

Investment Business

THE LAW SOCIETY OF SCOTLAND

Guidance to the Incidental Financial Business Regime Under The Financial Services and Markets Act 2000 and The Solicitors (Scotland) (Incidental Financial Business) Practice Rules 2004

1. Regulatory Framework

The Financial Services Authority (FSA) is the principal regulator for investment business in the United Kingdom. The FSA became fully operational on 1st December 2001 and its powers are set out in the Financial Services and Markets Act 2000.

The Act provides that no individual or firm may carry on a regulated activity unless that individual/firm is authorised by the FSA. From 1st December 2001 to 31st October 2004 the FSA's regulatory regime was confined to the conduct of investment business. However, with effect from 31st October 2004, the FSA's regulatory regime is extended to incorporate mortgage business and with effect from 14th January 2005, the regime is extended to include general insurance business.

Regulated activities are defined in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 which has been amended by the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment No.1) Order 2003 to include mortgage business and by the Financial Services & Markets Act 2000 (Regulated Activities) (Amendment No.2) Order 2003 to include insurance business.

An individual solicitor or firm of solicitors can undertake certain regulated activities and thereby be exempt from the requirement to be authorised by the FSA if that solicitor/firm is licensed by the Society under Part XX of the Financial Services and Markets Act 2000. The Part XX regime allows the establishment of exempt professional firms (exempt from the FSA's regime) to undertake exempt regulated activities provided such activities are an integral part of a solicitor's professional services. For the purposes of the Part XX regime, the Society is a Designated Professional Body and licenses firms to conduct exempt regulated activities.

The Society's regime is known as the "Incidental Financial Business (IFB) Regime" effective from 31st October 2004 and this regime replaces the Incidental Investment Business Regime which has been in operation since 1st December 2001. The IFB regime allows firms to conduct certain activities which would otherwise require FSA authorisation. The essence of these incidental financial business activities is that they are integral to the professional services provided to clients and are not conducted on a stand-alone basis. Furthermore, such activities must not be marketed on a stand-alone basis.

As the FSA's regime has been expanded to include mortgage and insurance business, there has been a similar expansion to the Society's IFB regime so that it incorporates investment, mortgage and general insurance business.

There are four options open to firms of Scottish solicitors under the UK's investment business regulatory regime and these are -

- FSA authorisation.
- An IFB Licence from the Society.
- Acting as an introducer to an independent financial adviser – this option can be undertaken in connection with either of the first two options.
- None of the above.

It is important to recognise the wide definition of a regulated activity which includes -

- advising on investments, mortgages and general insurance.
- making arrangements in investment, mortgages and general insurance.
- selling investments, mortgages and general insurance.

The definition of regulated activities is therefore very wide and is not confined only to the giving of advice but includes making arrangements in the following product areas -

Insurance products includes after the event legal expenses insurance, Bonds of Caution, building insurance, defective title indemnity insurance, household contents insurance, missing beneficial indemnity insurance, term assurance, unoccupied property insurance and warranty in insurance

Investment products includes shares, fixed interest stock, individual savings accounts, pension and collective investment schemes, unit trusts and open-ended investment companies.

Regulated mortgage contract is one which is secured by a first legal mortgage on land which is in the United Kingdom and where at least 40% of the land is, or is to be used, as a dwelling by the borrower.

2. Direct Authorisation by the FSA

There are currently just over 100 firms of Scottish solicitors authorised for investment business by the FSA. The FSA has its own rules and procedures for those firms which it authorises.

An application for authorisation should be made direct to the FSA whose contact details are:

The Financial Services Authority,
25 The North Colonnade,
Canary Wharf,
London. E14 5HS

FSA switchboard number - 020.7066.1000

Website address – www.fsa.gov.uk

A firm which is authorised by the FSA will be able to give its own specific advice on individual investment products and investment companies. Furthermore an FSA authorised firm will also be able to give specific advice on mortgage lenders and mortgage products.

A firm which is authorised by the FSA for investment business cannot also be authorised for incidental financial business by the Society. A firm's FSA authorisation also covers such a firm for incidental financial business as the Society's "incidental regime" does not cover any incidental financial business conducted by FSA authorised firms. The relevant FSA rules cover the incidental financial business of FSA authorised firms.

3. Incidental Financial Business Regime

The Society's Incidental Financial Business (IFB) regime came into operation on 31st October 2004. The IFB regime is much wider than the previous incidental investment business regime which was restricted as its name implies, to investment work arising from legal work.

The IFB regime incorporates four types of incidental business as follows –

- Incidental insurance business
- Incidental investment business
- Incidental long-term care insurance business
- Incidental mortgage business

The Society's Client Relations Office will have responsibility for handling any complaints arising from any of the above four types of incidental financial business.

Before looking at the specific types of business which may be conducted under this regime it is necessary to highlight the conditions which must be followed if a firm is to be licenced for IFB.

Conditions for conducting Incidental Financial Business

- (a) A firm's incidental financial business services must be an integral part of its professional services. A firm cannot have stand-alone incidental financial business.
- (b) The incidental financial business conducted must be linked to the provision of a particular professional service to a particular client.

- (c) (A firm licensed for incidental financial business cannot also be authorised by the FSA and must not hold itself out as being so authorised.
- (d) Any commission, financial or other pecuniary benefit received from third parties due to the conduct of incidental financial business belongs to the client. This means that any commission arising from the incidental financial business must either be given to the client or the client can agree to the commission being offset against his/her fees. However, the client must agree to this offsetting in writing in advance. Typically, this can be arranged by a pro forma letter signed by the client agreeing to this offsetting. Such a letter can be sent to the client for signing along with the terms of business letter.
- (e) The firm's income from incidental financial business cannot account for more than 50% of the firm's total income.

The above conditions must be met in relation to the four types of incidental financial business which may be conducted. Each of these four categories of incidental financial business are explained below -

Incidental Insurance Business

The regulation of insurance business as a category of incidental financial business will bring more firms into this regulatory regime than under the previous regime. This is because of the wide definition of insurance business within the legislation.

The incorporation of insurance business into the regulatory regime has been taken on a staged basis as follows -

- with effect from 31 st October 2004 long-term care insurance is a regulated activity under the Society's IFB regime and the FSA regime.
- with effect from 14 th January 2005, all other insurance business (principally general insurance) is a regulated activity under the Society's IFB regime and the FSA's regime.

The legislation refers to insurance business as "insurance mediation". The insurance business which falls into the incidental financial business regime consists of the following activities -

- introducing, proposing or carrying out other work preparatory to the conclusion of contracts of insurance.
- concluding contracts of insurance.
- assisting in the administration and performance of contracts of insurance, in particular in the event of a claim.

A firm will be conducting insurance business under the IFB Licence when, in connection with its professional services it introduces, sells, arranges and advises on general insurance, such as after the event legal expenses insurance, buildings insurance, contaminated land insurance, defective title indemnity insurance, household contents insurance, missing beneficiary indemnity insurance, trustees indemnity insurance and unoccupied property insurance. Significantly, as the definition of insurance mediation includes “assisting in the administration and performance of contracts of insurance, in particular in the event of a claim” where a firm acts for an insured in bringing a claim against his/her own insurer, this activity when undertaken in conjunction with professional services will fall into the new regime. Where a firm acts for an insurance company in the defence of a claim, this activity will not fall under the new regime if the activity is covered by the exemption in Article 39B of the Regulated Activities Order 2001. This Article provides an exemption where a firm “manages claims on behalf of an insurer” as part of the firm’s professional services. It should be noted that where a firm acts for a third party in an insurance claim such an activity will not fall under the definition of insurance mediation as the third party is not making a claim under his/her own insurance policy. An example of such a third party claim is where a pedestrian is injured in a road traffic accident and then he/she wishes to bring a personal injury claim against the car driver who caused the accident.

The insurance element of the incidental financial business regime does allow a firm to give its own advice and recommendations to a client on a specific contract of insurance. A firm therefore can give its own advice on insurance contracts or insurance companies under the IFB regime.

Incidental Investment Business

The following activities are examples of what may constitute investment incidental financial business –

- (a) arranging for the purchase or sale of shares on the instructions of clients without providing advice on those shares. Such arrangements may arise within an executry or trust work.
- (b) discussing with a client investment advice which has been provided by an independent financial adviser. The firm may comment upon such advice and, acting on the client’s instructions, carry out investment arrangements based on the advice.
- (c) a firm undertaking matrimonial work can obtain the advice of an independent financial adviser regarding the matrimonial investment assets. The firm can comment upon the advice in negotiating a financial settlement in the matrimonial work on the client’s instruction.
- (d) a firm at its own initiative can advise a client that the investment advice or investment arrangements provided by another person do not appear to be in the client’s best interest and that the client should seek further independent financial advice.

A firm under this section of the IFB regime may not give its own specific advice on investment products or investment companies. A firm may, however, give generic advice on the range of investment products and investment companies.

Incidental Long-Term Care Insurance Financial Business

This section of the IFB regime allows a firm to introduce, arrange or advise on long-term care insurance policies, products and providers.

Incidental Mortgage Financial Business

The IFB regime for incidental mortgage financial business comes into force on 31st October 2004.

A firm which wishes to arrange a mortgage on the instructions of a client will be able to undertake such arrangements through this element of the IFB regime. However, a firm will not be able to give its own advice on a specific mortgage product, or mortgage lenders to a client and such specific advice will have to come from an independent mortgage adviser. On receipt of such third-party advice a firm will be able to discuss the advice with a client and acting on the client's instructions arrange a mortgage.

4. Introductions

A firm either with or without an IFB Licence may undertake introductory business where a client is referred to an independent financial adviser. There are different rules depending on the type of financial business which is introduced. The types of financial business which may be introduced can be categorised as follows:-

Introductory Insurance Business – either general insurance or long-term care insurance – if a firm wishes to introduce clients to an independent insurance broker for any contract of insurance a firm will require an IFB Licence. This is because the general statutory provisions on introductions under Article 33 of the Regulated Activities Order are disapplied for insurance mediation.

Introductory Investment Business – a firm may introduce a client to an independent financial adviser. The firm making the introduction must do no more than bring together the client and the independent financial adviser to whom the introduction is made. Any commission arising from the introduction can be retained by the firm.

Introductory Mortgage Business – a firm may introduce a client to an independent mortgage broker. There are two principal conditions which apply to such introductions which are -

- a firm must not receive any money paid by the borrower in connection with the introduction; and
- before making the introduction the firm must disclose to the borrower details of any payment or any other reward which may arise out of the introduction.

5. Incidental Financial Business Practice Rules 2004

(a) Commencement date of IFB Practice Rules

The new Practice Rules come into operation on 31st October 2004 for incidental investment business, incidental long-term care insurance and incidental mortgage business. The Rules for incidental insurance business come into force on 14th January 2005.

(b) Application for an Incidental Financial Business Licence

An application for an IFB Licence must be made by a firm to the Society by submitting the application form contained in Schedule 1 to the Rules. The deadline for submission of a firm's application form before the commencement of the new Rules was 31st August 2004. Firms can apply for an IFB Licence at anytime after the commencement of the Rules if an application form was not submitted ahead of the 31st August 2004 deadline.

The application form requires details of the principal within the firm who will have overall responsibility for the conduct of insurance mediation where a firm wishes to undertake incidental insurance or incidental long-term care insurance. No person having a criminal record disclosing a serious criminal conviction, involving any crime against property or related to financial services can fulfil this role. No person who is subject to bankruptcy proceedings can fulfil this role. These prohibitions are requirements of the Insurance Mediation Directive from which the Society's IFB Rules are derived.

The application form also seeks notification to the Society of those solicitors who are to be individually licensed for each incidental financial business activity. Each solicitor identified must indicate which incidental financial business activities will be undertaken by ticking one or more of the appropriate boxes. The options are – incidental investment business (IB); incidental insurance business (IM); incidental long-term care insurance (LTC) and incidental mortgage business (MMA).

No solicitor who wishes to conduct incidental insurance or long-term care insurance work can undertake such work where they have a criminal record (as defined above) or where they have been subject to bankruptcy proceedings.

The application form then asks as firm to identify those non-solicitors who will conduct any form of incidental financial business. The same information is requested for non-solicitors as for solicitors. The same prohibitions also apply to those persons as they do to a solicitor.

The application form asks the firm to provide the date from which the new Incidental Financial Business Licence is required.

(c) Duration of an Incidental Financial Business Licence

The Licence runs for the normal twelve month term of the Society's practice year, from 1st November to 31st October.

(d) Renewal of an Incidental Financial Business Licence

A firm's IFB Licence will be renewed annually through the Practising Certificate renewal forms which are sent out by the Society's Records Department in October. If a firm does not wish to renew its IFB Licence, notice of this intention and the date from when the Licence is to be revoked must be sent to the Records Department.

(e) Annual fee for an Incidental Financial Business Licence

The annual fee for an IFB Licence will be set at the Society's Special General Meeting in September each year. Notification of these fees will be included in the Practising Certificate renewal application form which is sent to each firm. Fees for the practice year 2004/2005 are £50 per licensed firm and £40 per licensed person.

(f) Display of the Incidental Financial Business Certificate

A firm must display at its place of business its Incidental Financial Business Certificate (or a copy). This requirement is contained in Rule 23(2). A firm will be issued with an Incidental Financial Business Certificate after it first applies to be licensed for such work from the Society.

(g) Notification to the Society in changes of personnel who undertake Incidental Financial Business

A firm must notify the Director of Financial Services in writing of any changes to the list of personnel originally provided to the Society of those who conduct incidental financial business within a firm. This notification must be made to the Society within one month of any change to the original list of licensed individuals (Rule 10(1) and 10(2)).

(h) Specific Rule requirements for insurance mediation activity (general insurance and long-term care insurance)

- every firm which undertakes incidental general insurance or incidental long-term care insurance must appoint a principal who has overall responsibility for the conduct of such work within the firm. This person will be referred to as the Insurance Mediation Officer. (Rule 11(1). It is this person who will be identified on the FSA's website as being responsible for insurance mediation within a firm.
- A firm will not be able to undertake any form of insurance mediation work (general insurance or long-term care insurance) until that firm is registered on the FSA's Register for this work. It is the Society which has responsibility for transmitting this information on firms and their insurance mediation officer to the FSA. The Society will update the information on the FSA's Register on a weekly basis.
- Provision of information - certain information requires to be provided to a client where a firm concludes a contract of insurance for a client. The information which requires to be provided is set out in pro forma style in Schedule 1 to this guide. The information can be provided orally if the client requests this or if the client requires immediate cover. Furthermore, where the contract is concluded by telephone and the client agrees to receiving limited

information after the conclusion of the contract, the general information to be provided in writing need not be given.

- Scope of services - where a firm acts as an insurance intermediary providing advice on particular types of insurance a firm must have undertaken an appropriate analysis of the insurance market to show that the advice given on a particular contract of insurance is adequate to meet a client's needs. A record should be made of how a firm has undertaken an appropriate analysis of the insurance market.
- Statement of demands and needs - where a firm makes a personal recommendation to a client of a specific contract of insurance or arranges for a client to enter into a specific contract of insurance, before the conclusion of that contract the client must be provided with a statement of his demands and needs in respect of that insurance contract. This statement is in essence a "reason why letter" explaining to the client why a particular contract of insurance has been recommended by the firm. The letter should also clearly state the demands and needs of the client. A pro forma style of this statement is provided in Schedule 2 to this guide.

(i) Incidental Financial Business Compliance Certificate

A firm is required to submit an Incidental Financial Business Compliance Certificate for each six-month period within a firm's financial year. The form of Compliance Certificate which must be submitted to the Society is set out in Schedule 3 to the Rules. The Compliance Certificate requires the following information:-

- The accounting period to which the Certificate relates.
- Confirmation that the six statements set out in the Certificate do apply to the firm.
- Date and signing of the Certificate by a partner, sole practitioner/director/controller/member.

The Society's team of inspecting accountants will monitor a firm's compliance with the new Rules as part of the Society's two-yearly cycle of Accounts Rules inspection.

(j) Terms of business

Whenever a firm undertakes incidental financial business a terms of business letter must be issued to a client. A pro forma style of terms of business letter form incidental financial business is provided in Schedule 3 to the guidance.

(k) Disclosure on a firm's notepaper

A firm is not required to state on its notepaper that it is licensed by the Society for incidental financial business - Rule 23(1). No such disclosure on a firm's notepaper is required due to the requirement to issue terms of business letters.

(l) Training

There is no requirement to undertake an investment business exam or any specified level of investment business CPD for those individuals who are licensed to conduct incidental financial business. The training obligations for individuals who undertake incidental financial business are set out in general terms in Rule 24. The responsibility is on firms and those licensed individuals to ensure that they keep themselves up to date on incidental financial business matters.

(m) Record keeping requirements

The record keeping requirements are set out in Rule 25. The general obligations under Rule 25 are as follows:-

- Best execution – instructions from clients to carry out specific incidental financial business should be arranged with due timeliness.
- Records of statements of demands and needs – these must be kept for a minimum of three years from the date on which a firm's personal recommendation on a specific contract of insurance or the arrangements to enter into a specific contract of insurance have been made.
- Records of a client's instructions – a firm must retain records of instructions from clients to carry out specific incidental financial business and instructions from the firm to any third party to effect or arrange such incidental financial business. These records must be retained for at least ten years from the date of the instruction.
- Records of accounting to clients for commission etc – a firm must retain records of how it has accounted to its clients for any IFB commission or other pecuniary reward from third parties. Such records must be kept for at least ten years from the date of accounting. This record keeping can be achieved by retaining copies of the letter and payment details where commission is paid direct to the client. Alternatively, where the commission is deducted from a firm's fee note, a copy of the fee note detailing this deduction is sufficient.
- Safe-keeping of assets – where a firm holds for safe-keeping purposes documents of title i.e. share certificates, a firm should ensure that at all times such documents are readily accessible and are separately identifiable from any of the firm's own investments. A firm should also ensure that storage facilities are appropriate to the value and risk of loss of the investments to be safe-guarded and provide protection from damage, misappropriation or other losses. Where a firm uses a third party custodian to safe-keep such documents a firm must be satisfied that such a third party is suitable to act as a custodian.

Schedule 1

Style of information letter to be used before or immediately after the conclusion of a contract of insurance with a client.

1. The firm of AB has its principal place of business at.....
2. The firm of AB is not authorised by the Financial Services Authority. However, the firm is included on the Register maintained by the Financial Services Authority so that this firm can carry on insurance mediation activities, which is broadly the advising on, selling and administration of insurance contracts. This part of our business, including arrangements for complaints or redress if something goes wrong, is regulated by the Law Society of Scotland. The Register can be accessed via the Financial Services Authority website at www.fsa.gov.uk/register.
3. The information provided in parts 1 and 2 above may be checked on the FSA's Register by visiting the FSA's website at www.fsa.gov.uk/register or by contacting the FSA on 0845.606.1234.
4. The firm of AB does not have any holding, direct or indirect, representing more than 10% of the voting rights of, or the capital in, an insurance undertaking.
5. No insurance undertaking or parent of an insurance undertaking has a holding, direct or indirect, representing more than 10% of the voting rights of or capital in this firm.
6. The contract of insurance on which this firm has provided advice or arranged has been selected on the basis of a fair analysis of the insurance market. This analysis was undertaken by reviewing the range of insurance products on the market.
7. The firm of AB has Professional Indemnity Insurance under the Law Society of Scotland of Scotland's Master Policy. The current level of indemnity on the Master Policy is £1.5m per claim. The firm of AB is also covered by the Scottish Solicitors Guarantee Fund which is a fund established by Section 43 of the Solicitors (Scotland) Act 1980 for the purpose of making grants in order to compensate persons who, in the opinion of the Council of the Law Society of Scotland suffer pecuniary loss by reason of dishonesty on the part of a Scottish solicitor in connection with the practice of the solicitor.
8. Any complaint which you may have about any service provided by the firm should be directed to the partner within AB. Furthermore, you have a right to complain to the Law Society of Scotland, 26 Drumsheugh Gardens, Edinburgh. EH3 7YR (website address www.lawscot.org.uk and telephone 0131.226.7411) and thereafter to complain against any finding of the Society to the Scottish Legal Services Ombudsman, 17 Waterloo Place, Edinburgh. EH1 3QL (telephone number 0131.244.3044).

Schedule 2

Style of Statement of Demands & Needs when advising on or arranging a specific contract of insurance.

1. The firm of AB has recommended that you (name of client) take out a contract of insurance for household contents with CD insurance company of (insert address of insurance company).
2. The demands and needs of (client's name) in respect of this insurance contract are that insurance cover is required for your household contents for your newly purchased property.
3. The firm has recommended the household insurance contract of CD insurance company becauseinsert reasons for recommendation which should relate to the insurance contract meeting the client's insurance needs.

Schedule 3

Style of Terms of Business letter for incidental financial business.

1. The specific incidental financial business undertaken by this firm will be the sale of a ABC shares in DE through stockbrokers FG on your instructions. The firm has limited its incidental financial business activities to arranging the sale of these shares given the limited scope of activities allowed under the incidental financial business regime.
2. The firm of AB is licensed by the Law Society of Scotland to carry on incidental financial business under the Solicitors (Scotland) (Incidental Financial Business) Practice Rules 2004.
3. The firm of AB is not authorised by the Financial Services Authority under the Financial Services and Markets Act 2000.
4. The firm of AB has Professional Indemnity Insurance under the Law Society of Scotland of Scotland's Master Policy. The current level of indemnity on the Master Policy is £1.5m per claim. The firm of AB is also covered by the Scottish Solicitors' Guarantee Fund which is a fund established by Section 43 of the Solicitors (Scotland) Act 1980 for the purpose of making grants in order to compensate persons who, in the opinion of the Council of the Law Society of Scotland suffer pecuniary loss by reason of dishonesty on the part of a Scottish solicitor in connection with the practice of the solicitor.
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