

**Consultation on Review and Consolidation of the
Financial Services Regulatory Legislation**

**A Consultative Paper on the
Financial Services Rule Book
covering
Conduct of Business,
Risk Management & Internal Control
and Administration**

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Financial Supervision Commission Barrantee Oaseirys

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SECTION 1

1. INTRODUCTION

The Financial Supervision Commission has issued a number of consultation documents on the consolidation and review of financial services legislation:-

- **CAROL 1** (issued on 6th March 2006) covered the scope and nature of the project to review and consolidate the financial services regulatory legislation, with particular reference to the contents of the proposed Financial Services Bill;
- **CAROL 2** (issued on 1st June 2006) published drafts of the Regulated Activities Order and Exemption Regulations;
- **CAROL 3** (issued on 21st December 2006) published the draft Bill; and
- **CAROL 4** (issued on 16th April 2007) published the first chapters of the Rule Book covering Financial Resources and Audit Requirements.
- A further Consultative Paper published the revised versions of the Financial Resources and Audit Requirements chapters of the Financial Services Rule Book (issued 24th September 2007).

Whilst work is continuing on other parts of the Rule Book, this consultation covers the parts on Conduct of Business, Risk Management & Internal Control and Administration (see Appendices A, B and C). Section 2 of this document gives a brief overview of the Rules and Section 3 highlights the key changes to the current secondary legislation. The attached RoadMap (see Appendix D) identifies what has happened to the relevant provisions in the current framework.

The Commission is also working on the Regulated Activities Order and Exemption Regulations which have been on hold pending further progress on the Collective Investment Scheme Bill. Comments received in response to CAROL 2 and 3 are being incorporated into these revised documents and it is hoped that a further consultative document will be published in the first quarter of 2008.

It would be much appreciated if we could have any comments on these revised chapters of the Rule Book as soon as possible. The closing date for comments is 31st January 2008.

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SECTION 2

2. FINANCIAL SERVICES RULE BOOK – OVERVIEW

This Section gives an overview of the structure and content of the Rule Book and how it will apply to the various regulated sectors. The key differences between the Rule Book and the existing regulatory requirements are highlighted in Section 3.

2.1 Background

As discussed in CAROL I, it is proposed that there will be just one Regulatory Code or Rule Book that brings together the common standards and requirements that apply across all regulated sectors. Where there are different sector-specific requirements, these will be specified separately. The Commission will, of course, continue to issue guidance to industry where this is appropriate.

In designing the new Rule Book, we have reviewed rules in the UK, Jersey, Guernsey and other jurisdictions, as well as our own current laws to identify what appear to be the options best suited to the Isle of Man to help our licenceholders to remain competitive and develop their business opportunities globally. Wherever possible, we have simplified the requirements, ensuring clarity and consistency. We have also changed the layout of the Rule Book and incorporated a number of tables in order to make the Rules more user-friendly. However, inevitably, where requirements are subject to standardisation, this will result in some changes to sectoral requirements.

The Rule Book will have a number of chapters which will cover each of the following topics –

- Financial Resources & Reporting
- Audit Requirements
- Clients' and Trust Money
- Clients' Assets
- Conduct of Business (including treating customers fairly and advertising)
- Risk Management & Internal Control (including compliance)
- Administration

There will also be a section on Definitions which will be consulted upon in due course. In the meantime, existing definitions may be relied upon.

We will be consulting on the various chapters in stages. This consultation covers the parts covering Conduct of Business, Risk Management & Internal Control, and Administration.

The review of financial services legislation project is largely a consolidation of existing regulatory legislation. Most requirements of the Rule Book will be familiar to you as they reflect the current pillars of regulatory legislation (with some rearrangement and standardisation across all regulated sectors).

2.2 Structure of Rule Book content

Where appropriate, each chapter of the Rule Book will be divided into –

- Basic Requirements;
- General Requirements for all Licenceholders;
- General Requirements for Isle of Man incorporated entities;
- General Requirements for non-Isle of Man incorporated entities;
- Specific Requirements for Licenceholders undertaking specific regulated activities.

Some existing Codes will appear in a different part of the Rule Book, to be consulted upon separately, or may have been removed and incorporated in the Licensing Policy.

SECTION 3

3. FINANCIAL SERVICES RULE BOOK – KEY CHANGES CONDUCT OF BUSINESS, RISK MANAGEMENT & INTERNAL CONTROL AND ADMINISTRATION

The rules relating to Conduct of Business, Risk Management & Internal Control, and Administration are a consolidation of the regulatory requirements contained in the following secondary legislation –

- Banking (General Practice) Regulatory Code
- Fiduciary (General Requirements) Regulatory Code
- Financial Supervision Commission (Conduct of Business) Regulatory Code
- Financial Supervision Commission (Advertising) Regulatory Code
- Financial Supervision Commission (General Requirements) Regulatory Code
- Financial Supervision Commission (Stockbrokers) (No 2) Regulatory Code 2003

3.1 Basis of Approach

The basis for the review of Conduct of Business, Risk Management & Internal Control, and Administration has been to consolidate existing Investment Business Conduct of Business, Advertising and General Requirements Regulatory Codes with the Fiduciary (General Requirements) Regulatory Code and Banking (General Practice) Regulatory Code to make a more universally applicable Rule Book. Rules from the existing codes have been rearranged so that they fall into the relevant chapters.

The approach has been to base these parts of the Rule Book on all existing codes and to apply these, where appropriate, to all licenceholders. Therefore, whilst some sectors will have new rules applied to them, they will not be new for all. In addition, many of the rules are standard business practice and as such will be being applied by licenceholders. It is not envisaged, therefore, that these rules will cause any difficulties. Where there is a specific sectoral difference, different requirements have been applied. The wording of some existing requirements has been simplified or amended to encompass the different regulated sectors, however, the principles have not necessarily changed. In addition, various issues with the current requirements have been addressed e.g. –

- ✦ additional details are now contained in the rules on complaints; and
- ✦ specific conduct of business rules for schemes functionaries; and

there are new rules covering cold calling and corporate governance. Reviews of the requirements in other jurisdictions (Jersey, Guernsey and the United Kingdom) have been undertaken prior to finalising the various parts.

One area which has changed in relation to banks is that specific rules for managed banks have not been carried into the new Rule Book as the rules for deposit takers will apply. Where it is not appropriate for all rules to apply, these will be dealt with by waivers from the Rule Book.

3.2 Conduct of Business

To assist with the navigation of this consultation, the more significant changes relating to Conduct of Business requirements are highlighted below. It should, however, be noted that some requirements will have been moved into the new part on Risk Management & Internal Control and these are highlighted in the RoadMap. In addition, some guidance has been formalised as rules.

3.2.1 *Cold Calling*

There is a new rule on cold calling (rule 7.4(2)) which has been based on current requirements for stockbrokers and the Financial Services Authority rule requiring that communication should not be at an unsocial hour (unless previously agreed).

3.2.2 *Terms of Business / Inter-professional Agreements*

In addition to the original Investment Business requirement for a client agreement, there is now a new requirement for investment service providers and collective investment scheme service providers (rules 7.38 and 7.60) to have either terms of business or inter-professional agreements. This formalises various disclosure requirements into a requirement for them to be contained in a specific document which, in practice, is the way in which most of these types of disclosures are made and ensures that the services being provided are clear and not misleading.

3.2.3 *Disclosure of Remuneration*

There is a new requirement (rule 7.40) that the terms of business should contain a statement informing clients that they may request details of the amount of the remuneration being received by the licenceholder.

3.2.4 *Disclosure of Qualifications / Experience*

There is a new requirement (rule 7.40) which requires that the terms of business should contain a statement informing clients that they may request details of the educational qualifications, experience and track record of the licenceholder or any employee engaged in providing services to clients.

3.2.5 *Chapter 4 – Specific requirements for CIS service providers.*

Rules 7.51, 7.53 to 7.55, and 7.59 to 7.60 are new rules which are applicable solely to CIS service providers. It was identified that the existing Conduct of Business Regulatory Code did not address schemes specific issues and therefore the eleven rules contained in this chapter are designed to address this deficiency. These rules have been drafted taking into account the requirements in the Channel Islands.

3.3 Risk Management & Internal Control

This part has been created to deal specifically with risk management and internal control with much of the content being obtained from existing codes. To assist with the navigation of this consultation, the more significant changes to existing requirements contained in the various Regulatory Codes are highlighted below. As with paragraph 3.2 some guidance has been formalised as rules.

3.3.1 Corporate Governance

This rule (rule 9.3) has been adapted from existing requirements which have been enhanced to ensure that it is clear that the Board of a licenceholder is responsible for the good governance of the licenceholder and compliance with the Rule Book. Whilst the wording is slightly changed the requirements should not be new to any licenceholder.

3.3.2 Risk Management

This rule (rule 9.6) has been adapted from existing requirements which have been enhanced to ensure that it is clear that the Board of a licenceholder is responsible for establishing and maintaining appropriate internal and operational controls, systems, policies and procedures relating to all aspects of its business. The rule specifically includes a new requirement to identify risks posed by a group company which may impact upon the licenceholder and provides the Commission with the ability to identify additional risks for the purpose of this rule.

3.3.3 Compliance Officer and Money Laundering Reporting Officer

There are additional requirements for the functions and status of the compliance officer, money laundering reporting officer and deputy money laundering reporting officer.

3.3.4 Compliance Returns

The annual compliance return (rule 9.27) is still being reviewed and will be subject to consultation at a later time.

3.3.5 Conflicts of Interest Policy and Register

These are new rules (rule 9.28 and 9.29) which formalises the need for a policy which should already exist in practice. It is not anticipated that this would be too onerous on licenceholders as the Conflicts of Interest Policy is to be appropriate to the size, organisation and nature, scale and complexity of the business. This new requirement has been based on MiFID requirements. Whilst the Commission has not undertaken to adopt MiFID requirements generally, this concept is merely a clarification of the existing general rule on Conflicts of Interest (rule 7.13). There is also a requirement to include details of the licenceholder's Conflicts of Interest Policy in the client agreement where the client is a private investor.

3.3.6 Delegation of Function – This rule (rule 9.11) is new to all licenceholders except banks. It provides a basis for the guidance issued by the Commission on outsourcing.

3.3.7 Isle of Man Resident Directors and Officers

The current requirement for “four-eyes” is retained, but is now referred to as “Isle of Man Resident Officers” (rule 9.19). For Isle of Man incorporated licenceholders there is a new requirement for at least two resident directors, one of whom may be non-executive (rule 9.18). Where existing licenceholders do not meet this requirement, there will be an opportunity to seek a waiver to this rule. For both non Isle of Man

incorporated licenceholders and Isle of Man incorporated licenceholders there is a requirement to have two local officers. There is also an additional rule which requires arrangements to be in place to ensure that, in the absence of one of the two local directors or local officers, an alternative fit and proper person exercises the functions (rule 9.20).

3.3.8 Conflicts of Interest Register –

Rule 9.29 is a new requirement that a Conflicts of Interest Register is maintained. This new requirement has been based on MiFID requirements. Whilst the Commission has not undertaken to adopt MiFID requirements generally, this concept is merely a clarification of the existing general rule on Conflicts of Interest (rule 7.13).

3.3.9 Complaints

The requirements in relation to complaints have been enhanced to make reference to the Financial Services Ombudsman (“FSO”) and to follow the procedures in dealing with complaints expected by the FSO i.e. the complaint should be investigated within 12 weeks of receipt.

3.3.10 Professional Indemnity Insurance

The levels of Professional Indemnity Insurance are now contained in a rule rather than in guidance and there is a limit to the aggregate cover. There is also an additional requirement that the cover is obtained from an underwriter who is subject to regulation in an acceptable jurisdiction.

3.4 Administration

There are various rules which originated in specific sectors which have been generalised and extended to all licenceholders resulting in a number of new rules for different sectors.