ICAEW representation

ICAEW REP 17/05

REVIEWING THE FSA HANDBOOK

Memorandum of comment, issued by the Institute of Chartered Accountants in England and Wales, in October 2005, responding to the Financial Services Authority on their consultation document CP05/10 entitled "Reviewing the FSA Handbook - Money Laundering, Approved Persons, Training and Competence, and Conduct of Business"

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Introduction and general comments

1. The Institute of Chartered Accountants in England and Wales welcomes the FSA's review and proposed simplification of its Handbook, and the opportunity to comments on its proposals. The Institute is the largest accountancy body in Europe, with more than 127,000 members operating in business, public practice and within the investor community. The Institute operates under a Royal Charter, working in the public interest.

2. The Institute takes a consistent approach across a wide range of subject areas in favour of principles based regulation, with a reduction in detailed rules in favour of a requirement for entities to comply with the spirit behind them. We believe that generally this approach is more likely to be applied efficiently by those subject to the rules, avoiding concentration on the less important but more measurable aspects and thus conforming more with the policy intentions behind them. For these reasons we support the approach being taken by the FSA, in the review of the handbook.

3. However, neither the FSA nor the regulated sector should assume that this is an easy option, or one that will necessarily introduce a dramatic decrease in costs. An element of responsibility is being transferred from the FSA itself to senior management, to ensure that their people are both adequately trained and competent to carry out very responsible functions. This will mean that entities will tend to have to introduce more sophisticated personnel evaluation and control mechanisms, due to the removal of detailed external requirements. There is consequently a possibility of a loss of economies of scale, with individual firms having to undertake functions previously undertaken by the FSA. This may disproportionately affect small and medium size firms which have limited resource to ensure quality implementation of the proposed changes.

4. People and organisations within the financial services may fear a decline in standards, due to some entities taking advantage of the simplification of the rules by a failure to replace them with equivalent or more appropriate internal patterns of controls, training and evaluation. The UK financial services industry lives on its reputation and such a decline in standards would be wholly unacceptable. It will be a continuing and very important function of the FSA to explain, remind and enforce its rules in such a way that entities neither accept a decline in their own standards of behaviour nor fear one in that of their competitors.

5. One way in which the FSA can do this is by inclusion in guidance of a reminder of the usual ways in which competence can be assessed, and of its support for such assessment. For example, the gaining of a relevant exam-based qualification is a very good means (in our view the best) of demonstrating initial competence to take on new responsibilities. The FSA's continuing and evidenced support for the development and use of relevant exams will be important to the continued use of

exams as an appropriate way of demonstrating initial competence as an element of fitness and propriety. Similarly, attendance at periodic courses for development and updating of skills is a valuable and evidential tool to ensure continued competence, but only if such courses are relevant and taken seriously. The FSA has the responsibility to ensure that senior management have the systems to control these matters appropriately, and senior management have the responsibility for ensuring that their people also take seriously the need to achieve and maintain their competency.

6. The FSA should also be alert for the possibility of unintended consequences arising from changes to their rules. In particular, we are concerned that exemptions from the strict requirements of the Data Protection Act, that are available by reason of the FSA's statutory authority for its rule making functions, should not be lost, where these provide a cost effective means of ensuring appropriate controls over the competence and fitness and propriety of individuals. It is important to ensure that no unintended legal or practical risks or impediments are introduced as a result of the simplification of the handbook. Discussions with the Office of the Information Commissioner may be appropriate, to ensure that an adequate and consistent approach to the recording of personal competence can be maintained.

7. The finalisation and timing of the implementation of the changes should take into account the implementation of the Markets in Financial Instruments Directive. Any changes in areas of the management of financial sector businesses that may be affected by the terms of the Directive (such as the treatment of individuals whose classification in terms of the type of customer that they serve may need to be amended) should be conformed with the requirements of the Directive. No changes should be introduced which are likely to have to be changed again in the short or medium term.

Responses to specific questions posed in the consultation

Chapter 1: Overview

Q1: Do you have any suggestions for areas of the Handbook that should be reviewed, or opportunities that you think could be taken to achieve the review's objectives?

8. We have not identified other areas of the Handbook which should be singled out for particularly early action, but would encourage the FSA to promptly consider any further suggestions from respondents.

Q2: Do you agree with the principles we have set out for our review?

9. Yes. The Institute is a strong supporter of a principles-based rule making system, based on high level standards which are only supported with detailed rules where

these are absolutely necessary. In general, senior management should be allowed the flexibility to apply the principles as they see fit. We are also particularly pleased to see that the timing of reforms will be taken into account; the avoidance of gold plating of the European Directives (which, when it occurs, tends to introduce competitive distortions across Europe); and the avoidance of an increase in costs over the long term.

Chapter 2: Reviewing the Money Laundering regime

Q3: Do you agree with our proposals for changing our money laundering regime?

10. Yes. The radical simplification of the money laundering regime should do away with the costs associated with the need to take into account two sets of guidance, in the FSA and JMLSG provisions, which were similar but not identical. We believe that both the existing and revised versions of the JMLSG Guidance are sufficiently comprehensive as to avoid the need for details provisions published by the FSA, and further have the advantage of Treasury approval.

11. The JMLSG Guidance has one distinct disadvantage in that it fails to address itself to the generality of the regulated sector, with professional services firms (including, specifically, law and accountancy firms) outside the scope of the revised version. The consultation version of the Guidance recognised the wide divergence within the regulated financial services and accommodates those differences, but this has not been extended to include the regulated financial services provided by professional firms.

12. We suggest that the FSA should provide that authorised firms which are not within the scope of the JMLSG Guidance can apply equivalent Guidance produced by their professional bodies, where this is approved by the Treasury, is consistent with the JMLSG Guidance and provides equivalently comprehensive guidance. This would allow authorised professional firms to apply their professional guidance to all their activities and avoid the duplication that the FSA proposes to remove, for the other firms it authorises.

13. In this context, you will be aware that the Consultative Committee of Accountancy Bodies (CCAB) did open enquiries with a view to joining the JMLSG, but were refused, on the grounds that the latter is a body specific to firms which specialise wholly or mainly on the regulated financial services, not for more general professional services firms with a minority presence in mainstream financial services. We have therefore had no input into the guidance developed by the JMLSG, beyond that of an interested third party. It is inequitable to expect our member firms to be judged in relation to the guidance, in these circumstances .

Q4: Do you agree that these changes may benefit firms and would not create additional material ongoing costs? Do you have any information

on the likely costs and benefits involved?

14. Additional material costs will only be experienced if the regulated sector is unclear as to the way in which the simplified requirements of the FSA are or will be enforced. A consistent enforcement policy will allow the expected benefits to be achieved.

15. The FSA will need to be alert to the need to ensure that appropriate guidance is freely available to the whole of the regulated sector. If the JMLSG Guidance is used as the effective standard for financial services, unnecessary additional costs will be experienced by some providers of regulated financial services (such as small professional service firms) if they do not have direct access to the Guidance or supplementary services provided by the JMLSG. In this context, we understand that the next version of the JMLSG guidance is to be available on the public record. This is not the case with the existing guidance, which is only available to our member firms on payment of a fee.

16. Additional cost savings would be achieved if professional services firms were permitted to follow professional guidance on the anti-money laundering requirements addressed specifically to their needs. This would reduce their costs, by removing the need for them to compare and take into account two sets of guidance which are likely to be broadly convergent but differ in detail. We do not believe that this would reduce standards of compliance, in any way.

Q5: Do you have any comments on the proposed changes to the Handbook to implement our new approach?

17. We suggest that provision is made in the Rules for reference to other Treasury approved Guidance addressed to certain parts of the regulated sector.

Q6: Do you have any comments on the idea of extending our main generic provisions in Annex 2 to cover fraud risk?

18. In recent years a great deal of attention has been paid to the control of money laundering and the financing of terrorism, and rightly so. Terrorism and organised crime (the main generator of large quantities of laundered funds) are serious scourges of our society, which the financial services sector can unwittingly support through the normal operation of its business activities. Further, the statutory definition of money laundering ensures that not only these areas of crime are included among the predicate offences for AML requirements, but also any other crime with an economic effect, including fraud and other financial crimes. It therefore needs to be recognised by everyone concerned that the FSA's policy in relation to money laundering is also an element in the fight against fraud and other financial crime.

19. However, the fight against money laundering is effectively aimed at the control of actions in relation to either the proceeds of past crimes or of funds intended for the financing of terrorism. Consideration should also be given to whether specific obligations in relation to the risk of future financial crimes should also be imposed on the senior management of financial services firms, either by the further extension of the main generic provisions or elsewhere. There is a growing consensus, for example, that attempted fraud does not constitute attempted money laundering, as there may not yet be any criminal proceeds which are the subject of the attempted money laundering. However, that does not mean that senior management should not be given responsibilities for its control - we believe that responsibility for controls intended to reduce the scope for financial crime should be more extensive and sophisticated than being limited to AML requirements, with additional procedures being introduced as required to control the generality of economic crime risks.

20. Fraud is a key risk to regulated financial services, but other types of crime should not be excluded, particularly in view of the comprehensive nature of the FSA's obligations in relation to financial crime. Any FSA requirements should not, for example, exclude market abuse, which indirectly affects the consumers of financial services and market confidence and so comes under several of the FSA's statutory objectives.

Chapter 3: Reviewing the Approved Persons regime

Q7: Do you agree with our approach to senior management responsibility for ensuring fitness and propriety?

21. Yes, we agree with your approach in general, subject to careful consideration of how it will be implemented. Senior managers already have responsibility to ensure that their staff comply with the FSA requirements for fitness and propriety. In many of the large firms there are already adequate systems and controls for that purpose. However, smaller firms may lack internal resource and a lessening of guidance or enforcement from the FSA could potentially have a negative effect on levels of competence in some areas.

Q8: Do you agree with our proposal to delete the sole trader function (CF7)?

22. Yes, we agree with your proposal.

Q9: Do you agree with our proposal to delete the significant management function annual reporting requirement?

23. Yes, we agree with your proposal.

Q10: Do you agree with our proposals to merge the significant management functions and the systems and controls functions?

24. Yes, we agree with your proposals.

Q11: Do you agree with our proposals to change the scope of the customer functions, so that they do not apply to individuals that do not deal with private customers?

25. We agree that the scope of the customer functions should be changed so that they do not apply to individuals that deal only with those non-private customers who come within the definition of market participants. We are more ambivalent over the need to retain approval for those who deal with intermediate customers, though on balance we concur with the proposal to remove this category as well. Corporate customers and even participants in the wholesale markets can be surprisingly unsophisticated, as was demonstrated by the problems generated by the sale of interest rate swaps to local authorities, culminating in the case of Hazell vs Hammersmith and Fulham (1992). However, as was also demonstrated by those cases, regulated firms are subject to both financial and reputational risks in these circumstances, as well as their customers. Ultimately, regulated firms and their customers should be responsible for, and should be in a position to, manage their risks in the most appropriate way

26. However, we also acknowledge concerns expressed by some bodies over the possible impact of removing the Approved Persons regime for wholesale market providers on market confidence and consumer protection. The removal of this regime, with its associated requirements for training, testing of competence and FSA registration of approved persons, could create a vacuum in discipline and compliance standards. In certain firms with weaker controls and systems for the training and vetting individuals, this could create reputational hazards for the firms, and ultimately for the reputation of the City, which are eliminated by the current system.

Q12: Do you agree with our proposal to delete the Corporate Finance Adviser function (CF23)?

27. On the whole, we would support the deletion of the Corporate Finance Adviser function. This is an area where advice to private clients is rare and those private clients are likely to be in a better position to judge the value of the quality of the advice (and seek advice from more than one source) than the general run of consumers. However, the FSA will need to remain alert to the possibility of oppression of private clients in particular circumstances or by particular individuals, and to the need to apply its other powers in relation to those individuals and not just their employers. The effect of the removal of this function

should be carefully monitored by the FSA to ensure that it does not prove detrimental to private customers.

Q13: In relation to customer functions in the retail sector, do you think that we should pursue option a)(no change), b)(removing some or all of the customer functions) or c)(simplifying the customer functions)? Do you have any information on the practical implications, costs and benefits of each option?

28. There is considerably less of an argument for deregulation of the approved person regime in the retail sector than is proposed in the wholesale sector. The customers in the retail sector are typically less sophisticated than those in the wholesale sector, and the providers typically deal with a large number of small transactions. In these conditions standardisation is more appropriate. The extent and definition of each class is something which we believe should be the subject of further consideration: a simplification of the structure of customer functions could well be helpful without significantly reducing consumer protection.

Q14: Do you have any views on how we should implement any changes that we make to the controlled functions?

29. Further thought might need to be given to how the proper implementation of these proposals might be affected by the implementation of the Markets in Financial Instruments Directive (see paragraph 7 above). Otherwise, we have no views on how the changes are implemented, but are pleased that the FSA is giving this matter careful thought, as such matters of detail can impact disproportionately on costs.

Q15: Do you agree that firms should benefit from these changes and will not face costs of more than minimal significance as a result of them? Do you have any information on the likely costs and benefits involved?

30. A considerable element of the costs borne by firms are in the form of fees charged by the FSA. The simplification of the structure of approvals and the removal of some categories will reduce the burden of the associated fees. However, the anomaly whereby approved persons within professional firms bear a disproportionately high burden where they need approval in relation to a small proportion of their work will not be removed. We welcome the commitment of the FSA to review the structure of their fees, as noted in paragraph 3.61, and we look forward to seeing your discussion paper on this matter.

31. Firms will also be likely to incur new costs associated with additional checks and verifications for screening new recruits, following from the removal of the register of approved persons of individuals working in the wholesale markets. There could also be unforeseen costs related to compliance and reputational risks which could be incurred, if the firms fail to maintain the current standards imposed by the FSA.

Q16: Do you have any comments on our proposed changes to the Handbook (in Annex 3) to implement our proposals?

32. Proposed paragraph 1.4.33 of the Amended Integrated Prudential Sourcebook runs:

> "1.4.33 G Where a *firm* outsources a *controlled function*, such as the *systems and controls function*, it should…"

We suggest that this is amended to:

> "1.4.33 G Where a *firm* outsources a *controlled function*, such as the internal audit element of the *systems and controls function,* it should…"

to avoid giving the impression in the guidance that it might be appropriate to outsource the whole of the systems and control function.

Q17: Do you have any comments on further changes that could be made to the Approved Persons regime in the future?

33. We have no comments to make at this time on the Code of Practice for approved persons.

34. We note that the FSA has no power to "licence" approved persons which would effectively provide a portable approval. We do not consider that this alone is an adequate reason to fail to address this matter if the FSA considers that such a reform would be cost effective, useful and uncontroversial. We recognise the pressure on Parliamentary time, but this Government is committed to proportionate regulation and we are sure that an opportunity could be found to reform the law if that is appropriate. Alternatively, the administrative processes which are under the FSA's control could be reviewed to simplify the position of approved persons moving between authorised firms. However, any reform of the system would need to take into account the fact that the approval regime takes account of competence as well as probity. An approved person moving between regulated firms may be fully competent in relation to their old functions without necessarily being so in relation to their new ones.

Chapter 4: Reviewing the Training and Competence regime

Q.18: Do you agree with our proposals to disapply the detailed training and competence requirements in TC2 in respect of activities carried on with or for non-private customers?

35. Yes. We believe that this change is a logical consequence of the changes made by the FSA in July 2004 with the move from "approved" to "appropriate examinations". We also support the move to a more principles-based approach and one where employers and individuals are encouraged to exercise their own judgement - as demonstrated by, for instance, the Institute's new approach to continuing professional development. We agree that wholesale clients present a different risk profile. We anticipate that firms and employees will appreciate the trust that will be placed in them to decide the most appropriate and relevant course of action. It is also the Institute's position that employers have a vital interest in ensuring that their employees are competent. They will also want to attract, retain and develop the best talent through offering highly valued professional development and professional qualifications.

36. We do, however, consider that the FSA will need to ensure that sufficient guidance is given to firms to discourage those that may be tempted to use this new approach as an excuse for cutting training and personal development budgets. We would encourage the FSSC to continue its cooperation with the firms, the professional and awarding bodies and the training providers. For example, the new Corporate Finance (CF) qualification for practitioners, launched by the Institute this year, has been created based on demand from the market and in partnership with the key players in the field . The syllabus integrates the necessary technical skills with the relevant regulatory framework in corporate finance, thus providing the required measure of competence for regulators and firms at the different stages of professional development.

Q.19: Do you agree that firms would benefit from these changes and would not face costs of more than minimal significance as a result of them? Do you have any information on the likely costs and benefits involved?

37. Yes, the costs/benefits are, in our opinion, generally in favour of the benefits. We do not have specific information on the likely costs and benefits but suspect that firms will welcome the empowerment to use their own judgement on training and competence matters. We would envisage that there could be new items of cost associated with:

    - managing the enhanced risks resulting from discontinuing transparent competence benchmarks; and

    - developing customised approaches to training and competence, including searching for and validating the quality of professional qualifications.

Q.20: Do you have any comments on the draft amendments to the Training and Competence sourcebook which would give effect to our proposals?

38. No.

Q.21: Do you agree that we should review TC as a whole, and do you have any specific suggestions for further changes that could be made to the Training and Competence regime?

39. Yes. We would welcome a greater emphasis upon development as opposed to threshold competence. For example, through the introduction of our new principles based approach to CPD and also our new Corporate Finance qualification, the Institute recognises that whilst initial competence is necessary it may not be sufficient. Firms should be encouraged to develop and implement integrated professional development strategies for their employees. There is a risk of the industry ending up with inconsistent and opaque standards. However, our view is that this risk can be managed and is outweighed by the benefits from firms being able to develop and implement approaches to training and competence that more closely matches their needs.

Chapter 5: Reviewing the retail Conduct of Business regime

Q22 to Q26

40. We have no comments to make on the detail of the proposals in relation to the Conduct of Business regime, though it is the overall policy position of the Institute that wherever possible necessary regulation should be presented in the form of high level principles rather than in the form of detailed rules. In this way, for example, costs could be minimised by the development of appropriate compliance mechanisms by individual firms or in response to guidance developed with a particular sector or sub-sector in mind.

41. Cost savings resulting from this policy will only be achieved, however, if regulated firms can be confident that they understand the enforcement position that will be taken by the FSA, and that enforcement policy is applied consistently.

Other matters: Use of Research and Statutory Audit Requirements

42. We were pleased to note from paragraph 1.16 of the consultation document that the FSA will be taking into account the results of independent research in carrying forward their policy on reducing unnecessary costs. This represents a welcome example of evidence-based policy making.

43. We also welcome your announcement of a review of the way in which you use audited information, as indicated in paragraph 1.3 of the consultation document. We would encourage the FSA to consider the cost/benefit implications of the requirement for full statutory audits. In particular we would encourage the FSA to assess the extent to which financial statement audits address specific regulatory needs for each category of regulated activity conducted by small financial

services companies. For certain categories of activity, audits can be highly relevant, for example those where financial resources present a regulatory risk. Financial statement audits are less relevant for addressing certain other regulatory risks, for example the risk of providing bad advice. Consideration should also be given to extent to which alternative, more targeted and potentially less costly reporting could be provided by registered auditors, such as reports on compliance with client money rules or addressing specific aspects of the internal controls environment. If there is to be a significant change in approach in this area, this might require the development or modification of guidance to auditors. We look forward to discussing these areas in more detail with the FSA over the course of its review and would be happy to provide further information and active input.

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