ees
<i>Category B1</i> (including any <i>Network</i> in this category)	£10,000	<i>Adjusted net current assets</i> of £1	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 C 13.12.2 to 13.12.5 A
<i>Category B2</i> which is permitted to carry on the activity of <i>investment management</i> in respect of portfolios containing only <i>life policies</i> or to delegate such activity to an <i>investment firm</i>	£10,000	<i>Adjusted net current assets</i> 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>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 assets</i> of £1	Adjusted capital equal to the higher of 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 assets</i> of £1	Adjusted capital equal to the higher of 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 assets</i> 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 client money 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

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)	Balances on proprietor's or partners' ² capital accounts
<i>Eligible LLP members' capital</i>	current accounts (see 13.10.2AR)
<i>Share</i> premium account	
Retained profits (see 13.10.2AR) and interim net profits (Note 1)	
Revaluation reserves	Revaluation reserves
Short term subordinated loans	Short term subordinated loans
Debt capital	
less	less

Intangible assets Material current year losses Excess LLP members' drawings	Intangible assets Material current year losses Excess of current year drawings over current year profits
Note 1 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.	

- 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

13.3 CAPITAL RESOURCES REQUIREMENT FOR CATEGORY B FIRMS AND OPTED-IN EXEMPT CAD FIRMS

13.12.1B R A *Category category B firm* must have at all times financial capital
13.3.1 resources calculated in accordance with ~~rules 13.12.2~~ 13.3.3 to ~~13.12.5~~
13.3.14 which equal or exceed the amount specified in ~~rules 13.12.1C~~
13.3.2 to F as applicable.

13.12.1C R A *Category category B1 firm*, including a *Network* must have financial
13.3.2 meet a 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 ~~13.12.2~~ 13.3.3R to ~~13.12.2D~~ 13.3.8R; or

(2) an amount equal to £400 multiplied by the number of its *advisers*;
~~or~~

(3) £10,000 20,000;

(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~~ 13.3.3 R A ~~Category~~ category B 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 its profit and loss account must be adjusted ~~proportionately~~ recent RMAR drawn up at its accounting reference date.
- ~~13.12.2A~~ 13.3.4 R Where a ~~Category~~ 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~~ 13.3.5 R A ~~Category~~ category B firm may deduct from its ~~relevant~~ total annual expenditure ~~the items (a) to (f) set out in table 13.12.2 13.3.5, unless the firm is a Category B1 firm, in which case it may not deduct item (c).~~

Table ~~13.12.2~~ 13.3.5

This table forms part of ~~rule 13.12.2~~ 13.3.5

DEDUCTIONS FROM EXPENDITURE	
(a)	staff bonuses <u>(except to the extent that they are guaranteed);</u>
(b)	employees' and directors' shares 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 <u>readily realisable investments</u> ;
(d)	shared commissions paid <u>commission and fees payable</u> which are directly related to commissions received <u>commission and fees receivable</u> that are included within total revenue;
(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.~~

13.3.7

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 13.2.3R(2) 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.~~

13.3.9

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

- (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

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) plus other reserves</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.</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 <i>Securities</i> 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 <i>Securities</i> 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;</p> <p style="padding-left: 40px;">(ii) investment management fees;</p> <p style="padding-left: 40px;">(iii) other fees earned in connection with the firm's investment business;</p> <p>which are due from other authorised or EEA firms, recognised investment exchanges or recognised clearing houses and have been due and unpaid for 30 days or less;</p> <p>(b) (i) investment management fees; or</p> <p style="padding-left: 40px;">(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 <i>investment management</i> 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 <i>deposits</i> 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 <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 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>FSA</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 subsidiary	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 Securities 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) Over the counter derivatives	<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 <i>rules</i> 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 <i>surrender value</i>) and</p> <p>(b) discounted by the applicable percentage specified in table 13.12.3A.</p>
(4) Debtors relating to Unsettled Securities 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>

(5) Debtors relating to Unsettled Securities Transactions Free Deliveries	(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. (b) Exclude in full if more than 3 days have passed since delivery.
(6) <i>Regulated collective investment schemes</i>	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.
(7) Debts of <i>group</i> or <i>connected companies</i>	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.
(8) Trade debtors	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.
(9) Prepayments	Include prepayments which relate to goods or services to be received or performed within 90 days.
(10) Accrued income	(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. (b) Include any other accrued income receivable within 90 days.
(11) <i>Deposits</i>	Include amounts in respect of (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; (b) money on <i>deposit</i> with a UK local authority which can be withdrawn within 90 days; (c) money <i>deposited</i> and evidenced by a certificate of tax <i>deposit</i> .

(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>

(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 its business up to its balance sheet date.
(20) Unsettled <i>Securities Transactions</i> – Cash against Documents	Include creditors where the <i>firm</i> has entered into a transaction on its 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 investments and their current <i>market value</i> , 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 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) Over the counter derivatives	<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 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 two years, they must be treated in accordance with <i>rules</i> 13.12.5 and 13.12.5A.</p>
(26) Net open foreign currency position	<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>

DISCOUNTS FOR INVESTMENTS	
<p>The percentages in the table are applied to the <i>market value</i> (unless otherwise stated) or <u>of</u> 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 <i>investment</i> is the net of any long or short positions held in that same investment.</p>	
Investment	Discount
A. Debt	
UK Government or local authority stocks:	
- 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%
Debt security:	
- debt instruments issued or accepted by an <i>approved bank</i> with less than 90 days to final redemption	2%
- 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%
B. Equities	

<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> - <i>shares</i> traded on a recognised <i>recognised</i> or designated investment exchange <i>designated investment exchange</i> - other <i>shares</i> for which there is a <i>market maker</i> in the UK 	<p style="text-align: right;">25%</p> <p style="text-align: right;">35%</p> <p style="text-align: right;">35%</p>
<p>C. <i>Derivatives</i></p> <ul style="list-style-type: none"> — <i>exchange traded futures</i> — <i>OTC futures</i> — <i>Purchased options</i> — <i>Contracts for differences</i> 	<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>D C. <i>Other Investments</i></p> <ul style="list-style-type: none"> - <i>Unit</i> linked bonds and units in <i>authorised unit trust schemes</i> (other than <i>higher volatility funds</i> and <i>property funds</i>) or regulated collective investment schemes <i>regulated collective investment schemes</i> - <i>units</i> in <i>higher volatility funds</i> and <i>property funds</i> - <i>with profit life policies</i> (only applicable to <i>firms</i> other than <i>traded life policy market makers</i>) 	<p style="text-align: right;">25%</p> <p style="text-align: right;">50%</p> <p style="text-align: right;">20% of the <i>surrender value</i> of the <i>policy</i></p>

-	<i>shares in subsidiary companies and shares which are not readily realisable securities in connected companies</i>		100%
-	<i>traded endowment policies (Note 1):</i> 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 firm’s 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 category B* firm may treat a subordinated loan as a financial resource capital resources, as specified in rules 13.12.5
~~13.3.11~~ 13.3.13R to 5A and 13.3.14R, if the short term subordinated loan is eligible for such treatment in accordance with rule 13.12.4A
13.3.12R;

~~13.12.4A~~ R A short term subordinated loan is eligible for such treatment if:
~~13.3.12~~

- (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* ~~meet~~ 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~~
13.3.13 R A ~~Category~~ category B firm must calculate:

- (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~~
13.3.14 R A ~~Category~~ category B firm must treat as a liability in the calculation ~~or of its financial capital resource any amount by which the sum of 13.12.5(1) 13.3.13R(1) exceeds the product of 13.12.5(2) 13.3.13R(2).~~

Handbook text:

Supervision manual (Retail
Mediation Activities Return)
(amendment) Instrument 2009

**SUPERVISION MANUAL (RETAIL MEDIATION ACTIVITIES RETURN)
(AMENDMENT) 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 power);
 - (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. This instrument comes into force on 6 December 2009.

Amendments to the Handbook

- D. The Supervision manual (SUP) is amended in accordance with the Annex to this instrument.

Citation

- E. This instrument may be cited as the Supervision Manual (Retail Mediation Activities Return) (Amendment) Instrument 2009.

By order of the Board
5 November 2009

Annex

Amendments to the Supervision manual (SUP)

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

16 Annex 18BG **Notes for completion of the Retail Mediation Activities Return ('RMAR')**

...

NOTES FOR COMPLETION OF THE RMAR

...

Section E: Professional Indemnity Insurance

Note: *Home purchase* and *reversion activity* should be included under the existing mortgage headings in this section of the RMAR.

This section requires *firms* to confirm that they are in compliance with the prudential requirements in relation to professional indemnity insurance (PII).

Data is required in relation to all PII policies that a *firm* has in place, up to a limit of ten (the system will prompt you to submit data on all applicable policies). If a *firm* has more than ten policies, it should report only on the ten largest policies by premium.

Note on the scope of Section E: *retail investment firms* that fall within the scope of these data requirements, but do not meet the definition of *personal investment firm*, i.e. are not subject to *IPRU(INV)* 13, will **not** be subject to this section.

The PII requirements for *authorised professional firms* ('APFs') that carry on *retail investment activities* are set out in *IPRU(INV)* 2.3. APFs that carry on *home finance mediation activity* or *insurance mediation activity* are subject to the full requirements of *MIPRU* 3.

Firms which are subject to the requirements in both ~~*PRU*~~ and *IPRU* and *MIPRU* must apply the PII rules outlined in *IPRU(INV)* ~~13.1.4(1)~~ 13, not *MIPRU* 3.

Section E: guide for completion of individual fields

(Note to readers: the order of some of the rows of information has changed. These changes of order are not identified below.)

Part 1

Does your firm hold a comparable guarantee or equivalent cover in lieu of PII, or is it otherwise exempt from any holding PII in respect of any regulated activities (tick as appropriate)?	<p>This question will establish whether a <i>firm</i> is exempt from the requirements and so is not required to hold PII.</p> <p>The conditions for comparable guarantees and exemptions from the PII requirements for <i>firms</i> carrying on insurance or home finance mediation are set out in <i>MIPRU</i> 3.1.1R paragraphs (3) to (6).</p> <p>Personal investment firms can only be exempted by individual waiver granted by the <i>FSA</i> (unless <i>IPRU(INV)</i> 13.1.5R <u>13.1.7R</u> applies in respect of comparable guarantees).</p> <p>...</p>
If the firm does not hold a comparable guarantee or equivalent cover and is not exempt, does the firm currently hold PII?	...
Has the firm renewed its PII cover since the last reporting date?	<p>This question will ensure that a <i>firm</i> does not fill in PII basic and detailed information <u>Part 2 of the PII section of the RMAR</u> each time it reports, if the information only changes annually.</p> <p>If the <i>firm</i> is reporting for the first time, you should enter 'yes' here and complete the data fields.</p> <p>You should only enter 'n/a' if the <i>firm</i> is exempt from the PII requirements for all the <i>regulated activities</i> forming part of the RMAR.</p>

Part 2

At this point, if the *firm* has PII policy details to report, it should do so by clicking on the 'add PII policy' button in the summary screen. This will then prompt you to name the sub-section, e.g. 'policy1'. You may also add further sub-sections if the *firm* has two or more policies (up to a maximum of ten). You may enter one policy per line in the PII basic information table (up to a maximum of ten) and policy excess and exclusions in the PII detailed information table (up to a maximum of ten per policy).

PII Basic information

Activities What activities are covered by the policy(ies)?	You should indicate which <i>regulated activities</i> are covered by the <i>firm</i> 's PII policy or policies.
If your policy excludes all business activities carried on prior to a particular date (i.e. a retroactive start date), then insert the date here, if not please insert 'n/a'	<p>Required terms of PII are set out <u>out</u> for <i>personal investment firms</i> in <i>IPRU(INV)</i> 13.1.4 <u>13.1.5R</u> and for <i>mortgage intermediaries</i> and general insurance intermediaries in PRU <u>9.2.10</u> <u>MIPRU</u> 3.2.4R.</p> <p>...</p>
Annualised premium	This should be the annual premium that is paid by the <i>firm</i> , net of tax and any other add-ons.

<p>Limit of indemnity received <u>Indemnity</u></p>	<p>You should record here the indemnity limits on the <i>firm's</i> PII policy or policies, both in relation to single claims and in aggregate.</p> <p>Those <i>firms</i> subject to <i>Insurance Mediation Directive (IMD)</i> requirements should state their limit in Euros; those that are not subject to the <i>IMD</i> should select 'Sterling' from the drop-down list.</p> <p><i>Insurance intermediaries</i>, see <i>MIPRU 3.2.7R</i> and select either 'Euros' or 'Sterling' as applicable.</p> <p><i>Home finance intermediaries</i> should state their limits in Sterling (see <i>MIPRU 3.2.9R</i>).</p> <p>For <i>personal investment firms</i>, see <i>IPRU(INV) 13.1.4(2)R</i> 13.1.9R and 13.1.4(5)E <u>13.1.13R</u> and select either 'Euros' or 'Sterling' as applicable.</p> <p>If the <i>firm</i> is subject to more than one of the above limits (because of the scope of its <i>regulated activities</i>), and has one PII policy for all of its <i>regulated activities</i>, the different limits should be reflected in the policy documentation. If there is more than one limit, only the highest needs to be recorded in this field.</p>
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PII detailed information

<p>Business line</p>	<p>Business lines for policy excesses should only be selected for FSA regulated business that you have undertaken in the past or will undertake during the period covered by the policy.</p> <p>Each such business line that has a policy excess should be selected from the drop-down list.</p> <p>If the <i>firm</i> has only one excess for all business lines, then you should select 'All'.</p> <p>If the <i>firm</i> has a policy excess for one specific business line (e.g. Endowments), it should select it from the drop-down list, and in the line beneath select 'All other' for the <i>firm's</i> remaining business lines.</p> <p>If the <i>firm</i> has a policy excess for a business line that is not in the drop-down list, then the most relevant 'other' should be selected.</p>
<p>Policy excess</p>	<p>For <i>insurance intermediaries</i> and <i>home finance intermediaries</i>, see <i>MIPRU 3.2.10-14R</i>.</p> <p>For <i>personal investment firms</i>, see <i>IPRU(INV) 13.1.4E</i> 13.1.25R.</p> <p>The amount of the excess relating to the business line selected should be entered here. If the policy has more than ten excesses, you should report only on the ten largest by excess.</p>
<p><u>Increased excess(es) for specific business types (only in relation to business you have undertaken in the past or will undertake during the period covered by the policy)</u></p>	<p><u>If the prescribed excess limit is exceeded for a type or types of business, the type(s) of business to which the increased excess applies and the amount(s) of the increased excess should be stated here</u></p> <p><u>(Some typical business types include pensions, endowments, FSAVCs, splits/zeros, precipice bonds, income drawdown,</u></p>

	<u>lifetime mortgages, discretionary management.)</u>
Policy exclusions <u>exclusion(s)</u> for specific business types (only in relation to business exclusions you have <u>had in the past undertaken in the past</u> or will undertake <u>have</u> during the period covered by the policy)	<p>Select from the drop-down list <u>If there are any exclusions in the firm's PII policy which relate to any types of businesses or activities that the firm has carried out either in the past or during the lifetime of the policy, enter the business type(s) to which the exclusions relate here.</u></p> <p><u>(Some typical business types include pensions, endowments, FSAVCs, splits/zeroes, precipice bonds, income drawdown, lifetime mortgages, discretionary management.)</u></p> <p><u>If the firm has a policy exclusion for a business line that is not in the drop-down list, then the most relevant 'other' should be selected.</u></p>
Start date <u>Date</u>	The date the current cover began.
End date <u>Date</u>	The date the current cover expires
Insurer name (please select from the drop-down list)	<p>The <i>firm</i> should select the name of the <i>insurance undertaking</i> or Lloyd's syndicate providing cover. If the PII provider is not listed you should select 'Multiple/Other' <u>'other'</u> and enter the name of the <i>insurance undertaking</i> or Lloyd's syndicate providing cover in the free-text box.</p> <p><u>If a policy is underwritten by more than one <i>insurance undertaking</i> or Lloyd's syndicate, you should select 'multiple' and state the names of all the <i>insurance undertakings</i> or Lloyd's syndicates in the free-text box.</u></p>
Annual income as stated on the most recent proposal form	This should be the income as stated on the <i>firm's</i> most recent PII proposal form. For a <i>personal investment firm</i> , this is relevant income arising from all of the <i>firm's</i> activities for the last accounting year before the policy began or was renewed (IPRU(INV) 4.3.1.3(3)R <u>13.1.8R</u>). For <i>insurance intermediaries</i> and <i>mortgage intermediaries</i> this is the annual income given in the <i>firm's</i> most recent annual financial statement from the relevant <i>regulated activity</i> or activities (MIPRU 4.3.1R to 4.3.3R).
Amount of additional capital required for increased excess(es) (where applicable, total amount for all PII policies)	This should be calculated using the tables in IPRU(INV) 4.3.1.4(12)E <u>13.119R</u> or MIPRU 3.2.14 -16R <u>to 3.2.16R</u> as applicable. The total of additional capital (i.e. in relation to all of the <i>firm's</i> PII policies) should have been reported under 'additional capital requirements for PII' and/or 'additional own funds for PII' in section D1.
Total amount <u>Amount</u> of additional own funds <u>capital resources</u> required for policy exclusion(s)	<i>Personal investment firms</i> only - this should be calculated in line with IPRU(INV) 4.3.1.4(13)R <u>13.1.23R</u> . The total of additional own funds <u>capital resources</u> (i.e. in relation to all of the <i>firm's</i> PII policies) should have been reported under 'additional capital requirements for PII' and/or 'additional own funds <u>capital resources</u> for PII' in section D1.
Total of additional own funds <u>capital resources</u> required	<i>Personal investment firms</i> only – this is the same figure as in section D1, representing the total of additional own funds <u>capital resources</u> required under IPRU(INV) 4.3.1.4(8)R <u>13.1.23R</u> to 4.3.1.4(13)G <u>13.1.27R</u> for all of the <i>firm's</i> PII policies.
Total of readily realisable own funds <u>capital resources</u>	<i>Personal investment firms</i> only - you should state here the total of the own funds reported in section D that are classed as 'readily realisable' under the terms of <u>IPRU(INV) 4.3.1.4(4)R</u> .

<p>Excess/deficit of readily realisable own funds</p>	<p>In this field, enter the result of the 'total of additional own funds required' less the 'total of readily realisable own funds'.</p> <p><u>This field is no longer relevant.</u></p>
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