

Chapter 9

Financial resources requirements for an exempt CAD firm

9.1 APPLICATION

9.1.1

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- (1) This chapter applies to an *exempt CAD firm* which is:
 - (a) an *investment management firm*; or
 - (b) a *securities and futures firm*.
- (2) This chapter also applies to a *local firm*.



9.2 GENERAL REQUIREMENTS

9.2.1 **G** For an *exempt CAD firm*, the *rules* contained within this chapter replace the *rules* in respect of financial resources, financial resources requirements and nonfinancial resources related requirements contained within Chapter 3 or 5, as applicable. However, an *exempt CAD firm* must continue to comply with the requirements of Chapter 3 or 5, to the extent it is referred to Chapter 3 or 5 by a *rule* in this chapter.

9.2.2 **R** A *firm* must be able to meet its liabilities as they fall due.

9.2.3 **R** An *exempt CAD firm* that carries on any *regulated activity* other than *MiFID business* must also have and maintain at all times financial resources calculated in accordance with the chapter of *IPRU(INV)* to which the *firm* is otherwise subject (Chapters 3 or 5) at least equal to the requirements set out in the relevant chapter (except that if the only *designated investment business* an *exempt CAD firm* is carrying on in addition to *investment services and activities* is *making arrangements with a view to transactions in investments* (article 25(2) *Regulated Activities Order*) or agreeing to carry on that *regulated activity* or both, it only needs to comply with requirements set out in this chapter and not chapters 3 or 5).

Initial capital and professional indemnity insurance requirements - exempt CAD firms that are not IDD insurance intermediaries

9.2.4 **R** (1) An *exempt CAD firm* which is not an *IDD insurance intermediary* must have:

- (a) *initial capital* of EUR 50,000; or
- (b) professional indemnity insurance covering the whole territory of the *EEA* or some other comparable guarantee against liability arising from professional negligence, representing at least EUR 1,000,000 applying to each claim and in aggregate EUR 1,500,000 per year for all claims; or
- (c) a combination of *initial capital* and professional indemnity insurance in a form resulting in a level of coverage equivalent to (a) or (b).

[Note: article 31(1) of the *CRD*]

(2) If a *firm* chooses to meet the requirements of either (b) or (c) above, it must nevertheless have *initial capital* of at least £5,000.

Initial capital and professional indemnity insurance requirements - exempt CAD firms that are also IDD insurance intermediaries

- 9.2.5 **R** (1) An *exempt CAD firm* that is also an *IDD insurance intermediary* must comply with the professional indemnity insurance requirements at least equal to those set out in ■ IPRU-INV 9.2.4R(1)(b) (except that the minimum *limits of indemnity* are at least EUR 1,250,000 for a single claim and EUR 1,850,000 in aggregate) and in addition has to have:
- (a) *initial capital* of EUR 25,000; or
 - (b) professional indemnity insurance covering the whole territory of the *EEA* or some other comparable guarantee against liability arising from professional negligence, representing at least EUR 500,000 applying to each claim and in aggregate EUR 750,000 per year for all claims; or
 - (c) a combination of *initial capital* and professional indemnity insurance in a form resulting in a level of coverage equivalent to (a) or (b).
- [Note: article 31(2) of the *CRD* and articles 10(4) and 10(5) of the *IDD*]
- (2) If a *firm* chooses to meet the requirements of either (b) or (c) above, it must nevertheless have *initial capital* of at least £5,000.

9.2.5A **G** Article 10(7) of the *IDD* requires *EIOPA* to review the *limits of indemnity* every five years to take into account changes in the European index of consumer prices and to develop draft regulatory technical standards to adapt the base amount in euro by the percentage change in that index. Therefore, the *limits of indemnity* will be subject to further adjustments that will apply to *firms* in accordance with the regulatory technical standards adopted under article 10(7) of the *IDD*.

[Note: The regulatory technical standards adopted under article 10(7) of the *IDD* will be available on *EIOPA's* website at: <https://eiopa.europa.eu/>]

9.2.6 **G** A trade-off between *initial capital* and professional indemnity insurance is appropriate such that EUR 1 of *initial capital* is the equivalent of professional indemnity insurance cover of EUR 20 for a single claim against the *firm* and EUR 30 in aggregate.

Comparable guarantee

- 9.2.7 **R**
- (a) If another *authorised person* which has net tangible assets of more than £10 million provides a comparable guarantee, an *exempt CAD firm* can treat it as an alternative to effecting or maintaining professional indemnity insurance pursuant to the rules relating to professional indemnity insurance above.
 - (b) If the *exempt CAD firm* is a member of a *group* in which there is an *authorised person* with net tangible assets of more than £10 million, the comparable guarantee must be from that *person*.
 - (c) A comparable guarantee means a written agreement on terms at least equal to those required by the *initial capital* and professional indemnity insurance requirements above to finance the claims that might arise as a result of the breach by the *exempt CAD firm* of its duties under the *regulatory system* or civil law.

Initial capital and ongoing capital requirements for local firms

9.2.8

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A *local firm* must:

- (a) have *initial capital* of EUR 50,000; and

[Note: article 30 of the *CRD*]

- (b) maintain *own funds* calculated in accordance with the *rules* relating to *own funds* in 9.5, at least to the requirement for *initial capital*.

Ongoing capital requirements

9.2.9

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- (1) An *exempt CAD firm* must, at all times, maintain a combination of professional indemnity insurance and *own funds*, (*own funds* to be calculated in accordance with (2)), at least equal to the requirements in this chapter for professional indemnity insurance and *initial capital*.

- (2) (a) If the *exempt CAD firm* is an *investment management firm* its *own funds* must be calculated in accordance with the *rules* in ■ IPRU-INV 5.2 to ■ 5.7.

- (b) If the *exempt CAD firm* is a *securities and futures firm* its *own funds* must be calculated in accordance with the *rules* relating to *own funds* in 9.5.

9.3 CALCULATING INITIAL CAPITAL

Initial capital

9.3.1

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A firm's *initial capital* consists of the sum of the following items:

- (1) ordinary *share* capital which is fully paid;
- (2) perpetual non-cumulative *preference share* capital which is fully paid;
- (3) *share* premium account;
- (4) reserves excluding revaluation reserves;
- (5) audited retained earnings;
- (6) externally *verified* interim net profits;
- (7) partners' capital;
- (8) *eligible LLP members' capital* (in accordance with the provisions of ■ IPRU-INV Annex A); and
- (9) *sole trader* capital.

Perpetual noncumulative preference share capital

9.3.2

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A firm may include *preference share* capital in *initial capital* only where any *coupon* on it is not cumulative, and the *firm* is under no obligation to pay a *coupon* in any circumstances.

Audited retained earnings

9.3.3

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When calculating *initial capital*, a *firm* may include its audited retained earnings only after making the following adjustments:

- (1) a *firm* must not recognise the fair value reserves related to gains or losses on cash flow hedges of financial instruments measured at amortised cost;
- (2) in respect of a *defined benefit occupational pension scheme*, a *firm* must derecognise any *defined benefit asset*;
- (3) a *firm* must not include any unrealised gains from investment property (these should be reported as part of revaluation reserves);

- (4) where applicable, a *firm* must deduct any asset in respect of *deferred acquisition costs* and add back in any liability in respect of deferred income (but excluding from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.

Externally verified interim net profits or current account

9.3.4 **R** A *firm* may include interim net profits or current account when calculating *initial capital* to the extent that they have been *verified* by the *firm's* external auditor and are net of any foreseeable tax, dividend and other appropriations.

9.3.5 **R** When calculating *initial capital*, a *firm* may include its partners' capital only after making the following adjustments:

- (1) a *firm* must not recognise the fair value reserves related to gains or losses on cash flow hedges of financial instruments measured at amortised cost;
- (2) in respect of a *defined benefit occupational pension scheme*, a *firm* must derecognise any *defined benefit asset*;
- (3) where applicable, a *firm* must deduct any asset in respect of *deferred acquisition costs* and add back in any liability in respect of deferred income (but excluding from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.

Defined benefit pension scheme: defined benefit liability

9.3.6 **R** For the calculation of *initial capital*, a *firm* may substitute for a *defined benefit liability* the *firm's deficit reduction amount*. The election must be applied consistently in respect of any one financial year.

9.3.7 **G** A *firm* should keep a record of and be ready to explain to its supervisory contacts in the *FCA* the reasons for any difference between the *deficit reduction amount* and any commitment the *firm* has made in any public document to provide funding in respect of a *defined benefit occupational pension scheme*.

9.4 POLICY TERMS FOR PROFESSIONAL INDEMNITY INSURANCE

Insurers whose professional indemnity insurance policies can be used by an exempt CAD firm

9.4.1

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An *exempt CAD firm* that has professional indemnity insurance in accordance with this chapter must take out and maintain professional indemnity insurance that is at least equal to the requirements of the rule below from:

- (1) an *insurance undertaking* which is authorised to transact professional indemnity insurance in the *EEA*; or
- (2) a person of equivalent status in:
 - (a) a *Zone A country*;
 - (b) the Channel Islands, Gibraltar, Bermuda or the Isle of Man.

Terms to be incorporated in the professional indemnity insurance policy

9.4.2

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The policy of professional indemnity insurance must incorporate terms which make provision for:

- (1) cover in respect of claims for which an *exempt CAD firm* may be liable as a result of the conduct of itself, its *employees* and its *appointed representatives* or where applicable, its *tied agent* (acting within the scope of their appointment);
- (2) the minimum *levels of indemnity* per year as set out in the rules relating to professional indemnity insurance above;
- (3) appropriate cover in respect of legal defence costs; and
- (4) cover in respect of *Ombudsman* awards made against the *exempt CAD firm*.

Policies in other currencies

9.4.3

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If a professional indemnity insurance policy is denominated in any currency other than euros, an *exempt CAD firm* must take reasonable *FCA* steps to ensure that the *limits of indemnity* are, when the policy is effected and at *renewal*, at least equivalent to those required for the purposes of the rules relating to professional indemnity insurance above.

Conditions and exclusions

9.4.4

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A professional indemnity insurance policy must not be subject to conditions or exclusions which unreasonably limit the cover provided (whether by exclusion of cover, by policy excesses or otherwise).



9.5 CALCULATION OF OWN FUNDS

9.5.1 **R** *A firm's initial capital:*
minus the sum of the items set out against **B**
plus the sum of the items set out against **C**
minus *material holdings in credit and financial institutions and material insurance holdings*
 equals *own funds*.

9.5.2 **R** Table
 The table forms part of *rule 9.5.1R*

(1)	<i>Investments in own shares at book value</i>	B
(2)	<i>Intangible assets</i>	
(3)	<i>Material current year losses</i>	
(1)	Revaluation reserves	C
(2)	Perpetual cumulative preference <i>share</i> capital	
(3)	Long-term subordinated loans	
(4)	Perpetual long-term subordinated loans	
(5)	Fixed term preference <i>share</i> capital	

9.5.3 **R** **Perpetual long-term subordinated loans and perpetual cumulative preference share capital**

 Perpetual long-term subordinated loans and perpetual cumulative preference *share* capital may not be included in the calculation of *own funds* unless they meet the following requirements:

- (1) it may not be reimbursed on the holder's initiative or without the prior agreement of the *FCA*;
- (2) the instrument must provide for the *firm* to have the option of deferring the dividend payment on the *share* capital;
- (3) the shareholder's claims on the *firm* must be wholly subordinated to those of all non-subordinated creditors;

- (4) the terms of the instrument must provide for the loss-absorption capacity of the share capital and unpaid dividends, whilst enabling the *firm* to continue its business; and
- (5) it must be fully paid-up.

Subordinated loans

9.5.4 **R** A *firm* may include a subordinated loan in the calculation of its *own funds* only:

- (a) if it is drawn up in accordance with the standard forms obtained from the *FCA*;
- (b) if it is signed by authorised signatories of all the parties; and
- (c) to the extent that it is fully paid up.

Long-term subordinated loans

9.5.5 **R** A long-term subordinated loan may not be included in the calculation of *own funds* unless it meets the following requirements:

- (1) it must be fully paid-up;
- (2) it has an original maturity of at least five years;
- (3) the extent to which it may be used in the calculation of *own funds* shall be amortised on a straight line basis during at least the five years before repayment; and
- (4) it must not become repayable before the agreed repayment date other than in the winding-up of the *firm* or unless the *firm* has provided the *FCA* with at least five years' written notice.

9.5.6 **R** A *firm* must not (except in accordance with the terms of the loan) make any payment of interest if after such action the *firm's own funds* will fall below 120% of its *own funds requirement*.

Perpetual noncumulative and cumulative preference share capital

9.5.7 **R** A *firm* may include perpetual non-cumulative and cumulative preference share capital in its *initial capital* and its *own funds* only if there is an agreement between the *firm* and the shareholders which provides that redemption of the shares may not take place, if after such redemption the *firm* would be in breach of its *own funds requirement*

Own funds - Restrictions

9.5.8 **R** (1) In calculating *own funds*:

- (i) the total amount of revaluation reserves, perpetual cumulative preference *share capital*, long-term subordinated loans, perpetual

- long-term subordinated loans and fixed term preference *share* capital must not exceed 100% of *initial capital* minus B; and
- (ii) the total amount of fixed term preference *share* capital and long-term subordinated loans must not exceed 50% of *initial capital* minus B.

9.6 NON-FINANCIAL RESOURCE REQUIREMENTS

Reconciliation of balances

9.6.1

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- (1) A *firm* must reconcile all balances and positions with:
- (i) *banks and building societies* (other than a client bank account subject to the *client money rules*), *exchanges, approved exchanges, clearing houses and intermediate brokers*; and
 - (ii) *eligible counterparties* which are *members* of an exchange or approved exchange

as recorded by the *firm* to the balance or position on a statement or circularisation obtained by the *firm* from those entities and must correct any differences by agreement on a timely basis, unless:

- (i) the balances and positions due to and from the *eligible counterparties* have been agreed by other means; or
 - (ii) it arises solely as a result of identified differences in timing between the records of the *firm* and the *bank or building society*.
- (2) A *firm* must perform reconciliations under (1) above as frequently as is appropriate for the volume of transactions on the accounts and in any event not less than once every five weeks or, in relation to positions with *eligible counterparties*, not less than once every year.
- (3) A *firm* must circularise or request statements from *banks, building societies, exchanges, approved exchanges, clearing houses, intermediate brokers and eligible counterparties* which are members of an *exchange or an approved exchange* in good time in order to be able to comply with (1) and (2) above.
- (4) A *firm* must use its best endeavours to respond within one month of receipt to any circularisation from another *firm* requesting confirmation of outstanding balances.

9.6.2

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For *guidance* notes on the reconciliation of a *firm's* balance with market counterparties see Appendix 20 to Chapter 3.

Financial notification

9.6.3

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A *firm* must notify the *FCA* in writing as soon as it has reason to believe that it is in breach of its *own funds requirement*.

