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FSA/FSCS OPEN LETTER – FSCS INTERIM LEVY – TARIFF ISSUES

FSCS Interim Levy: implications for firms

1. We have received a large number of queries relating to the recent interim levy announced by the FSCS, particularly in respect of the tariff measures used for allocating the levy for, and between, firms. We thought it helpful to set out a number of points to assist you and your members who will be understandably concerned about the impact of the levy. Below we summarise the background to the interim levy and provide information about tariff data and the relevant considerations for firms wishing to resubmit the data.

Background

2. To maintain confidence in the financial services industry and the products and services it provides, it is important that consumers are protected from loss when a financial services business fails. The FSCS acts as a safety net providing compensation in the event an authorised firm is unable, or likely to be unable, to pay claims against it.

3. The FSCS operates within a set of clear rules. The rules under which the FSCS operates are made by the FSA, after full consultation with the industry. The FSCS is operationally independent from the FSA, including for decisions related to the payment of compensation and raising of levies. The FSA acts as agent for the FSCS in raising those levies, as it is administratively more convenient and efficient.

4. Generally, the FSCS will only pay compensation where it is satisfied that a failed firm owed a liability to the claimant. On 24 January 2011, the FSCS raised an interim levy of £326m in respect of the failure of firms in the Investment Intermediation sub-class, most notably relating to claims in respect of Keydata/Lifemark products. Keydata was in default under the FSCS rules in June 2009. This levy is payable by firms in the Investment Intermediation (SD02) and Investment Fund Management (SD01) sub-classes.

5. Investment intermediaries can be levied up to £100 million annually for compensation costs. As part of the cross-subsidy arrangements investment fund managers have been required to fund further claims to the value of £233 million.

6. In the case of Keydata/Lifemark, the FSCS concluded that the marketing materials produced by Keydata to promote the Lifemark products did not comply with the Financial Services Authority's rules. The FSCS determined, as announced at the end of November, that for the purposes of compensation, these investments have no value in the hands of the investors. The FSCS now has a duty to promptly compensate eligible investors.

Funding the interim levy

7. The FSCS raised a levy totalling £326 million on 24 January 2011. Under the FEES Rules, firms should have paid this to the FSCS in full by 23 February 2011.

8. To meet its compensation costs, the FSCS raises levies from the industry on a "pay as you go" basis. Generally it raises an annual levy, based on an estimate of the amount it will need in order to compensate eligible claimants during the next 12 months. This approach means that the FSCS does not draw down money from the industry which it does not expect to pay out. But it can mean, as in this case, that it needs to raise significant levies at relatively short notice in the event of high claims amounts or levels which were not forecast during the annual levy raising exercise.

9. The claims for which the interim levy was raised are attributable to the activities covered by the Investment Intermediation sub-class. The allocation to SD02 was recently confirmed by the court in the judicial review brought against the FSCS by a number of intermediary firms. As noted, this sub-class can be levied up to £100 million annually in compensation costs. The FSCS had previously raised £14 million in compensation costs and so the Investment Intermediation sub-class will pay a further £86 million of the interim levy in compensation costs, plus a further £7 million in specific management costs which relate to the operations of the FSCS.

10. Under the FSA's FEES rules, once a sub-class reaches its annual compensation threshold, the connected sub-class in the broad class is required to contribute to any further compensation costs (again up to an annual limit). This happened with the interim levy. As the Investment Intermediation sub-class reached its annual compensation threshold, the Investment Fund Management sub-class has been levied to contribute the remaining £233 million in compensation costs for the year. The maximum annual compensation threshold for the Investment Fund Management sub-class is £270 million.

11. The FSA has facilitated an instalment arrangement with Premium Credit Ltd (PCL) in order to provide an option to firms that do not wish or are unable to pay the whole levy in one lump sum. This arrangement with PCL has been in place for a number of years and is available each year for FSA fees and FSCS levies, as well as this interim levy. PCL take monthly instalments from firms at a competitive rate of interest. A monthly payment facility agreement form was sent out with the invoice, alternatively a copy can be obtained direct from Premium Credit at http://www.premium-credit.co.uk/FSA.html or by calling: 0844 736 9818.

How are the levies allocated?

12. Once a levy is raised, the FSA FEES rules outline how that will be divided between each member of the relevant sub-class. The tariff measure for the Investment Fund Management and Investment Intermediation sub-classes is "*annual eligible income*". At the option of the firm, annual eligible income is income relating to activities falling within the Investment Fund Management or Investment Intermediation sub-class (as appropriate) in respect of compensatable business with or for the benefit of eligible claimants[1] or all income relating to activities falling within the Investment Fund Management or Investment Intermediation sub-class (as appropriate). Please see Annex 1 for the full Handbook definition of annual eligible income.

13. For the annual and interim levy, firms have been levied on the basis of the income figure that they reported to the FSA at year end for levies in the 2010/11 levy period[2]. The total industry aggregate data used to calculate the interim levy in January this year for the Investment Fund Management sub-class amounted to £6,065 million and the Investment Intermediation sub-class was £3,701 million.

14. This aggregate total amount for the Investment Intermediation sub-class has reduced since the annual levy was raised in June/July 2010. This is a result of firms either: amending their tariff data for the relevant period (as they have a right to apply to do under FSA rules); firms going out of business; or the validation exercise the FSA undertook of certain firms data prior to the invoices being raised in June/July 2010.

15. Annex 2 shows a typical calculation for both the Investment Fund Management and Investment Intermediation sub-classes.

Can firms resubmit their tariff data?

16. We have received a number of requests from firms to resubmit the tariff data they submitted to the FSA. Any changes accepted to the aggregate total income figure, due to firms resubmitting tariff data, will need to be reflected in the allocation of the interim levy amount.

17. Even if firms have submitted such request, we reiterate that all firms with interim levy invoices, in Investment Fund Management (SD01) and Investment Intermediation (SD02) sub-classes, should make payment in accordance with the FEES rules and the invoice terms i.e. within 30 days. For most firms this means payment was due on 23 February **irrespective of any request to revise tariff data**.

18. However, under FSA rules, firms may apply to amend their tariff data (under the relieving provisions in FEES 2.3) up to 2 years after submission of the original data. In so doing, firms must be able to satisfy the criteria included in the rules, which allow for the FSCS to agree to remit or refund a levy where in the exceptional circumstances of a specific case the FSCS considers that payment of the levy would be inequitable. A poor estimate by the levy payer, when providing the tariff data, is unlikely, of itself, to amount to an exceptional circumstance. By contrast, a mistake of fact or law may give rise to such a claim.

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[1] Someone who is eligible to bring a claim for compensation under the FSA rules in the Compensation sourcebook.

[2] For the year end preceding 31 December 2009. For a firm with a 31 March year-end, this would be 31 March 2009. For a firm with a 31 December year-end, this would be 31 December 2009.

19. For those firms who choose to resubmit their tariff data, the FSCS, in conjunction with the FSA, will consider all such requests under the FEES Rules. To ensure consistent treatment of all firms, it is proposed that all such requests to resubmit data will be considered at about the same time. As it may take some time before all such requests are received we cannot say when this process will be completed, and plan to handle all requests received by 31 March 2011 in the first (and maybe only) batch. For the avoidance of doubt, this date is for administrative purposes; it is not an extension of time to resubmit data.

20. If firms decide to resubmit their tariff data then they should contact the FSA who will receive the resubmission on behalf of the FSCS. The resubmission must be in a letter from the firm's chief executive officer (or equivalent) and provide:

    a. an explanation why the firm wishes to resubmit its tariff data;

    b. an explanation how any error in the previous data occurred/why the data was incorrect;

    c. what the revised data now amounts to; and

    d. an assurance that systems and controls are in place to ensure data will be reported correctly and consistently in future.

21. Firms should include any other information that they consider may be relevant to the request at the same time.

22. Working with the FSA, the FSCS will consider and make a decision on each case. If a request to resubmit data is approved, the firm's share of the levy will be recalculated and a credit note (or additional invoice) issued. Where the firm has a credit balance a refund may be made, or the amount set against future levies.

How do firms calculate their tariff base?

23. We have received a number of queries as to what firms should consider if they decide to review their tariff data. The table overleaf outlines the tariff data applicable in the 2008/09, 2009/10 and current tariff measures. Firms can locate the definitions underlying previous years' tariff measures via the FSA Handbook, changing the year as appropriate (http://fsahandbook.info/FSA/html/handbook/FEES/6).

Sub-class	2008/09 tariff data	2009/10 tariff data	2010/11 tariff data
Investment Fund Management	Gross income	Net income	Annual eligible income
Investment Intermediation	Approved Persons and split of business (as a percentage) between life & pensions and investment business and number of traders (principal dealers only)	Approved Persons and split of business (as a percentage) between life & pensions and investment business and number of traders (principal dealers only)	Annual eligible income

24. When considering the definition of annual eligible income firms should refer to FEES 6 Annex 3R. Firms should also consider the guidance we have included in FEES 6 Annex 4R. This includes guidance as to what should or should not be considered as income for each of the sub-classes. Please see Annex 1 for a transcript of the relevant current rules.

25. As noted, firms can choose to include only business relating to eligible claimants. The conditions for eligibility for FSCS compensation are in the Compensation Sourcebook at COMP 4.2.1R and COMP 4.2.2R. A firm reporting income relating to eligible claimants only will need to be able to identify eligible and ineligible claimants, and must take care not to omit any eligible claimants.

26. Annex 3 includes the answers to some common questions we have received. Firms should note that this is not definitive and if in doubt should take legal advice.

Next steps

27. All firms with interim levy invoices, in Investment Fund Management (SD01) and Investment Intermediation (SD02) sub-classes, must make payment in accordance with the FEES Rules and the invoice terms (i.e. within 30 days). For most firms this means payment was due on 23 February, irrespective of any actual or intended request to revise tariff data.

28. If firms have further queries on the tariff measures, they can call the FSA customer contact centre on 0845 606 9966.

I hope this letter is of assistance.

Yours sincerely

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ANNEX 1: FSA HANDBOOK DEFINITION AND RULES

Annual eligible income:

"(in *FEES*) (in relation to a *firm* and a *sub-class*) the annual income (as described in FEES 6 Annex 3 R) for the *firm's* last financial year ended in the year to 31 December preceding the date for submission of the information under, FEES 6.5.13 R, attributable to that *sub-class*. A *firm* must calculate *annual eligible income* from such annual income in one of the following ways:

(a) only include such annual income if it is attributable to business conducted with or for the benefit of *eligible claimants* and is otherwise attributable to compensatable business; or

(b) include all such annual income."

FEES 6 Annex 3R:

- "Sub-class D1: *annual eligible income* where *annual eligible income* means annual income adjusted in accordance with this table. Annual income is equal to the net amount retained by the *firm* of all income due to the *firm* in respect of or in relation to activities falling within *sub-class* D1."

- "Sub-class D2: *annual eligible income* where *annual eligible income* means annual income adjusted in accordance with this table. Annual income is equal to the net amount retained by the *firm* of all income due to the *firm* in respect of or in relation to activities falling within *sub-class* D2."

- Notes on *annual eligible income* for *sub-classes* D1 and D2:

    (1) For the purposes of calculating annual income, net amount retained means all the commission, fees, etc. in respect of activities falling within *sub-class* D1 or D2, as the case may be, that the *firm* has not rebated to customers or passed on to other *firms* (for example, where there is a commission chain). Items such as general business expenses (for example employees' salaries and overheads) must not be deducted.

    (2) The calculation is adjusted in accordance with the definition of *annual eligible income*.

    (3) Box management profits are excluded from the calculation of annual income.

FEES 6 Annex 4R applicable to the Investment Fund Management or Investment Intermediation sub-classes

Calculation of annual eligible income for firms in sub-class D1 who carry out discretionary fund management and are in FSA fee block A7

1.1 G The tariff base for *sub-class* D1 is calculated by taking gross income falling into *sub-class* D1 and then deducting commission, fees and similar amounts rebated to customers or passed on to other *firms* (for example, where there is a commission chain). Items such as general business expenses (for example employees' salaries and overheads) should not be deducted. The calculation should be further adjusted so as to exclude income that is not attributable to business conducted with or for the benefit of *eligible claimants*, unless the *firm* chooses to include such income.

1.1 G Gross income for the activity of *managing investments* is the sum of the following:

(1) the amount of the annual charge on all assets in portfolios which the *firm* manages on a discretionary basis received or receivable in the latest accounting period (this is calculated as a percentage of funds invested, typically 1% p.a.); plus

(2) the front-end or exit charge levied on sales or redemptions of assets in portfolios which the *firm* manages on a discretionary basis (typically 4-5% of sales/redemptions) in that same accounting period; plus

(3) the amount of performance management fees from the management of assets in portfolios which the *firm* manages on a discretionary basis received or receivable in that same accounting period; plus

(4) any other income directly attributable to the management of assets in portfolios which the *firm* manages on a discretionary basis in that same accounting period, including commission and interest received.

1.2 G *Annual eligible income* should exclude

[2] income received or receivable from assets managed on a non-discretionary basis, being assets that the *firm* has a contractual duty to keep under continuous review but in respect of which prior specific consent of the client must be obtained for proposed transactions, as this activity is covered in *sub-class* D2 (the investment intermediation *sub-class*).

1.3 G A *firm* should make appropriate arrangements to ensure that income is not double counted in relation to the activities it undertakes (for example, where it operates and manages a *personal pension scheme* or *collective investment scheme*).

Calculation of annual eligible income for firms in sub-class D1 and who carry out activities within FSA fee block A9

2.1 G The calculation of income in respect of activities falling into *sub-class* D1 and *FSA* fee block A9 should be based on the tariff base provisions for that fee block (in Part 2 of FEES 4 Annex 1 R). It should be adjusted so as to exclude income that is not attributable to business conducted with or for the benefit of *eligible claimants*, unless the *firm* chooses to include such income.

[2]2.2 G Although the calculation should be based on the one for fee block A9, the calculation is not the same. *FSA* fee block A9 is based on gross income. *Sub-class* D1 is based on net income retained.

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	Difficulties in calculating annual eligible income	
4.1	G	The purpose of Note 2 in the section of notes at the end of FEES 6 Annex 3 R (Financial Services Compensation Scheme - classes and sub-classes) is to deal with the practical difficulties of allocating income correctly between different *sub-classes* and in deciding whether income falls outside FEES 6 Annex 3 R altogether. Note 2 requires a *firm* to carry out the necessary apportionment on a reasonable and consistent basis.
4.2	G	The following provides some *guidance* as to how *firms* may approach the allocation of *annual eligible income*.
4.3	G	Where a *firm* cannot separate its income on the basis of activities, such as a fund manager which acts on a discretionary and non-discretionary basis for the same *client* and who only sends out a single invoice, the *firm* may apportion the income in another way. For instance, a *firm* may calculate that the business it undertook for a *client* was split 90% on a discretionary basis and 10% on a non-discretionary basis calculated by reference to funds under management. The *firm* may split the income accordingly.
4.4	G	A *firm* may allocate trail or renewable commission on the basis of the type of *firm* it receives it from. For instance, if it comes from a life provider the *firm* may consider it as life and pensions mediation income. If it comes from a fund manager the *firm* may treat it as investment mediation income.
4.5	G	If a *firm* receives *annual eligible income* from a platform based business it may report *annual eligible income* in line with the proportionate split of business that the *firm* otherwise undertakes. For instance, if a *firm* receives 70% of its other commission from life and pensions mediation business and 30% from investment mediation business, then it may divide what it receives in relation to the platform business on the same basis.
4.6	G	Unless a *firm* chooses to include all relevant annual income, *annual eligible income* excludes business that is not compensatable under the *compensation scheme*. This can create difficulties because, for example, a *person* may move between being and not being an *eligible claimant* over time. The purpose of Note 3 in the section of notes at the end of FEES 6 Annex 3 R is to deal with that difficulty by fixing a date for deciding this.

ANNEX 2: ILLUSTRATIVE CALCULATIONS OF THE DISTRIBUTION OF THE LEVY

Investment Intermediation sub-class

The total levy will be around £93m. This should be divided by the total annual eligible income for all participant firms in the sub-class (£3,701m) and this should then be multiplied by the firm's own annual eligible income for this sub-class (as shown on their 2010/11 regulatory fees and levies invoice).

Example

Firm A reported £27,500 annual eligible income for sub-class SD02.

93,000,000 divided by 3,701,000,000 multiplied by 27,500 = approx £691 levy to pay.

Investment Fund Management sub-class

The total levy will be around £233m. This should be divided by the total annual eligible income for all participant firms in the Investment Fund Management sub-class (£6,065m) and this should then be multiplied by the firm's own annual eligible income for this sub-class (as shown on their 2010/11 regulatory fees and levies invoice).

Example

Firm B reported £755,000 annual eligible income for sub-class SD01.

233,000,000 divided by 6,065,000,000 multiplied by 755,000 = approx £29,005.

ANNEX 3: ANSWERS TO COMMON QUESTIONS ASKED IN RELATION TO FSCS TARIFF MEASURE ANNUAL ELIGIBLE INCOME

Firms should note that this is not definitive. If in doubt they should take legal advice.

When considering the definition of annual eligible income firms should refer to FEES 6 Annex 3R. Firms should also consider the guidance we have included in FEES 6 Annex 4R. This includes guidance as to what should or should not be considered as income for each of the sub-classes.

The conditions for eligibility for FSCS compensation are in the Compensation Sourcebook at COMP 4.2.1R and COMP 4.2.2R. A firm reporting income relating to eligible claimants only will need to be able to identify eligible and ineligible claimants.

Question	FSA Response
1. How far do you have to look through funds/investments?	Annual eligible income relating to eligible claimants (AEI) is based on income generated from business that is: ▪ conducted with or for the benefit of eligible claimants; and ▪ compensatable. The exclusions to who is an eligible claimant are set out in COMP 4.2.2R. In certain circumstances the FSCS may look through to the underlying claimant to decide upon eligibility as in COMP 12.6.
2. Can you clarify the treatment where funds are held on by nominees on behalf of a firm's clients?	Where a 'nominee company' may have a claim on the FSCS, FSCS must look through the nominee and treat the beneficiaries as having the underlying claim (COMP 12.6.2R). This means that it is the beneficiary, not the 'nominee company', who must be an eligible claimant. The income from business conducted using nominees could, therefore, count towards AEI.
3. Can you clarify the treatment where assets are held on a platform?	Again this will depend on the details of the case, but key to the consideration is the nature of the platform. If it exists as a firm, excluded under COMP 4.2.2R then there may be no eligible claim and no AEI. If, however, there is a potential eligible claim against the firm, income will count towards AEI.
4. What about clients of Private Equity Firms? Are such clients eligible to claim if they are individuals?	We would require more detail of the particular case under consideration. However, generally, the same consideration of FSA authorisation and the possibility of an eligible claim apply.

Question	FSA Response
5. Is a charity an eligible consumer?	Whether a charity is covered will depend on how it is constituted. There is no requirement for charities to be established by way of a particular structure or form. According to section 1 of the Charities Act 2006, a 'charity' is simply an institution established for charitable purposes only, which is subject to the control of the High Court in the exercise of its jurisdiction with respect to charities. There are as many permutations of charitable structures as there are types of legal personality. As charities are not specifically provided for in the eligibility rules of the COMP Sourcebook, their eligibility will be determined by their structure and legal personality. For example, a charity can be constituted as a limited company, or an unincorporated association. In those circumstances, the eligibility test would be as follows: A limited company would be treated as having a claim, and hence protection in its own right up to the compensation limit if it fell within the definition of a 'small company'. A company qualifies as a 'small company' under the provisions of section 247 of the Companies Act 1985 (which still applies to any company whose financial year commences before 6 April 2008) if it fulfils two of the following three criteria: ▪ it has a turnover of not more than £5.6 million; ▪ it has a balance sheet total of not more than £2.8 million; and ▪ it has not more than 50 employees. Similarly, a company qualifies as a 'small company' under the provisions of section 382 of the Companies Act 2006 if it fulfils two of the following three criteria: ▪ it has a turnover of not more than £6.5 million; ▪ it has a balance sheet total of not more than £3.26 million; and ▪ it has not more than 50 employees. If the charity is an unincorporated association, it will be entitled to claim up to the compensation limit, unless it falls into the category of a 'large mutual association' (see COMP 4.2.2(13)) - the test which applies is that it must have less than £1.4 million in net assets.
6. What about SIPPs/Pensions held in a nominee name?	This will depend on the details of the case, but COMP 12.6.2AR provides for look through in the case of pension schemes. Again if compensation can look through to an eligible client, the income will count as AEI.