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Financial Services Authority

The FSA Principles for Businesses

September 1998



The Financial Services Authority invites comments on this consultation paper.
It would be helpful if your comments could reach us by 30 January 1999.

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The FSA will assume that your comments are not confidential unless you indicate otherwise.

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The FSA Principles

Consultation Draft

1

Integrity

A firm must conduct its business with integrity.

2

**Skill, care
and diligence**

A firm must conduct its business and organise its affairs with due skill, care and diligence.

This will include arranging adequate protection for customers' assets when responsible for them.

3

**Management
and control**

A firm must organise and control its affairs effectively.

This will include:

- a) having directors and senior managers who are all fit and proper for their roles, and operating adequate arrangements for securing the suitability of persons who carry out functions on its behalf;
- b) apportioning responsibilities among its senior managers and directors in such a way that
 - their individual responsibilities are clear; and
 - the business and affairs of the firm are adequately monitored and controlled at senior management and board level;
- c) operating robust arrangements for meeting the standards and requirements of the regulatory system, and for guarding against involvement in market abuse or financial crime (including the detection and prevention of money laundering); and
- d) keeping adequate and orderly records of its business and internal organisation.

4

Prudence

A firm must conduct its business and organise its affairs with prudence.

This will include:

- a) maintaining adequate financial resources, including adequate liquidity; and
- b) maintaining adequate risk management systems.

5

Market conduct

A firm must observe proper standards of market conduct.

6

**Customers:
general**

A firm must pay due regard to the interests of its customers and treat them fairly.

This will include:

- a) paying due regard to their information needs;
- b) communicating information in a way that is fair and not misleading; and
- c) managing conflicts of interest fairly.

7

**Customers:
relationships
of trust**

A firm must keep faith with any customer who is entitled to rely upon its judgment.

This will include taking reasonable care to ensure the suitability of its advice and discretionary decisions.

8

**Relations with
regulators**

A firm must deal with its regulators in an open and cooperative way.

This will include telling the FSA promptly anything about the firm of which the FSA would reasonably expect prompt notice.

1 Introduction

Context

1. This paper sets out the FSA's proposals for a set of Principles to apply to businesses authorised under the integrated system of regulation which will be established under the new financial services and markets legislation. Our aim is to formulate succinct high-level precepts stating the fundamental obligations of regulated businesses. This should be seen within the overall context of the FSA's proposed approach to regulation, outlined in *Meeting our responsibilities*, published last month.
2. The FSA's power to lay down Principles will derive from the general rule-making power in the new legislation¹ – a power to make provisions and (within limits) to specify the legal consequences of their breach.
3. These Principles will operate as a set of obligations on firms², ranging from large multifunctional organisations to one-person firms. They will not bind anyone who is not an authorised person. The FSA intends to establish a separate statement of Principles binding on approved individuals, coupled with a code of individual conduct, using the separate power expected to be given to us by the new legislation.³
4. We envisage that the document containing the Principles for businesses, when they are made, will have three parts:
 - *Introductory Guidance*. The proposed text is set out in **Annex A**.
 - *The Principles*. The proposed Principles are set out opposite and discussed in **Section 3**.

1 Clause 70 of the draft Bill published for consultation on 30 July 1998. Clauses 76 (financial promotion) and 77 (money-laundering) are also particularly relevant.

2 In this paper the word 'firms' is used to denote the term 'authorised persons' used in the Bill, and 'approved individual' is used to reflect the term 'approved person' used in the Bill.

3 Clause 48.

- *Rules about Application.* The proposed rules governing the application of the Principles are set out in **Annex B**.
5. We invite comments on this paper by **30 January 1999**, although we will also be ready to receive comments after that date in respect of the inter-relationship between the Principles and the other rules and supporting guidance which will be issued for consultation by the FSA in due course.
 6. The Principles will be a keystone in the FSA Handbook.⁴ We will therefore aim to bring their drafting to near-finality in the first half of next year. The FSA will make them once the new Bill has been enacted, and bring them into force at the same time as the new legislation. Meanwhile, we will proceed with the preparation of modules of the Handbook on the provisional basis set out in this consultation paper. Each module will itself be the subject of consultation.

Considerations

7. The main considerations which have guided us in formulating the draft Principles are as follows:
 - i. **The FSA's new regulatory objectives.** The *content* of the draft Principles reflects our proposed regulatory objectives of maintaining confidence in the UK financial system, promoting public understanding of the financial system, protecting consumers and reducing financial crime. And since the Principles are designed to leave firms with latitude about how they meet the required standards, the *style* of the Principles is in harmony with our responsibility to regulate in a way which
 - a) takes account of the responsibilities of senior management,
 - b) ensures that burdens and restrictions on firms are proportionate to the benefits of regulation,
 - c) facilitates innovation in financial services, and
 - d) does not unnecessarily impede or distort competition between firms.⁵

⁴ See Designing the FSA handbook of rules and guidance. (Consultation Paper 8, April 1998.)

⁵ Clause 2(3)(b), (c), (d), and (f).

- ii. **Fitness and propriety.** Although the Principles will be made under the FSA's rule-making powers and will be binding in their own right on firms, we also regard them as throwing light on what is required for a firm to be fit and proper. They should not, however, be viewed as a comprehensive statement of the fit and proper standard, guidance on which will form part of the FSA Handbook.
- iii. **Durability and flexibility.** We believe that the Principles should be formulated at a level of generality which will enable them to be durable without amendment (unless there is a major change in the legislative environment). They are written in a way which should allow them to take changing circumstances and practices in their stride, and allow ample differentiation along the professional-retail spectrum.
- iv. **Practical experience.** The Principles draw heavily upon the existing UK models⁶, which have operated with success since their introduction over the last decade or so.
- v. **International models.** We have also aimed to ensure that the Principles are in harmony with relevant international standards – in particular, those of the EU, Basle⁷ and IOSCO.⁸

The wider regulatory context

- 8. The Principles will be relevant to all firms, but their practical implications for firms' conduct, organisation and resources will depend on the size of the firm and the business it undertakes. The Principles do not require small firms to act or be treated as if they were large organisations.
- 9. Although the Principles will be binding on firms in their own right, they must also be viewed in the wider context of the overall FSA Handbook. We do not expect the Principles to function in a vacuum, but in harmony with the other materials making up the framework within which firms must operate. The implications of the Principles will be elaborated in binding rules, 'evidential' provisions⁹, and guidance.¹⁰ Wherever detailed

6 The current models are the old SIB Principles, the minimum criteria in Schedule 3 to the Banking Act 1987, the criteria of prudent management in section 45 of the Building Societies Act 1986, the criteria of prudent management in section 50 of the Friendly Societies Act 1992 and the criteria of sound and prudent management in Schedule 2A to the Insurance Companies Act 1982.

7 Core Principles for Effective Banking Supervision, Basle Committee on Banking Supervision. September 1997.

8 IOSCO Consultation Draft on Objectives and Principles of Securities Regulation. May 1998.

9 Clause 79.

10 Clause 87.

provisions and guidance can be regarded as expressions or illustrations of the high-level Principles – as will often be the case – we will make that clear. The implications of the Principles will be evident throughout the Handbook.

10. We envisage that, in supervisory contexts, the new Principles will function in much the same way as do the current models. Thus routine supervisory monitoring will rest on the Principles *coupled with amplificatory rules, evidential provisions and guidance*, rather than on the Principles alone. However, the Principles may be relevant in situations for which no rule or guidance yet exists. In such situations firms and supervisors alike need to be prepared to make judgments based on the values embodied in the Principles. The FSA's aim will be to respond quickly and substantively to reasonable requests (from firms who have made a bona fide effort to analyse the issue) for informal guidance on the bearing of the Principles on particular circumstances. We will also aim to extend our standing guidance to deal with new issues.
11. We also envisage that the Principles will be a basis for disciplinary proceedings in situations which demand a disciplinary response. The role of the Principles in disciplinary contexts will be discussed in detail in our forthcoming consultation paper on disciplinary policy.

Costs and benefits

12. The Principles would impose costs if they obliged firms to adopt more elaborate methods of carrying on their business. For well managed firms it seems clear that the Principles will not require such changes. Moreover, since the Principles are intended to accord with existing UK requirements (including detailed rules) and with international standards, and should also match firms' self-interest, we believe it unlikely that any firm will face an increase in costs caused by the Principles of more than minimal significance.
13. The main benefit of the Principles is that they will underpin the maintenance of existing high standards. They also provide firms and others with a clear and concise statement of the general standards that the FSA expects regulated businesses to meet. Also, for groups with diverse businesses, the ability to pursue all activities with reference to identical Principles should provide the benefits that flow from consistency and simplicity.
14. We therefore believe that the benefits of these Principles significantly outweigh their costs. We would welcome comments on the costs and benefits.

2 Applicability and legal effects

15. In general, the Principles are designed to apply to businesses authorised by the FSA and – subject to the limitations outlined below – to European firms with automatic authorisation. The Principles will not apply to industrial and provident societies (and similar mutual societies) in relation to which the FSA will not have any regulatory functions. The position of credit unions will be the subject of a Treasury consultation.
16. In the context of *corporate groups*, the Principles will apply only to those group companies which are authorised by the FSA or by virtue of being European firms with automatic authorisation. However, the position of unauthorised companies in the group may be relevant to judgments which have to be made under the Principles in relation to authorised companies in the same group. For example, judging the ‘adequacy’ of a firm’s financial resources may involve taking account of the activities of unauthorised companies in the group.
17. In general, the ‘business’ to which the Principles are designed to apply is business that will be a regulated activity under the new Act, and business carried on in connection with regulated activity.
18. The Principles will not represent any extension of conduct of business regulation to deposit-taking and general insurance, and we have no plans for such an extension at this stage. However, the FSA, acting as a prudential supervisor, may view it as a matter of prudential concern (for example, because of reputational risk) if any firm falls significantly short of the standards set by the Principles in its treatment of customers. This accords with the current approach of insurance, banking and building society supervisors.
19. We do not propose to disapply any of the Principles in the context of firms’ dealings with *professional counterparties*. However, their operation in

inter-professional markets will be conditioned by the conventions of those markets and the presumed ability of participants in them to protect their own interests. We expect to publish a discussion paper on the regulatory regime for inter-professional business later this year.

20. Our proposals for the *international dimension* to the application of the Principles are set out in **Annex B**. In broad terms we envisage that:
- The prudential significance of the Principles extends internationally, reflecting the legitimate expectation, not confined to the United Kingdom, of high standards from firms authorised by the FSA. However, where the Principles pertain to the regulation of conduct of regulated activities their reach is, as would be expected, confined to the United Kingdom.
 - The Principles will apply to the operations of automatically authorised *European firms* in the UK only to the extent that they lay down obligations which are conduct of business obligations in EEA terms. Where they lay down prudential obligations, they will not apply to these European institutions.
 - However, the Principles will apply to *other overseas firms* with FSA authorisation.
21. Within their sphere of application, we propose that the Principles should be:
- relevant to *judgments of fitness and propriety*, both at the time of authorisation (is the applicant able and willing to observe the Principles?) and in the context of continuing supervision;
 - a basis for the exercise of powers of *investigation* and *intervention*;
 - a basis for obtaining *injunctions* (or in Scotland, *interdicts*);
 - a basis for *disciplinary proceedings*; and
 - a basis for *requiring restitution*.¹¹

¹¹ At present it is open to SRO disciplinary tribunals to make an award of redress as part of a disciplinary adjudication. Since the disciplinary finding may be based on breach of the Principles made under the Financial Services Act, so may the award of redress. See new Clause 206.

22. The new legislation is expected to give investors who are ‘private persons’ a right of action for damages in cases of loss caused by breach of the FSA’s rules, except for financial resources rules.¹² However, the FSA will be able to specify rules to which the right of action will not attach.¹³ Since the new Principles will be rules under the terminology of the new legislation, the FSA must determine whether they should provide a basis for actions for damages.
23. We propose that it should not be possible for private persons to found an action for damages on the Principles alone. We have designed the proposed Principles as a statement of *regulatory* expectations, not as a set of legal rights at large. The high level at which they are expressed makes it important that their interpretation and application should be in harmony with the overall body of FSA rules and guidance and declared authorisation, supervisory and enforcement policy. This might be put at risk if civil litigation between private parties were to become the engine driving the interpretation of the Principles. The investor protection need can be amply met (as it is at present) by providing for civil actionability below the level of Principles in more specific rules.
24. Since the Principles are not designed to create rights or liabilities in civil law, they will not provide a basis for payments under the compensation scheme.

12 Clause 80(1) and (2).

13 Clause 80(3).

3 The proposed Principles

25. We propose eight Principles. Each is set out below, accompanied by a short explanatory commentary. The latter does not form part of the draft text on which we are consulting at this stage. ‘Customer’ includes potential customer.

Principle 1 – Integrity

A firm must conduct its business with integrity.

26. Principle 1 states the fundamental obligation on firms to act honestly and straightforwardly, and reflects a key dimension of the ‘fit and proper’ standard. Integrity is a moral concept, and breaches of Principle 1 are likely to be among the gravest breaches of the Principles.¹⁴

Principle 2 – Skill, care and diligence

A firm must conduct its business and organise its affairs with due skill, care and diligence. This will include arranging adequate protection for customers’ assets when responsible for them.

27. The concept of ‘care’ includes care towards customers: to the extent that the firm owes duties to its customers, it must discharge those duties with care. What is ‘adequate’ will, of course, depend on the nature of the firm and its counterparties and the business it undertakes.

¹⁴ We propose to omit the reference to ‘high standards’ of integrity which appears in the old SIB Principles. We do not think that, in relation to the particular word ‘integrity’, the reference to ‘high standards’ adds anything.

Principle 3 – Management and control

A firm must organise and control its affairs effectively.

This will include:

- a) having directors and senior managers who are all fit and proper for their roles, and operating adequate arrangements for securing the suitability of persons who carry out functions on its behalf;
- b) apportioning responsibilities among its senior managers and directors in such a way that
 - their individual responsibilities are clear; and
 - the business and affairs of the firm are adequately monitored and controlled at senior management and board level;
- c) operating robust arrangements for meeting the standards and requirements of the regulatory system, and for guarding against involvement in market abuse or financial crime (including the detection and prevention of money laundering); and
- d) keeping adequate and orderly records of its business and internal organisation.

28. Principle 3 requires a firm to keep an effective grip on its own affairs. What this means in practice will depend on the size and complexity of the firm. Relatively simple procedures will be enough in the case of a one-person business, while sophisticated systems of control are likely to be necessary in the case of a complex organisation.¹⁵

29. Paragraph a) deals with the firm's responsibility to make sure its people are suitable for the roles they fill. This extends to competence as well as honesty, and in some cases their financial position may also be relevant. 'Persons who carry out functions' on behalf of the firm includes not only employees, but also self-employed representatives and corporate agents such as administration companies.

¹⁵ Principle 3 is, of course, concerned with the obligations of the *firm*. The Principles and code of conduct for approved individuals will deal with the corresponding obligations of individuals. These will be the subject of consultation later this year.

30. Paragraph b) requires the firm to operate a clear division of duties among its directors and senior managers and to make sure that the whole business and affairs of the firm are controlled at senior management level through an appropriate combination of individual and collective responsibilities.
31. Paragraph c) requires the firm to operate compliance arrangements that are robust – sturdy and reliable. They must include safeguards against participating in or being used by others as a vehicle for market abuse or financial crimes such as money-laundering. Paragraph c) also requires the firm to establish effective complaints-handling systems and procedures.
32. Paragraph d) requires good records not only of business transacted but also of internal organisation – for example, of the apportionment of responsibilities among senior managers. Accounting records are included.

Principle 4 – Prudence

A firm must conduct its business and organise its affairs with prudence. This will include

- a) maintaining adequate financial resources, including adequate liquidity; and
 - b) maintaining adequate risk management systems.
33. ‘Prudence’ connotes foresight and circumspection, but not necessarily risk aversion. A firm whose business includes speculation is not precluded from entering into speculative transactions, but the prudence requirement means it must not assume risks without taking due account of the possible consequences. A firm’s non-regulated activities as well as the regulated and non-regulated activities of other members of a corporate group may be relevant to the adequacy of the firm’s resources, including liquidity.

Principle 5 – Market conduct

A firm must observe proper standards of market conduct.

34. This Principle requires firms to achieve proper standards as participants in organised and over-the-counter markets. In many cases the requisite standards will be set out in FSA’s Code of Market Conduct (on which we are currently consulting) and evidenced in market codes, such as the Takeover Code, or exchange rules. We plan to discuss shortly with the Takeover Panel how best to carry forward into the new regime the present arrangements whereby authorised firms are expected to comply with the

Takeover Code. We will wish to consider whether it would be appropriate to endorse any particular market code using the power of endorsement to be created by the new legislation.¹⁶ We expect Principle 5 to be an important foundation of the new regime for inter-professional dealings, on which we plan to consult later this year.

Principle 6 – Customers: general

A firm must pay due regard to the interests of its customers and treat them fairly. This will include:

- a) paying due regard to their information needs;
- b) communicating information in a way that is fair and not misleading; and
- c) managing conflicts of interest fairly.

35. In certain circumstances firms will, independently of the Principles, be under an obligation to put their customers first – for example, because the relationship is one of agency or trusteeship. In such circumstances Principle 6 does not remove that more exacting obligation. In paying due regard to customers’ information needs firms will have to provide clear information to retail customers about the benefits and risks associated with different services and products which firms provide or advise upon.

Principle 7 – Customers: relationships of trust

A firm must keep faith with any customer who is entitled to rely upon its judgment. This will include taking reasonable care to ensure the suitability of its advice and discretionary decisions.

36. Principle 7 is designed to reflect the fiduciary or ‘trust-based’ nature of many relationships that arise in the course of regulated activities, with the customer trusting the firm to give advice (or provide a portfolio management service) reflecting his or her personal situation and needs.¹⁷

¹⁶ Clause 74.

¹⁷ The requirement on suitability does not detract from the so-called ‘best advice’ requirement in areas where that is also applicable.

Principle 8 – Relations with regulators

A firm must deal with its regulators in an open and cooperative way. This will include telling the FSA promptly anything about the firm of which the FSA would reasonably expect prompt notice.

37. Principle 8 addresses the need for candour and cooperation in a firm's relationship with its regulators. This Principle extends to the provision of information and notification of events concerning non-regulated activities and other members of the corporate group, where appropriate. When a firm has broken other Principles or rules, its observance or non-observance of Principle 8 will be relevant to the question of mitigation or aggravation.

ANNEX A

Introductory Guidance Consultation Draft

1. The Principles are a general statement of the fundamental obligations of authorised firms under the regulatory system. They apply in whole or in part to all authorised firms. They derive their authority from the FSA's rule-making powers as set out in the Financial Services and Markets Act.
2. The Principles apply to regulated activities generally, but in applying the Principles to the conduct of deposit-taking and general insurance business with customers, the FSA will proceed only as a prudential supervisor. On this basis, the FSA would not expect to consider exercising the powers brought into play by a conduct of business contravention of a Principle, unless the contravention were to amount to a serious or persistent violation which has implications for the soundness or fitness and propriety of a deposit-taker or insurance undertaking or for confidence in these sectors. Moreover, in interpreting the Principles in relation to general insurance and deposit-taking business, the FSA will take account of the general absence of detailed conduct of business requirements for that kind of business.
3. In substance, the Principles express the main dimensions of the 'fit and proper' standard set out for firms in paragraph 6 of Schedule 6 to the Act, though they do not derive their authority from that standard or exhaust its implications. Being able and willing to abide by the Principles is therefore a critical factor in applications for authorisation, and breaking the Principles may call into question whether a firm already authorised is still fit and proper.
4. Breaking the Principles makes a firm liable to disciplinary sanctions. The Principles are also relevant to the FSA's powers of investigation and intervention, and provide a basis on which the FSA may seek an injunction and require a firm to make restitution.

5. The Principles do not give rise to actions for damages by customers.
6. Some of the evidential provisions and guidance issued by the FSA will deal with the bearing of the Principles upon particular circumstances. However, since the Principles as a general statement of regulatory requirements are designed to be applicable in new or unforeseen situations, and in situations in which there is no need for guidance, the FSA's evidential provisions and guidance should not be viewed as exhausting the implications of the Principles themselves.
7. The Principles do not apply in their full extent to European firms automatically authorised in the United Kingdom. The rules in [Annex B] specify the application of the Principles in detail.

ANNEX B

Rules about Application Consultation Draft

Chapter A: Persons Authorised by the Financial Services Authority

1. Paragraphs 2 to 4 below relate to persons who are:
 - a) entitled to carry on regulated activities by an authorisation granted by the FSA under the Act, and
 - b) automatically authorised under [] (persons with authorisation before commencement of the Act).

Who?

2. The Principles apply to such persons, and:
 - a) Principle 4, so far as it relates to financial resources, also takes into account other members of a group of which such a person is a member, and
 - b) Principle 8, so far as it relates to the provision of information or the notification of events, also relates to activities of other members of a group of which such a person is a member.

What?

3. The Principles apply to such persons in relation to all regulated activities, including ancillary activities, and:

- a) Principle 4, so far as it relates to financial resources, also takes into account non-regulated activities, and
- b) Principle 8, so far as it relates to the provision of information or notification of events, also relates to non-regulated activities.

Where?

- 4. The Principles apply:
 - a) for the purposes of prudential supervision, in relation to activities wherever conducted, and
 - b) for the purposes of regulation of conduct of regulated activities, in relation to activities carried on, or treated under section 8 of the Act as carried on, in the United Kingdom.

Chapter B: Certain Persons Automatically Authorised

- 5. Paragraphs 6 to 7 below relate to persons who are automatically authorised under Schedules 3, 4 or 5 to the Act (persons reliant on certain Community instruments).

How far?

- 6. Subject to paragraph 7, the Principles apply to such a person in relation to regulated and ancillary activities carried on, or treated under section 8 of the Act as carried on, in the United Kingdom, but only insofar as the matters in question are not assigned by the Community instrument to the Home State supervisor.
- 7. Principle 4, in its application to liquidity, applies to such a person only:
 - a) if it is a credit institution; and
 - b) only in relation to the liquidity of the branch or branches established in the United Kingdom.

Chapter C: General

When?

8. The Principles come into force on [].

How?

9. The obligations contained in the Principles may be enforced, wherever applicable, by any of the methods provided for in the Act.
10. Breach of any of the Principles does not give rise to a right of action for private persons under section 80(1) of the Act, and, for the purposes of section 80, each of the Principles shall be taken to have provided that there is no such right of action in respect of it.

General

11. Where these rules refer to 'the purposes of prudential supervision', this means that the purpose of any enforcement action taken must be derived from:
 - a) the requirement, so far as applicable to the person concerned, that persons should have adequate resources and otherwise meet the 'fit and proper' standard, and
 - b) the need to maintain confidence in the financial system operating in the United Kingdom.
12. Where these rules refer to 'ancillary activities', this means that, in addition to regulated activities, other activities are relevant:
 - a) if carried on in connection with a regulated activity, or
 - b) if held out as being for purposes similar to those of a regulated activity.
13. The Principles are made under section 70 of the Act, and that section and the provisions contained in sections 71(2), (3) and (4), 72(1), 76, 77, 80(3) and 86 of the Act are specified for the purposes of section 83(2).