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The regulation of securities intermediaries by the FSA

Background paper to FMLC paper entitled, “Analysis of the need for and nature of legislation relating to property interests in indirectly held investment securities, with a statement of principles for an investment securities statute”

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The Regulation of Securities Intermediaries

This note aims to provide an overview of the way in which securities intermediaries in the UK are currently regulated. This review only considers the activity of accepting the deposit of investment securities. It does not discuss other related or similar activities that may also be regulated such as the arranging of deals, advising on investments or the establishing of an authorised unit trust scheme.

1. The regulatory provisions

Section 19 of the Financial Services and Markets Act 2000 ("FSMA") states that no person may carry on a "*regulated activity*" in the United Kingdom unless he is authorised by the FSA to do so, or he is exempt from the prohibition. This section is referred to as the "general prohibition".

Section 22 of the FSMA provides that an activity is a regulated activity if it is an activity specified in an order made by the Treasury, which is carried on by way of business and which relates to specified investments.

Under Article 40 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 as amended (the "**Regulated Activities Order**") the "*safeguarding and administering*" of assets belonging to another is specified as a regulated activity provided that the assets consist of, or include, any investment which is, or which may be, a "*security*" or a "*contractually based investment*".

It is also a regulated activity (under Article 40) to arrange for one or more other persons to carry out the functions of safeguarding and administering assets belonging to another or (under Article 64 of the Regulated Activities Order) to agree to safeguard and administer, or to agree to arrange for the safeguarding and administering of, assets belonging to another.

2. The regulated activity

The safeguarding and administering of assets belonging to another has to be carried on "*by way of business*". The FSA Handbook refers to the Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order 2001¹ but notes that the analysis is ultimately a question of judgement which takes account of several factors (none of which conclusive) such as the degree of continuity, the existence of a

¹ SI 2001/1177, which, broadly, has the effect that a person will be regarded as carrying on safeguarding and administration of assets by way of business if such person carries on the business of engaging in any regulated activity such as dealing in, managing, safeguarding and administering, or advising on, investments, or agreeing to do so.

commercial element, the scale of the activity and the proportion which the activity bears to other activities carried on by the same person but which are not regulated².

The activity must also be "*in the United Kingdom*". Section 418 of the FSMA helps to clarify the meaning of this phrase and in particular the "outward" territorial application of the general prohibition, which requires a person based in the United Kingdom who carries on regulated activities overseas to be authorised in the United Kingdom.

A person will not fall within the activity regulated by Article 40 unless he is both "*safeguarding*" and "*administering*" the assets³. However, it is also a regulated activity to arrange for the provision of, or to agree to provide or arrange the provision of, such functions. Therefore, if an entity performs only one of the functions but arranges for a third party to perform the other, or performs neither of the functions but arranges for one or more parties to do so, the entity may still be carrying out a regulated activity as the person responsible for the arrangements.

"*Safeguarding*" would include taking physical possession, holding title or "protecting the integrity of intangible assets not evidenced by a physical document". "*Administering*" would include any action such as settling transactions in investments, collecting and dealing with dividends, cash processing associated with customer assets, carrying out corporate actions on behalf of the client, operating nominee accounts and using sub-custodians, and guidance issued by the Securities Investment Board viewed maintaining accounts with clearing houses also as "*administering*"⁴. The FSA Handbook provides that the nature of the administration functions must be such that the custodian has no discretion (otherwise he is likely to be caught by the regulated activity of managing investments)⁵.

Article 43 provides that it is not "*administration*" to provide information concerning the number of units or value of assets held, to convert currency or to receive documents or information about the assets simply to forward as the client instructs.

The Regulated Activities Order defines "*security*" as shares, instruments creating or acknowledging indebtedness, government and public securities, instruments giving entitlements to investments, certificates representing certain securities, units in a collective investment scheme and rights to or interests in any of those products. A "*contractually based investment*" is defined as rights under a "*qualifying contract of insurance*", options, futures, contracts for differences, Lloyd's syndicate capacity and syndicate membership, and rights to or interests in any of those products. A "*qualifying*

² AUTH 2.3.3G

³ Article 40 reads "The activity consisting of both - (a) the safeguarding..... and (b) the administration ...".

⁴ SIB, Custody of Investments under the Financial Services Act 1986, Guidance Release 5/97 (June 1997). Even though this was issued prior to the introduction of the FSMA, its guidance on the meaning of the terms "safeguarding" and "administering" is still helpful.

⁵ AUTH 2.7.9(2)G.

contract of insurance" is a contract of long term insurance which is not a reinsurance contract nor one which, in certain circumstances prescribed in the Regulated Activities Order, is payable only on death or incapacity due to injury, sickness or infirmity.

3. The exemptions

Recognised investment exchanges, recognised clearing houses, appointed representatives of authorised persons and certain other persons prescribed under miscellaneous provisions are exempt from the need for authorisation⁶. Members of Lloyd's and members of the professions are not exempt as such but the general prohibition in Section 19 of the FSMA only applies to those persons in certain circumstances.

4. Exclusions

Bare nominees: Article 41 of the Regulated Activities Order provides that the prohibition on safeguarding and administering assets does not apply if a third party entity, which is either authorised or exempt from the requirement to be authorised to carry out in the United Kingdom the functions in Article 40, undertakes to the person to whom the assets belong a responsibility for the assets which is no less onerous than he (the third party) would have undertaken if he were performing the functions himself.

Introductions: Article 42 excludes arrangements that consist of an introduction to an entity that is authorised or exempt from authorisation to carry out the functions in Article 40 unless that entity is a member of the same group as the introducer, or pays for the introduction.

Acting as a trustee: Article 66(4) of the Regulated Activities Order excludes from Article 40 the activities of a person acting as trustee or personal representative unless that person holds himself out as providing a safeguarding and administering business⁷. Article 66(7) states that the exclusion does not apply if the trustee is remunerated for the safeguarding and administering of the assets in addition to any remuneration he receives as trustee or personal representative. For these purposes, however, the trustee or personal representative will not be considered as receiving additional remuneration merely because his remuneration is calculated by reference to time spent.

Profession or non-investment business: Article 67 excludes activities carried out in the course of any profession or business which does not otherwise consist of the carrying on of a regulated activity in the United Kingdom and which may be reasonably regarded as

⁶ Such as the Financial Services and Markets Act 2000 (Exemption) Order 2001, as amended which exempts, amongst others, the Bank of England, the ECB, the central bank of an EEA State other than the UK, the IMF, a person who provides the trading facilities which constitute a regulated market, a person acting as an insolvency practitioner or as an official receiver.

⁷ The SIB Guidance Release 5/97 indicated that a trustee or personal representative would only be holding himself out as providing such a business if he offers services over and above those which trustees or personal representatives normally provide.

a necessary part of other services provided in the course of that profession or business. This exclusion does not apply if the service of safeguarding and administering is separately remunerated.

Sale of goods and supply of services: Article 68(7) provides that safeguarding and administering of assets for the purposes of, or in connection with, the sale of goods or supply of services is not regulated under Article 40. The goods or services supplied do not have to come from the person safeguarding and administering the assets so long as the service is in connection with a sale or supply of goods or services and provided that the main business of the person providing the functions of Article 40, or of that person's group member, is the supply of goods and services and not a regulated activity.

Groups and joint enterprises: Article 69(6) excludes from Article 40 the safeguarding and administering of assets which belong to a member of a group of which the entity providing the functions is part, or which belong to a member of a joint enterprise, which the entity providing the functions is (or proposes to become) a participator and the functions are (or are to be) for the purposes of, or in connection with, that enterprise.

Employee share scheme: Article 71(5) excludes the safeguarding and administering of assets which further, or are carried on in operation of, an employee share scheme. The exclusion applies to the activities of a body corporate whose securities or debentures are the subject of the scheme, or to the activities of an entity in the same group as such a body corporate. The exclusion also applies to the activities of any trustee who holds securities or debentures under the share scheme.

Overseas person: Article 72(6) provides that it is not a regulated activity for an overseas person to agree to carry out the safeguarding and administering of assets belonging to another if the agreement is the result of an approach to the overseas person which has not been solicited by him in any way or is solicited in a way which does not contravene the financial promotion restrictions in Section 21 of the FSMA.

Information society services: Article 72A excludes from Article 40 any activity that constitutes the provision of an information society service from an EEA State (other than the United Kingdom).

5. Authorisation and consequential compliance requirements

If an entity wishes to perform a regulated activity in the UK and no relevant exemption applies, they must seek authorisation from the FSA, or operate under a Consolidated Credit Institutions Directive or Investment Services Directive passport (a "European passport").

Once authorised, the entity has to comply with the Client Asset ("CASS") Rules and the applicable FSA Conduct of Business (or "COB") Rules.

The CASS rules and Chapter 4 (Accepting Customers) of the COB Rules contain the provisions particularly relevant to custody services. However, if the entity operates in the UK under a European passport from another EEA state, the CASS Rules do not apply (although the COB Rules, to the extent applicable, including Chapter 4 will). If the services are provided by a UK entity authorised by the FSA but provided through a branch in another EEA State pursuant to a European passport, only the CASS Rules apply (and warning requirements contained in COB Chapter 5 if the client is classified as a private customer in the UK); though the entity will be subject to the high level requirements in the FSA's Principles for Business and local conduct of business rules. There are also fewer compliance obligations if the entity is only arranging for the safeguarding and administering.

Chapter 4.2 contains provisions that relate to the requirement for and content of the entity's terms of business and client agreement. These rules aim to ensure that the information needs of the customer are adequately met.

The CASS Rules include rules on custody, client money, collateral and client money distribution. These rules are mainly based on the requirement for a firm to arrange adequate protection for clients' assets when it is responsible for them.

The custody rules are contained in CASS, Chapter 2. They are designed primarily to restrict the commingling of client and firm's assets and to minimise the risk of client assets being used by the firm without the client's agreement or contrary to the client's wishes, or being treated as the firm's assets in the event of its insolvency⁸.

Cash held in connection with custody services is subject to the client money rules. The client money rules are contained in CASS, Chapter 4 and they aim to ensure the proper accounting and handling of client money. However, if the entity is an approved bank for FSA purposes, the client money rules do not apply to cash held by the entity in an account with itself. In other cases, provided that the client is not a private customer and does not fall into various other excepted cases, the entity may opt out of the client money rules. In particular, Section 4.4 contains rules that seek to facilitate the timely return of client money to a client in the event of the failure of the custodian or a third party at which the custodian holds client money⁹.

CASS Rule 3 contains record keeping requirements for arrangements in which the custodian is granted a security interest by way of outright transfer.

6. Summary

A securities intermediary will need to be authorised to the extent that it can be said to "safeguard and administer" "securities" or "contractually based investments" which

⁸ FSA Handbook, CASS 2.1.12 G

⁹ FSA Handbook, CASS 4.4.3 G

belong to another by way of business "in the United Kingdom" unless that intermediary is an exempt body or falls within one of the exceptions outlined above.

Some functions are found in the securities markets which are so passive, for example taking deposit of global notes, that those performing these functions do not "administer" assets and so may not need authorisation or exemption. Custodians would need authorisation or exemption (typically authorisation). Broker/dealers would also need authorisation or exemption (typically authorisation).

In an indirect holding system, the activities of a securities intermediary - that is to say maintaining securities accounts on behalf of others - are bound to be classified as 'safeguarding and administering': if as a matter of law the account is a necessary element of establishing title (in the jargon, when the securities are 'book-entry' securities), it follows that the account maintainer is 'protecting the integrity of the intangible asset' (i.e. safeguarding) and is 'settling transactions in investments' (i.e. administering), whether or not there are also the activities that would fall within the ordinary meaning of "administration" (e.g. collecting and dealing with dividends, carrying out corporate actions and possibly maintaining accounts with clearing houses).