

## SECTION 3

### ONGOING REGULATORY REQUIREMENTS FOR INVESTMENT BUSINESSES

#### 3.1 LICENCE CONDITIONS

[Section 3\(4\)](#) of the Investment Business Act 1991 ("the IBA") empowers the Commission to issue investment business licences subject to conditions. A breach of a licence condition imposed by section 3(4) is both a criminal offence and can lay a licenceholder open to action for damages at the suit of any private investor who suffers loss (see [section 14](#) of the IBA).

In general, licence conditions are restricted to defining the scope of business which may be conducted by the licenceholder.

These "standard" licence conditions are attached to most investment business licences, and may be augmented at any time by the imposition of "special" licence conditions, designed to respond to particular problems. [Section 3\(7\)](#) of the IBA enables the Commission to impose specific parts of a regulatory code (see [3.2](#) below) as a special licence condition upon an individual licenceholder should it wish to do so. For example, if there have been serious and/or persistent breaches of the code.

There are five categories of investment business licence. Categories 1 to 4 are listed in the [Financial Supervision Commission \(Financial Resources and Compliance Reporting\) Regulatory Code](#) (see [Appendix C1](#)). Category 5 licenceholders - Stockbrokers - have their own Code, the Financial Supervision Commission (Stockbrokers) (No2) Regulatory Code 2003. By restricting, through licence conditions, the scope of investment business carried on by a licenceholder, the Commission can grade the system of regulation to the risks of the business and its need for working capital. The permitted category of investment business will also influence the Commission's assessment of such things as competence and capacity.

It is important that licenceholders appreciate the significance of the difference between licence conditions and the Codes. Whatever the category of licence, conducting business in contravention of licence conditions risks criminal prosecution and/or civil action at the suit of anyone who suffers loss. The Commission has therefore sought to place the weight of regulation upon the observance by licenceholders of regulatory codes.

#### 3.2 REGULATORY CODES

##### 3.2.1 Regulatory Codes ("the Codes")

Section 6 of the IBA empowers the Commission to issue regulatory codes ("the Codes"). These Codes, which are intended to set standards of good practice and behaviour, apply to each licenceholder. Should a licenceholder breach any of the Codes, the Commission is empowered to take enforcement action. This action will be graded, dependent upon the seriousness of the breach.

Where a licenceholder acts outside the scope of its licence category, whether inadvertently or not, the Commission will expect it to abide by the requirements of any relevant code. For example, the [Clients' Money Code](#) should be applied to any clients' money inadvertently received by a licenceholder, even if that licenceholder is not entitled to receive clients' money within its permitted scope of business. The Codes, applicable to Category 1 to 4 licenceholders, cover the following: -

- a. [Financial Resources and Compliance Reporting](#)
- b. [Clients' Money](#)
- c. [Clients' Investments](#)
- d. [Conduct of Business](#)
- e. [Audit Requirements](#)
- f. [General Requirements](#)
- g. [Advertising](#)

The requirements for Category 5 licenceholders can be found in Appendix C8 Financial Supervision Commission (Stockbrokers) (No 2) Regulatory Code 2003 which covers all areas contained in (a) to (g) above.

Each of these codes is contained in [Appendix C](#) and is discussed below.

A glossary defining many of the terms contained in Codes (a) to (g) above is contained in the [Financial Supervision Commission \(General Requirements\) Regulatory Code and the Financial Supervision Commission \(Stockbrokers\) \(No 2\) Regulatory Code 2003](#).

##### 3.2.2

**The financial resources requirements are designed to promote a stable and orderly business environment which inspires confidence by minimising the risk of loss to investors which could arise from over-trading by a licenceholder or from adverse developments in the markets in which it operates. No system can eliminate risk and so the Commission's objective is to minimise risk without over-regulating those licenceholders conducting legitimate and well resourced investment business.**

Financial Resources and Compliance Reporting ([Appendix C1](#))

The requirements are directly related to the scope of investment business conducted by the licenceholder and therefore depend upon which category of business it is permitted to conduct.

There are four main categories to which this code applies, which can be summarised as follows (Category 5 licenceholders – Stockbrokers, should refer to the Financial Supervision (Stockbrokers) (No 2) Regulatory Code 2003 – see appendix C8):

Category 1 (Minimum net tangible assets of £5,000 for sole traders and £10,000 for partnerships and companies)

Group (a)- persons who do not control clients' money or assets and who arrange deals only in a limited range of investments (i.e., unit trusts, life and pensions products). Such persons may provide investment advice (other than to occupational pension schemes and collective investment schemes) on other types of investments, but may not arrange deals in them, except for subscriptions to new share issues.

Group (b)- tied agents selling the products of only one product company. Such persons may control clients' money, provided that the product company which the agent represents has provided an indemnity in respect of clients' monies to the Commission in an acceptable form.

Category 2

Group (a) (Minimum net tangible assets of £15,000 and 3 months annual audited expenditure to be maintained as liquid capital.)

- persons who arrange deals in any investment instrument but who do not receive or control clients' money; or
- persons who arrange deals in a limited range of products (as in category 1) but who may control clients' money; or
- persons who act as share distributor or provide share registration or accounting services to collective investment schemes established in approved jurisdictions; or
- - persons who act as investment adviser to occupational pension schemes and/or collective investment schemes.

Group (b) (Minimum net tangible assets of £30,000 with 3 months annual audited expenditure to be maintained as liquid capital.)

- managers of collective investment schemes (except EIFs and PIFs), but only where the manager is administered by a licenceholder who is authorised as a category 4 business.

Category 3 Minimum net tangible assets of £50,000 for Category 3(a) and £75,000 for Category 3(b) licenceholders and 3 months annual audited expenditure to be maintained as liquid capital.

Group (a)

- investment managers and dealers who control clients' money and assets;
- managers of international collective investment schemes (except as provided in category 2 above), including managers of more than one "exempt international collective investment" scheme within the meaning of section 11(7) of the Financial Supervision Act 1988 ("the FSA");

Group (b)

- persons acting as investment manager to collective investment schemes established and operated in another jurisdiction;
- managers of authorised collective investment schemes;
- managers or administrators of EIFs and PIFs;
- investment businesses, other than those included in categories 1, 2 and 4.

Category 4 Minimum net tangible assets of £175,000 and 3 months annual audited expenditure to be maintained as liquid capital.

- licenceholders providing administrative services to managers of authorised and/or international collective investment schemes including PIFs and EIFs (except as provided for in Categories 2 and 3 above).

In addition, licenceholders are required to notify the Commission if its Financial Resources Requirements have or will fall below 110% of the minimum net tangible asset requirement

There are two separate tests of the financial resources of licenceholders - the minimum net tangible asset test and the liquid capital test. The two tests reflect two measures of the solvency of a business; that its assets should exceed its liabilities and that it should be able to meet its liabilities as they fall due.

The net tangible assets test applies to all categories of licenceholder and requires every licenceholder to commit capital resources to the business scaled broadly in line with the requirement for investment in equipment, etc. For example a sole trader life assurance brokerage will be required to have minimum net tangible assets of £5,000, whereas a licenceholder acting as a third party fund administrator will require minimum net tangible assets of £175,000.

The liquid capital test, which applies to categories 2, 3 and 4, is an expenditure-based requirement which focuses upon realisable assets available against a number of months expenditure. The intention is that each licenceholder should have enough liquid working capital to sustain its business for a number of months to provide a cushion against unexpected market shocks or disruption of business and provide time, if necessary, for an orderly reconstruction or winding down of the business.

In addition, the Commission believes that all licenceholders should carry professional indemnity insurance. The level of insurance required is dependent upon the category of business being conducted. For example, it is recommended that category 1 businesses hold professional indemnity cover of not less than £250,000 or three times total revenue, whichever is the greater, whereas the minimum level for higher categories is £500,000. This requirement recognises that licenceholders are subject to a range of different types of risk (e.g., negligence), not all of which can be reduced by a financial resource requirement.

This code contains details of how the financial resource requirements are calculated and specifies a number of adjustments. One of the most important of these adjustments is that monies owing to the licenceholder from other group companies will be excluded for the purposes of calculating the financial resource requirement, except in certain very limited circumstances. Thus, a licenceholder will be expected to "stand alone" financially from the rest of its group.

Although the financial resource requirement is a day-to-day requirement, licenceholders are required to submit financial statements to the Commission at periodic intervals, generally either half-yearly, quarterly or monthly depending upon the Category of licence.

The Commission attaches great importance to accurate and timely reporting. Late, incomplete, or inaccurate returns are never a good sign and are often a symptom of serious problems. In any case, prompt and accurate reporting is an important part of the Commission's criterion that the business shall be conducted with prudence and professional skill, which is part of the "fit and proper" test (see Section 4).

As a consequence of the importance attached to it, the Commission expects that regulatory reporting will be of high quality, accurate and timely - the responsibility for which should be in the hands of an appropriately qualified and experienced individual.

Although the financial resource requirement is a day-to-day requirement, licenceholders are required to submit financial statements to the Commission only at periodic intervals. Generally, categories 2 and 3 group (a) are required to report half-yearly, whereas categories 3 group (b) and 4 businesses are required to report quarterly. Stockbrokers (category 5) are required to report on a monthly basis in accordance with the Financial Supervision Commission (Stockbrokers) (No 2) Regulatory Code 2003. This requirement may be changed or supplemented for individual licenceholders by additional information (e.g., averages, or maximum/minimum figures) if the Commission considers such a requirement to be appropriate. For all except category 1 businesses, licenceholders are subject to specific audit requirements.

### 3.2.3 **This code should be read in conjunction with the [Financial Supervision Commission \(Clients' Money\) Regulations 1993](#) ("the Regulations") (see Appendix D1).**

Clients' Money ([Appendix C2](#))

One of the main purposes of this code and the Regulations is to provide for the protection of clients' money in the event of the insolvency of the licenceholder, i.e., to ensure that a liquidator is unable to claim clients' monies as part of the general assets of the licenceholder. Thus, a fundamental requirement is that clients' money should at all times be held in segregated and properly designated accounts on trust for the investor. The Commission requires bankers to provide confirmation that monies held in such accounts are not subject to any charge or lien, right of set-off, etc.

Additional safeguards have been included in the code for those situations where clients' money is paid into bank accounts abroad. In such circumstances, it is the responsibility of the licenceholder to ensure and demonstrate to the Commission that clients' money held in such accounts is afforded similar protection to that provided under the Commission's code and Regulations. If this cannot be done the licenceholder must warn the client in writing that his money may not be as well protected (see [Clients' Money Code 6.1 \(d\)](#)).

The other main aim of this code is to ensure that clients' monies are properly recorded, reconciled and controlled so that money belonging to one client is not utilised to meet the liabilities of either the licenceholder or another client. Special provisions are included for clients with a high volume of investment transactions and for those undertaking margined

transactions (e.g. futures).

The Commission does not require that interest earned on clients' accounts should be paid to clients but, if it is not, the Commission expects this to be clearly stated in a written agreement between the licenceholder and its client.

It is important to note that, for the purposes of this code, money held in an account in the name of the investor himself (i.e. not in the name of the licenceholder) is not clients' money, even where an individual working for the licenceholder is a signatory to the account because such money would not be at risk in the event of the liquidation of the licenceholder. However, this will be regarded as "control" of money belonging to clients, which may have implications for the categorisation of the licenceholder and related financial resource requirement. Other matters relating to such money re category 1 – 4 are addressed in the [Conduct of Business Code 5.5\(e\)](#) ([Appendix C4](#)).

### 3.2.4 Clients' Investments ([Appendix C3](#))

The principal objective of this code is to ensure that, where licenceholders have possession or control of investments belonging to others, adequate arrangements are maintained to ensure that such investments are kept safely and are properly recorded, identified, segregated and controlled so that at any time investments belonging to others are accounted for and no administrative or financial difficulties to which the licenceholder may be exposed would have adverse consequences for those clients or other persons. The code recognises that licenceholders may hold clients' title documents on a temporary basis while they are in transit to clients. In such circumstances, the code will not be applied as long as the title documents are registered in the name of the client and are forwarded to him within 2 business days.

The Code requires that a licenceholder must not recommend to a client that any other person should have custody of or should act as the registered holder of the client's investments unless that person is an "eligible custodian". An eligible custodian can be either an approved banking institution, a nominee company with no other business which acts solely in accordance with the directions or instructions of the licenceholder (in which case the nominee will be regulated through the licenceholder) or an institution providing custodial services in another territory which, in the opinion of the Commission, is adequately supervised by a regulatory body or Government agency in that territory. The licenceholder is responsible for ensuring that the custodian acknowledges in writing that the provisions of the code will be complied with by such custodians.

The Commission requires all licenceholders and any "eligible custodians" to maintain adequate insurance for non-registered securities which are in their possession at any time, against negligence, accidental loss, fire, flood, theft and employee fidelity.

The code also requires that written statements of investments held should be provided to each client normally twice a year after a complete reconciliation of clients' title documents has been carried out by the licenceholder and any "eligible custodians". In certain circumstances, the Commission is prepared to allow licenceholders to adopt a "rolling" basis of reconciliation. Before doing so, however, the Commission will require a report from the licenceholder's auditors on the adequacy of the licenceholder's system of internal controls for recording client investments.

### 3.2.5 This code describes the general principles and standard of conduct which the Commission expects licenceholders to adopt in their dealings with clients and others. Throughout the code, the distinction is drawn from time to time between the private investor (i.e. the man in the street) and the experienced or professional investor. All clients will be deemed to be private investors unless they have elected in writing not to be.

Conduct of Business ([Appendix C4](#))

The Commission considers that the private investor requires a greater level of protection than the experienced or professional investor and this is reflected in the code. Where no distinction is drawn, the Commission considers that a similar level of protection is appropriate for all types of client.

The code is self explanatory and is divided into 7 main headings:-

- i. integrity and fair dealing;
- ii. skill, care and diligence;
- iii. disclosure and information;
- iv. acting with agreement;
- v. responsible conduct;
- vi. futures, options and contracts for differences; and
- vii. documentation and records.

### 3.2.6 Audit Requirements ([Appendix C5](#))

This code requires that auditors of investment businesses (other than category 1 licenceholders) are restricted to those firms which are covered by professional indemnity insurance of not less than £10 million. The Commission also wishes to be satisfied that the firm has sufficient knowledge and expertise in this specialised area and that the partner in charge of the audit can demonstrate that he has adequate experience. The Commission also prefers the auditors of its licenceholders to have local representation in the Isle of Man.

The code lays down specific requirements for the letter of engagement between the licenceholder and its auditor. These requirements specify the rights and duties of the auditor and include a number of specific audit report requirements which are contained within the code. The code requires the auditor to make reports to the Commission in relation to the [Financial Resources Code](#), the [Clients' Money Code](#), the [Clients' Investments Code](#) and specific parts of the [Conduct of Business Code](#) and these reports play an important part in the effective enforcement of these codes.

### 3.2.7 General Requirements ([Appendix C6](#))

The overriding principle within this code is contained in paragraph 3 which states:-

"A licenceholder should co-operate in an open and honest manner with the Commission and any other regulatory body to which it is accountable and should keep them promptly informed of anything relevant to the Regulator's task."

Indeed, the Commission believes that compliance with this code is a substantive test of a licenceholder's continued fit and proper status and would not expect any licenceholder to have difficulty with it.

Dual Control ("four-eyes" control)

The code lays down several fundamental requirements, perhaps the most important of which is the requirement for the business of licenceholders within categories 2 to 4 to be conducted on a day-to-day basis by at least 2 individuals (the "four-eyes" principle). The Commission must be satisfied that the individuals proposed to fulfil the four-eyes requirement are competent and that they are people of integrity - but they must also have the maturity and strength of character to act with proper independence of mind. The Commission writes, as a matter of routine, to the individuals proposed by the licenceholder, describing its requirements and reminding them that failure to carry out their responsibility has implications for their "fit and proper" status (see [Appendix G3](#)). In order to appoint or replace an individual who forms part of the four-eyes control, the licenceholder must write to the Commission to recommend an appropriate individual. The Commission has the right to object to the person proposed.

The concept of four-eyes control seeks to prevent the day-to-day management of a licenceholder and its affairs being carried on under the influence of a dominant individual, whether that person is an owner, controller or a director.

The Commission requires, wherever possible, the persons responsible for the "4-eyes" not to be also responsible for

compliance matters.

This code also lays down certain notification requirements, some of which are, for obvious reasons, immediate ("forthwith") while others are designed to enable proper consideration and discussion to take place before a change is implemented. For example, 21 days notice must be given to the Commission prior to the appointment of any new director, manager, or secretary.

Category 1 licenceholders who are sole traders or small businesses must make arrangements to safeguard investors' interests in the event of death, illness, holidays etc. The code also lays down certain notification requirements, some of which are, for obvious reasons, immediate ("forthwith") while others are designed to enable proper consideration and discussion to take place before a change is implemented. Other paragraphs require licenceholders to obtain Commission approval before certain important changes are effected (e.g. acquisitions, mergers, etc).

Directors' responsibilities

The Commission is concerned to ensure that directors accept their responsibilities for the proper conduct and financial well-being of an Isle of Man licenceholder. Accordingly, the Commission has issued [Guidance Notes on the responsibilities and duties of directors under the laws of the Isle of Man](#)

Company Secretary

[The General Requirements Code 5](#) requires the company secretary of a licenceholder either to be properly qualified in accordance with section 19(4), paragraphs (a) to (e) of the Isle of Man Companies Act 1982 or, exceptionally, an individual who, by virtue of his knowledge and experience, is specifically approved by the Commission to act as company secretary.

Normally, the Commission would not expect the Managing Director of a licenceholder to also act as company secretary.

Compliance Officer

The Commission deems the person responsible for compliance matters (i.e. the Compliance Officer/Manager) a "manager" for the purposes of [General Requirements Code 7.2](#). Accordingly, it should be noted that the Commission must be appropriately notified of the appointment or resignation of the compliance person. The Commission also requires, wherever possible, the persons responsible for the day to day operation of the business of the licenceholder (i.e. the "4-eyes") should not be responsible for compliance matters.

Commission Approval

Other parts of the code require licenceholders to obtain Commission approval before certain important changes are effected (e.g. acquisitions, mergers, etc.).

### 3.2.8 Advertising ([Appendix C7](#))

The term "advertisement" is defined in the IBA as follows: -

***"Every form of advertising whether in a publication or by the display of notices or by means of circulars or other documents or by an exhibition of photographs or cinematograph films or by way of sound broadcasting or television (including transmission by cable)."***

This definition includes scheme particulars, prospectuses and any other offer documents.

The Commission does not require licenceholders to submit draft advertisements for approval prior to publication. However, this code lays down general principles relating to advertisements to which licenceholders should adhere.

The code is divided into two sections: -

- a. General Requirements. These are basic principles which apply to any advertisement. For example "an advertisement shall not contain a statement, promise or forecast which is untrue or misleading".
- b. Requirements relating to specific investments. These are designed to ensure that advertisements disclose adequately any special areas of risk in the investment product being advertised. In the case of advertisements inviting direct investment in futures, options and contracts for differences, a specific risk warning should be included as follows: -

"The risks of loss from investing in commodity and financial futures, foreign exchange contracts, securities and index contracts and options can be substantial".

This requirement is, of course, consistent with the Commission's requirements under the [Conduct of Business Code](#).

### 3.2.9 Stockbrokers ([Appendix C8](#))

This code is specifically for Category 5 licenceholders and covers all of the areas covered by the seven regulatory codes applicable to category 1 – 4 licenceholders ie. financial resources, clients' money, clients' investments, conduct of business, general requirements, advertising and audit requirements although the requirements may vary slightly.

## 3.3 "KNOW YOUR CUSTOMER"

Although the nature of a licenceholder's business is within the control of the Board and management, the Commission has long been aware of the risk of abuse of the Island's investment businesses by criminals. As long ago as 1985, the Commission introduced a "Know Your Customer" policy, designed to alert investment businesses to the dangers of doing business with people they did not know and of relying solely upon introductions from the marketplace. The Know Your Customer policy requires licenceholders to seek evidence of identity, to verify that identity, to enquire as to the nature of the business and activity of the customer and to monitor the activity of any doubtful accounts.

Since then, there have been numerous international initiatives to combat money laundering - the Basel Supervisors Committee introduced its Statement of Principles in December 1988; the G7 countries formed a Financial Action Task Force on money laundering in June 1989, which produced its Recommendations in April 1990; and in December 1990 the Joint Money Laundering Working Group in the UK produced its Guidance Notes for Banks and Building Societies. The Criminal Justice Act 1990, as amended, contains comprehensive provisions relating to the countering of "all-crimes" money laundering. The [Anti-Money Laundering Code](#), which came into force on 1 December 1998, applies to investment businesses and the Commission has produced [Anti-Money Laundering Guidance Notes](#) for its licenceholders.

Compliance with the Island's Anti-Money Laundering requirements is a requirement of the Commission's Conduct of Business Regulatory Code, as well as a recommendation pursuant to section 9 of the IBA.

## 3.4

### COMPLIANCE PROCEDURES

[The Financial Supervision Commission \(Conduct of Business\) Regulatory Code](#) at [paragraph 6.7](#) states: -

"Compliance

A licenceholder should establish and maintain compliance procedures in writing where appropriate with a view to ensuring that: -

- a. its officers, employees and other representatives are aware of their obligations under the [Investment Business Act 1991](#) and any licence conditions, codes or regulations and are able to comply with them; and
- b. sufficient information is recorded and retained about the conduct of the licenceholder's business and its compliance with the [Investment Business Act 1991](#) and any licence binding upon it.

Compliance procedures should be in writing where the staff of the licenceholder exceeds ten.

A licenceholder should, at least annually, carry out a review of its compliance procedures to ensure that they are effective and have been complied with."

It is important that licenceholders are able to demonstrate compliance with all regulatory codes which impact upon them. The maintenance of comprehensive procedures and compliance manuals will assist licenceholders to evidence compliance with the above code and a review of such manuals will form a key part of supervisory visits.

Category 5 licenceholders should refer to codes 202-206 of the Financial Supervision Commission (Stockbrokers) (No 2) Regulatory Code 2003.

### 3.5 SUPERVISORY AND FOCUSED VISITS

The Commission's aim in conducting a programme of Supervisory and Focused Visits on its licenceholders is to promote high standards amongst those it regulates by identifying instances where investors or indeed, the licenceholder, may be at risk or where the standards and practices required by the Regulatory Codes are not being observed.

Specifically, the Supervision programme is to: -

- Assess whether those the Commission regulates remain fit and proper persons;
- Identify potential weaknesses in controls or procedures which may cause regulatory concern;
- Identify and investigate instances where investors' interests may be at risk from any failure to comply with the regulatory requirements;
- Assist those involved in investment business in understanding and meeting the Commission's requirements.

Commission's officers normally undertake supervisory visits on licenceholders at a pre-arranged time when the licenceholder is required to demonstrate that the requirements of the regulatory codes have been met. Reviews are not intended to be a comprehensive investigation of the licenceholder's activities. Whilst the Commission's Officers may suggest certain remedial actions and provide guidance where appropriate, it remains the ultimate responsibility of the licenceholder's Board to ensure the financial well-being and efficient management of the licenceholder, including compliance with the regulatory requirements and to protect the interests of shareholders.

Officers may conduct full Supervisory Visits, which extend to all activities carried on by the licenceholder, including any non-investment business and which will be undertaken over a number of days, or Focused Visits, concentrating on a particular area or areas such as [Know Your Customer](#) or [Clients' Money](#) which may be concluded in a shorter timescale.

It should be noted that the Commission's officers are bound by the strict rules of confidentiality laid down in sections 23 and 24 of the [Financial Supervision Act 1988](#).