EXPLANATORY MEMORANDUM TO

THE FINANCIAL SERVICES AND MARKETS ACT 2000 (REGULATED ACTIVITIES) (AMENDMENT) ORDER 2006

2006 No. 1969

1. This explanatory memorandum has been prepared by Her Majesty's Treasury and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 Government is proposing to amend through Parliamentary procedures the Financial Services and Markets Act 2000 (FSMA) Regulated Activities Order 2001 (RAO) to introduce a new regulated activity related to personal pension schemes from April 2007. The amendments will come into force early (1 October 2006) for purposes of applications only. This so that firms may apply to the Financial Services Authority (FSA) for permissions and these permissions can be determined by the FSA before the activity becomes a regulated activity in April 2007.

3. Matters of Special Interest to the Joint Committee on Statutory Instruments

3.1 Government is proposing an amendment to the Finance Act 2004 so that any person with permission to carry on this new activity is eligible to establish a tax-privileged pension scheme from 6 April 2007. This amendment will be made by the Finance Bill 2007

4. Legislative Background

4.1 In this instrument Government is proposing to make an amendments to the of the Financial Service Markets Act 2000 Regulated Activities Order (2001) (S.I. 2001/544) (RAO). This will introduce from April 6 2007 a new FSA regulated activity of 'establishing, operating or winding up a personal pension scheme' and the consequential arrangements of 'dealing in, arranging and advising on rights under such schemes.' This instrument follows the affirmative procedure.[1] Article 2 contains the amendments to the RAO.

4.2 In order to ease transition for business into the new regime firms which already have permission to carry on the regulated activity of establishing etc a stakeholder pension scheme will be deemed to have the equivalent permission in relation to the new activity. This is the effect of the transitional provision at article 3. (This follows he precedent in S.I. 2004/2737 where a similar transitional provision was made in relation to firms with permission to carry on the activity of providing full advice were deemed to have permission to carry on the activity of providing basic advice.)

4.3 Also to ensure that firms presently running personal pension schemes can keep on running the schemes whilst their applications are pending the Order provides for interim permissions and interim approvals to be granted. These provisions can be found at articles 4 and 5. To allow FSA rules, guidance and codes of practice to be

[1] Taking into account responses to their April 2006 consultation, the FSA will then make rules for the new activity by the start of October 2006 when doors open to receive applications.

tailored to firms with interim permission or approval articles 6 and 7 and the Schedule to the Order provide the necessary flexibility. (This follows the precedent in S.I. 2004/2615 relating to mortgage intermediary activities).

4.4 Articles 8 to 12 of the present order make the necessary consequential amendments to secondary legislation.

5. Extent

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1.1 The Economic Secretary to the Treasury has made the following statement under section 19(1)(a) of the Human Rights Act 1998:

> *'In my view the provisions of the Financial Services and Markets Act (Regulated Activities) (amendment) Order 2006 are compatible with the Convention rights.'*

7. Impact

7.1 A final Regulatory Impact Assessment (RIA) available on the HMT website has been prepared for this instrument. There will be limited impact on existing personal pension providers. New firms becoming registered for the first time will have to pay FSA fees. The industry support given to the new activity and limited comments on the RIA aligned with Government's view that the benefits of greater competition, consumer protection and transparency justified the change.

8. Policy Background

8.1 The main focus of this policy is consumer protection and deregulation. These will go hand in hand. At present to establish a tax-privileged 'registered' (ie, non-occupational) pension scheme an 'eligible' person must be on a permitted HMRC list. Following consultation, stakeholders overwhelmingly agreed with Government that this list is restrictive and limited potential competition, choice and innovation in the personal pensions market. From 6 April 2007 any persons (not just those on a selected list) wishing to be 'eligible' to offer a tax-privileged pension scheme can do this by seeking FSA approval to be registered for this new activity related to personal pensions. Many existing 'ineligible' providers who are currently forced to operate through third parties will now be able to access the personal pensions market directly (if they so wish).

8.2 The new activity will close gaps in FSA's consumer protection - for example by covering personal pensions schemes investing in hitherto unregulated assets such as commercial property. (Note the investments themselves would not be brought within the scope of FSA regulation.)

9. Contact

9.1 John McDonagh at the HM Treasury Tel: 020 7270 5688 or e-mail: mailto:john.mcdonagh@hm-treasury.x.gsi.gov.uk can answer any queries regarding the instrument.

FULL REGULATORY IMPACT ASSESSMENT

1. Title of proposal

Changes to the eligibility rules for establishing a pension scheme.

This is a two-stage process. First, the Financial Services and Markets Act (FSMA) Regulated Activities Order (RAO) is amended to include a new regulated activity of setting up and running a personal pension scheme. Second, the Finance Act 2004 (FA 2004)) is amended, so that any person with permission to carry on the new activity is eligible to establish a tax-privileged ("registered") pension scheme.

2. Purpose and intended effect

- Policy Objective

The objectives are essentially twofold:

a) to open up the personal pension market to a wider range of providers (a benefit for business), and

b) to make regulation of personal pension operators more transparent and comprehensive (a benefit for consumers).

It is anticipated that the first objective will have been achieved within five years of implementation. The second objective should be achieved from the point of implementation.

Although the proposed option involves the introduction of a new form of regulation, the proposal would also entail the removal of restrictive and cumbersome statutory rules from tax law. Overall, therefore, the effect of these proposals would be de-regulatory.

- Background

There is a general presumption that only suitably qualified or reputable "persons" (a term which includes financial institutions) should be allowed to manage pension savings. That is because of the large amounts of tax-relieved contributions going into pension schemes, and the extent to which individuals rely on their pensions to provide a secure income in retirement. Accordingly, tax law places restrictions on the type of person who may establish tax-privileged schemes.

These persons include:

a) employers to establish occupational pension schemes for their employees;
b) insurance companies, banks, building societies, open-ended investment companies and managers of authorised unit trusts (including firms based in other countries in the European Economic Area (EEA)[2]) to establish personal pension schemes for individual savers.[3]

What the persons set out at (b) above have in common is that their commercial activities in the UK are subject to independent regulation by the Financial Services Authority (FSA). The regulation provides them with a "badge" of suitability, and acts as a qualification for entry to the tax-privileged regime. The entry rule reduces the risk that unsuitable persons will gain access to the pensions market. But it is not clear from the face of the legislation that the eligible persons are specifically qualified to operate pension schemes.

The tax rules for pension schemes were radically reformed from 6 April 2006 (A-Day). Most of the former legislation governing the tax treatment of pension schemes was repealed from that date,

[2] The EEA covers the European Union, plus Norway, Iceland and Liechtenstein.
[3] Section 154 of the Finance Act 2004

and succeeded by new legislation contained in the FA 2004[4]. The various tax regimes for different types of pension scheme were swept away, and replaced by a single unified regime for all types of tax-privileged scheme. This reform process has been known generally as pension simplification.

As a consequence of pension simplification, many of the tax distinctions between occupational pension schemes and personal pension schemes have disappeared. It is no longer necessary for new schemes to be formally "approved" by HM Revenue & Customs (HMRC) in order to obtain tax privileges. Instead, all tax-privileged schemes are now known as registered pension schemes. Approved schemes automatically became registered schemes from A-Day (subject to an opt-out not being exercised).

However, the statutory rules on who may establish a new tax-privileged scheme were not significantly changed in FA 2004[5]. The new rules largely replicate those in force before A-Day.

It is now proposed that the rules be rewritten - so that eligibility no longer depends on belonging to a named category of person. Instead, any person with an appropriate permission from the FSA to carry on a regulated activity would become eligible to establish a new registered pension scheme in the UK.

Activities regulated by the FSA are set out in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the RAO). Eligibility to establish a registered pension scheme could depend on having permission to carry on one of the existing regulated activities of "managing investments", or "safeguarding and administering investments". But the proposal is to introduce a *new* regulated activity explicitly covering the establishment and operation of personal pension schemes, with eligibility under the tax rules depending solely on having permission to carry on that activity.

- Rationale for government intervention

The pensions market has changed over time - and is likely to change further in the future. Although most working people still rely primarily on occupational pensions to provide them with an income in retirement (about 10 million are currently members of occupational schemes), around 5 million others now contribute to personal or stakeholder pensions.

A large number of pension savers or providers may want to take advantage of the greater flexibility allowed under pension simplification, e.g.

a) a member of an occupational scheme may wish to start a personal pension scheme to top up the benefits due from the main scheme. The simplified tax regime, which applies a single (and generous) set of limits to all of an individual's pension savings, facilitates diversification of this sort.

b) an individual may wish to start a self-invested personal pension (SIPP), to secure a degree of control over his or her pension investments. Industry figures indicate that SIPPs still constitute only a small part of the market, with around 200,000 participants. But the number of SIPPs is growing.

c) small schemes may wish to invest pension savings in a wider range of assets than they are currently allowed. The aim must always be long-term growth, but certain types of asset may offer better prospects over twenty or thirty years than traditional share-based investments.

The vast majority of personal pension schemes are provided by insurance companies, but there are other potential providers who believe they are able to offer good quality pension products. Indeed, opening up the market to new providers would encourage innovation in product design, and increase choice and competition. This may in turn help to drive down costs.

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[4] The FA 2004 legislation was supplemented by some further legislation in the Finance Act 2005.

[5] The list of regulated persons entitled to establish a scheme now appears in section 154 FA 2004 (with section 155 defining certain terms used in section 154).

However, the tax rules act as a barrier to new entrants to the market. A number of those who would like to establish pension schemes are not included in any of the categories listed in tax law. Those excluded include many fund managers, custodians[6] and managers of investment trust companies, who are only able to establish new schemes by operating through institutions such as banks or insurance companies that are recognised in the legislation. Many SIPP operators (who are often trustees of their schemes) are also in that position.

There is another reason to consider change. As matters stand, even though the persons entitled to establish personal pension schemes are regulated by the FSA, that regulation does not extend to every aspect of operating a scheme, e.g.

d) the administration of a personal pension scheme (complying with tax and pensions legislation) is not covered by any existing regulated activity;

e) there are also gaps in the FSA's regulation of investment activity. Although pension operators will generally have permission to carry on the regulated activity of managing investments, there are certain investments - such as cash, residential property [7]and commercial property - that are not covered by that permission. This means, for example, that a pension operator investing a client's contributions by purchasing a particular property is not regulated in respect of that investment, and the client would have no statutory protection in the event of that investment going wrong.

The former tax rules allowed HMRC to approve any pension scheme that was a trust–based stakeholder scheme[8], irrespective of who established it. This provision is not replicated in the new rules – as, in practice, stakeholder schemes will generally be established by persons who are otherwise eligible under those rules. That slight restriction on eligibility removes the risk that unregulated persons could establish stakeholder schemes. There is an existing regulated activity of "establishing, operating or winding up a stakeholder pension scheme".

Persons establishing stakeholder schemes must have permission to carry on this activity. Accordingly, it is proposed to allow any person with this permission to be eligible to establish a registered pension scheme.

3. Consultation

- Within government

These proposals have been discussed by officials at HM Treasury, HMRC and with the FSA. In addition, the Department for Work and Pensions (DWP) and the Pensions Regulator have been notified of the proposals.

- Public consultation

[6] Custodians are responsible for safeguarding assets and undertaking administrative tasks such as record-keeping, accounting, and liaison with HMRC.

[7] Legislation included in the Finance (No.2) Bill 2006 removes tax advantages where self-directed registered pension schemes (including SIPPs) invest directly in residential property or other tangible moveable property.

[8] Stakeholder schemes were launched in 2001 to encourage pension saving among employees who do not belong to an occupational scheme. Most are set up as personal pension schemes, and all are characterised by a limit on the fees that the provider can charge. "Stakeholder pension scheme" is defined in section 1 of the Welfare Reform and Pensions Act 1999.

During 2004 and 2005, there was informal consultation about these proposals between HMRC officials and a number of bodies in the financial services industry. These bodies included the Investment Management Association, the Pep and ISA Managers' Association, the Association of Investment Trust Companies, and the Association of Member-directed Pension Schemes.

A formal consultation document was published in September 2005. In accordance with Cabinet Office guidelines, a period of twelve weeks was allowed for the receipt of responses. The following section summarises briefly both the consultation and RIA.

As part of a final RIA, Government is required to provide a short summary of responses to the consultation and the partial RIA.[9]

Twenty-five responses were received by 23rd December 2005, the closing date of the consultation. Respondents included trade and other representative bodies (such as the Association of British Insurers and the PEP and ISA Managers' Association), large personal pension providers and existing Self-Invested Personal Pensions (SIPP) providers.

Underlying the support for changes to the existing eligibility rules on establishing registered pension schemes, just three of the twenty–five respondents supported the Option of 'do nothing'. The majority supported the principle that any provider who wanted to enter the personal pensions market should have the opportunity to do so on an equal footing and avoiding any unnecessary administration costs, but this was not the case under current eligibility rules.

Over three quarters of respondents felt that the Government's preferred option of creating a new FSMA regulated activity would maximise potential new entry and consumer protection. Almost all agreed that it should be introduced from April 2007.

The limited RIA comments also endorsed this option. Respondents accepted there would be costs in terms of fees and compliance for those who chose to become authorised, but that these would not undermine the case for reform of rules. Consequently Government decided to make changes to eligibility rules as set out in option 3.

There was little support for the other options of either basing eligibility on existing permissions ('option 2') or of introducing an interim permission to cover the period 2006-7 ('option 4').

Summary of RIA responses and how any issues have been taken on board

A partial Regulatory Impact Assessment (RIA) was published with the original consultation document. This discussed the likely costs and benefits arising from the four options, and also the possible impact on small firms and market competition. There were limited comments from the consultation on the partial Regulatory Impact Assessment (RIA) - only seven of the twenty-five respondents made specific reference. In most cases, the comments and questions relate to matters for the FSA consultation and cost-benefit analysis to consider[10].

Government spoke once again with industry before finalising the RIA.

[9] Detailed responses to each of the questions posed in the original September 2006 consultation can be found in the formal Government's response published on March 23rd. A summary is given here.

[10] Sections 155 and 157 of FSMA require FSA to perform a cost benefit analysis (CBA) of proposed rules and guidance, and to publish the results. The FSA CBA will focus on the costs and benefits of the rules that FSA propose to introduce in order to implement Government's decision to amend the RAO. Under section 155(9)(c) of FSMA a CBA is not required for making rules on fees.

It was generally accepted that some providers (e.g. independent SIPP providers / administrators) would face additional costs to the extent they chose to become FSA regulated and so pay fees for the first time. Existing regulated providers were unlikely to be affected in terms of FSA fees and one explicitly acknowledged this. The overwhelming industry rejection of 'no change' aligned with the Government view that any costs would be more than offset by the benefits to firms, individuals and the wider economy of this change.

Reflecting the importance of FSA fees in determining costs for those who choose to become regulated, many respondents sought greater clarity on the precise magnitude of FSA fees. While the RIA made a number of assumptions about FSA fees, these could only be illustrative since they are reviewed annually, together with levies for the Financial Services Compensation Scheme (FSCS) and the Financial Ombudsman Service (FOS). The FSA have recently consulted[11] on application and periodic fee proposals for the new activity. In addition, FSA has confirmed[12] its final 2006/07 levies, and indicative fees for the new activities based on FSA proposals. 2006/07 rates can be estimated by using the FSA Online Fee Calculator[13].

The FSA's application fee proposals (including those for variations of permission) are wholly in line with assumptions made for the different groups in the partial RIA - summarised in column 2 of Annex 1. The groups have been slightly revised as a result of the FSA's consultation. Final application fee arrangements will be in place by the time FSA start to receive applications for authorisation to carry on the new activity in October 2006. FSA will then be consulting on periodic fee rates for the new activity in January 2007 so that these will be effective when the new activity is introduced in April 2007.

The final RIA updates the summary table in Annex 1. Example of possible regulatory fees and levies for new regulated activity (based on 2006/07 FSA periodic fees and FOS/FSCS levies, and proposals in the FSA's consultation) are provided in the final RIA. (Note there was an error in the original RIA table for ongoing fees and levies for small firms that as described in the text should have read 'upwards of £2,500')

Others questioned the fee implications associated with different types of activities and persons that might have to become regulated for the first time – for example administrators and trustees. Again the FSA guidance (following the consultation) will detail what is involved in each of the activities of 'establishing, operating or winding up a personal pension scheme'.

Five respondents specifically mentioned costs associated with firms developing and maintaining appropriate compliance functions. Four felt they didn't undermine the case for the Government's preferred Option with only one taking the contrary view.

Several respondents suggested additional costs associated with the full FSMA compliance aspects of the new regulated activity. For example one respondent noted disclosure costs, while others mentioned practical costs such as software. Further details on these will be provided following the FSA consultation. Government has discussed costs with industry on several occasions and noted in the partial RIA there may be compliance costs of a more practical nature (for example possible stationery costs were highlighted on page 21.)

[11] http://www.fsa.gov.uk/pages/library/policy/cp/2006/06_05.shtml

[12] http://www.fsa.gov.uk/pages/library/policy/policy/2006/06_02.shtml

[13] http://www.fsa.gov.uk/pages/Doing/Regulated/Fees/calculator/index.shtml

One respondent questioned the assumption made in the RIA that knowledge of pension legislation required similar skills set to tax legislation and suggested that in some cases an additional individual would have to be employed. Government accepts that this might be the case for some providers but feels it will not add disproportionate costs.

Three respondents suggested costs of regulation could be passed on to consumers. Related to this, some providers noted that existing business models with providers continuing to operate through third parties might be more cost effective than seeking to enter the market directly through the new activity.

These comments raise some fundamental issues that are spelt out again in the Final RIA for clarity. Firstly, registration for the new activity will be a commercial decision for individual firms taking into account their business model. No current or future provider will be 'forced' to become FSA regulated – e.g. if they wish to continue to operate through third parties and do not carry out any regulated activities. Secondly these changes will create a level playing field by giving any provider the opportunity to directly enter personal pensions if they so wish.

As the competition assessment in the partial RIA explained, a key intended effect of the new activity is to be pro-competitive. Respondents noted possible new entrants who may come into the market such as SIPP providers, fund supermarkets and investment trusts.

It is not for Government to speculate on the path of future SIPP charges in the RIA. However the final RIA reiterates that the SIPPs market has recently grown substantially with costs falling in the face of new entry – for example the minimum required contributions to open a SIPP also falling. Many experts are projecting continued strong future growth in SIPPs[14]. There is also evidence of competition between providers[15]. One respondent thought it 'doubtful whether charges in the shorter-term could be increased'.

4. Options

In putting forward possible changes to the eligibility rules for establishing a pension scheme, the Government considered the costs and benefits of pursuing a "Do Nothing" option. Against this, and in order to meet the policy objectives, the costs and benefits of three alternative options were considered. These options represented broad choices whilst permitting discussion on some of the detailed points.

Option 1: Do Nothing

It is open to the Government to make no change to the legislation, and proceed with pension simplification on the basis of the establishment rules in FA 2004.

The advantage of this option is that there would be one change fewer for the pensions industry to deal with. Already, the industry has to implement changes brought about both under pension simplification and by the Pensions Act 2004 (for which DWP are responsible). Adopting Option 1 would maintain the status quo in one area of the law affecting pension schemes.

The disadvantage of this option is that it would preserve the current restrictions on entry to the pensions market, and inhibit competition and product innovation. The pensions market may effectively remain closed to some people with relevant expertise. Moreover, if pension investments become more diverse , so an increasing range of pension investment activity (including the giving of certain advice) may fall

[14] Pensions Management Survey: 'Sipps: a growth market just waiting to happen', Pensions Management, June 1, 2006

[15] *'Selling Sipps is becoming more lucrative by the day and providers are anxiously jostling for a place in an increasingly crowded market.'* Quoted in the above PM survey.

outside the scope of FSA regulation. The degree of consumer protection may therefore be reduced, and opportunities for regulatory arbitrage may increase.

Option 2: Allow persons to establish registered pension schemes if they have permission to carry on an existing regulated activity that is related to investments

Under this option, any person with permission from the FSA to manage investments (under article 37 of the RAO) or safeguard and administer investments (article 40) would be eligible to establish a registered pension scheme from A-Day.

The existing list of eligible persons would be extended by the addition of those firms with FSA permission under articles 37 and/or 40 of the RAO. FA 2004 could additionally be amended so that any person with permission from the FSA to establish or operate a stakeholder scheme (article 52) would be eligible to establish a registered pension scheme that is also a stakeholder scheme.

Implementing this option would require an amendment to FA 2004[16] (and some amendments to HMRC guidance) in early 2006, but no amendment to the RAO.

The main advantage of Option 2 is that it would open the pensions market to new providers without most having to take any action to obtain any further permission from the FSA. That is because persons wishing to establish pension schemes are likely to be permitted to carry on one or both of these regulated activities already. Providers would be authorised by tax law to establish pension schemes in much the same way that they are authorised to manage Individual Savings Accounts or Child Trust Funds.

There are several disadvantages to Option 2. First, there would be no explicit link between the permitted activity and the operation of a pension scheme. Second, it could remain unclear that an eligible person had any particular expertise to deal with *all* aspects of operating a pension scheme (which requires specialist knowledge as well as competence with investments) – even if in practice that expertise were available. Third, an investment manager or custodian operating a personal pension scheme would not be supervised by the FSA in respect of that particular activity. Fourth, neither the Financial Ombudsman Service (FOS) nor the Financial Services Compensation Scheme (FSCS) would be available to consumers in respect of such pension schemes. Last, this change in particular may encourage a large number of new pension operators each investing only in a limited range of funds, so leading to greater fragmentation of pension investments.

In addition, some investment activity (including the giving of advice on certain investments) would remain outside FSA regulation, so limiting consumer protection and perhaps inviting arbitrage between regulated and unregulated investments.

Option 3: Allow persons to establish registered pension schemes only if they have permission to carry on a regulated activity that is related to personal pension schemes

Under this option, a new regulated activity would be built on the existing activity relating to stakeholder schemes, so as to cover any other type of personal pension scheme. FA 2004 would then be amended[17] to link with the existing and new activity. As a result, from 6 April 2007, a person seeking to establish a registered pension scheme would first require permission from the FSA to carry on either or both of the regulated activities of establishing, operating or winding up a stakeholder or a personal pension scheme.

Implementing this option would involve amending the RAO and then amending FA 2004. Implementation could not take place until April 2007, to allow time for the FSA to consult on the proposed changes. The FSA would analyse feedback from their consultation paper, with a view to making any agreed amendments to the FSA rulebook by October 2006. This would allow around six months before April 2007 for the making and processing of applications for permission to carry on the new activity. HMRC would also need to amend its guidance on establishment of registered schemes.

[16] This amendment can be made by Treasury Order under section 154(4) FA 2004.
[17] As with Option B, the amendment can be made by Treasury Order under section 154(4) FA 2004.

Certain existing regulated activities would apply to rights acquired by members of personal pension schemes as a result of these two changes, e.g. giving advice on the merits of joining or of placing a specific investment in a particular personal pension scheme would become regulated by the FSA.

The chief advantages of Option 3 are: first, that it makes an explicit link between an activity regulated by the FSA and eligibility under tax law to commence that activity; and second, it is transparent – allowing regulatory cover to extend to all key aspects of operating a personal pension scheme (including the giving of advice).

The chief disadvantage of Option 3 is that reform would be delayed until twelve months after A-Day (so separating it from the main body of tax changes due under pension simplification). Furthermore, if persons already with permission to operate stakeholder schemes could have that permission quickly converted to cover the new regulated activity, this may give them a head-start in attracting new business over those applying for the first time to carry on a pension-related activity.

Option 4: Allow persons to establish registered pension schemes if they have permission to carry on an existing regulated activity that is related to investments, but only until 6 April 2007, whereafter they may do so only if they have permission to carry on a regulated activity that is related to personal pension schemes

Under this option any person with permission from the FSA to manage investments or safeguard and administer investments (and possibly also to establish or operate a stakeholder scheme) would be eligible to establish a registered pension scheme from A-Day until 5 April 2007. Thereafter the rules laid out under Option 3 (above) would apply i.e. a person would require permission from the FSA to carry on either or both of the regulated activities of establishing, operating or winding up a personal pension scheme or a stakeholder scheme in order to be eligible to establish a registered pension scheme.

Option 4 would also involve amending both the RAO and FA 2004, but in this case FA 2004 would need to be amended twice, with the first amendment having to be in place before April 2006.

Under Option 4, the RAO and the second FA 2004 amendment would be delayed until later in 2006. As with Option 3, the FSA would consult on the necessary amendments to its rulebook, and then publish its final rules by October 2006. This would allow approximately six months for firms to apply for and obtain permission to carry on the new activity. As with Options 2 and 3, HMRC would need to amend its guidance.

Option 4 has a singular advantage over Option 3 in that it opens up the market twelve months earlier. In the short term, most of those wishing to establish schemes would not need to take any action as they are likely already to have the required permission.

The two disadvantages of Option 4 are: first, that it would involve a two-stage amendment to tax law, with two changes to the eligibility rules in the space of twelve months; and, second, there would be a year's delay after A-Day in bringing certain activities (including advice on the merits of acquiring rights related to particular SIPP investments) within the scope of FSA regulation.

Introduction of the new regulated activity under either Options 3 or 4 would make regulation by the FSA more explicit. There would be a better fit between regulation and tax law, and the pension saver would be more likely to have confidence in a person or firm that has specific permission to operate pension schemes (rather than the more general activities of managing investments, or safeguarding and administering investments).

5. Costs and benefits

- Sectors and groups affected

Options 2, 3 and 4 would affect persons and firms in the financial services industry, in particular those currently operating personal pension schemes, and those who wish to be able to operate such schemes. The former are primarily insurance companies, but also include around eighty SIPP operators, most of which are small specialist firms. The latter could include a range of fund managers, investment trust companies and potentially other firms such as fund supermarkets and stockbrokers.

- Benefits

Option 1

No benefits would accrue to consumers as a result of pursuing Option 1 (Do Nothing), and existing persons of firms currently operating personal pension schemes will maintain their hold on the market.

Options 2, 3 and 4

By making eligibility to establish a registered pension scheme dependent only on having an appropriate permission from the FSA, the Government would help to open up the pensions market. Eligibility would depend not on having a particular legal form or structure, but on being authorised to carry on a particular activity. Any person who met the FSA's conditions would be able to establish a new scheme. In addition, opening up the pensions market may help to encourage greater overall take-up of pension saving by working people.

The following benefits that might therefore flow from Options 2, 3 and 4:

- **the market would be opened up - since those wishing to operate personal pension schemes would no longer have to belong to one of the specified categories of person. This would lead to greater competition, which may in turn help to drive down costs.**
- **the arrival of more providers in the market (particularly those with fund management and marketing expertise elsewhere in the financial services sector) would lead to product innovation, and greater customer choice.**
- some providers (notably SIPP operators and investment trust managers) who are outside the current legislative framework would, if they were to obtain the appropriate permission, no longer have to operate through insurance companies or other structures specified in the tax legislation. Shedding such structures is likely to bring about cost savings (which may be offset against new costs), and lead to streamlining certain aspects of operating a scheme.

The following additional benefits would flow from Options 3 and 4:

- **use of the new permission would bring about greater transparency. The new permission would have a clear purpose, which those in the industry, and pension savers, can easily understand. Regulation of pension savings would no longer have to be interpreted through other statutory provisions. Greater clarity should assist in the comparison of products and costs.**
- **existence of the new permission would give confidence to existing and prospective pension savers. Individuals will see that the person who established and operates the scheme is authorised to manage and administer their *pension* investments, with recourse to the FSA, FSCS or FOS if something goes wrong.**
- **scheme members will have clear protection, as the professional operators of all types of personal pension schemes will be regulated by the FSA, regardless of the type of investment that the scheme holds.**
- **the new regulated activity would be comprehensive, embracing both the investment and management of pension savings and the administrative requirements placed on schemes by**

law. Regulation would extend to a greater range of pension-related investment activities, including the merits of joining a particular scheme.

The chief benefit flowing from Option 4 would be the opening up of the market one year earlier than would be the case under Option 3.

Costs

Option 1

No additional costs would accrue to persons or firms in the financial services industry as a result of pursuing Option 1 (Do Nothing). Existing costs met by persons of firms ineligible to operate personal pension schemes would remain.

Option 2

Option 2 would probably involve no significant cost, because most persons wishing to move into the pensions market would already have one of the required permissions (or will continue to operate through such a person).

Options 3 and 4

The FSA's Consultation Paper 06/05, published in April 2006, considers the fees that would be charged to persons applying for and obtaining permission to carry out the proposed new regulated activity.

The costs of obtaining permission would vary according to whether a person or firm:

a) already has permission for the article 52 activity or an activity related to an article 82 investment (establishing a stakeholder scheme, or dealing, arranging, advising on etc rights under a stakeholder scheme);

b) does not have permission for the article 52 activity or an activity related to an article 82 investment , but does have other permission for other regulated activities *and* is involved in pension provision

c) as above, but is *not* already involved in pension provision

d) has no existing permission to carry on a relevant regulated activity (i.e. is unauthorised).

As a general rule, those obtaining permission to carry on regulated activities would have to pay <u>one-off</u> application fees to the FSA, and may be liable for additional ongoing periodic fees. The anticipated fees payable are explained below, but FSA charging policy is reviewed annually - and so the figures may change for 2006/07.

Additionally, there will be internal administrative costs to firms applying for the permission, although these may not be very significant. Firms new to pension provision are likely to incur costs of setting up new systems (including a compliance function), control procedures, audit fees, and the appointment and training of approved individuals. These costs will generally be additional to those already incurred in adapting to the simplified tax regime from A-Day – although pension simplification should deliver savings over time. And the additional costs of obtaining permission for the new activity are likely to be relatively low.

With regard to the variances in FSA fees:

a) it is proposed that any person with permission for the existing article 52 or 82 activity would not need to apply for the permission to carry on the new activity. No application fee would therefore be payable, and the transitional costs of securing permission for the new activity would be negligible for

these persons. They may however become liable for periodic fees over and above their current levels, depending on the amount of business transacted.

b) persons without permission for the article 52 or 82 activity, but who are already involved in the provision of personal pensions, will almost certainly already have permission to carry on relevant regulated activities. Such persons will typically be life insurance companies. The FSA has proposed a one-off fee of £250 for varying a permission where an application to extend a firm's permission would not cause such a person to fall within a different "fee block."[18] (The FSA do not propose to move life insurers to a different fee block in the event of permissions being varied to include the new regulated activity.) However, the FSA propose to waive this fee for firms already carrying on personal pension activities and applying for permission to carry on the new activity. The FSA do not propose to impose new capital adequacy requirements[19] or levies on these providers. As in (a), firms may see an increase in periodic fees, but this depends on the extent to which they carry on the activity.

c) those persons (such as fund managers) who wish to move into the pensions market would also need to obtain permission for the new activity. Persons in this position are likely already to have permission to carry on other regulated activities - such as Managing Investments (article 37) and Safeguarding and Administering Investments (article 40). The firm would have to meet the cost mentioned above of varying its permission if it is moving into a new FSA fee block as explained above. The business might also have to increase the value of its funds and assets in order to meet capital adequacy requirements, and may face additional periodic fees.

d) a number of unauthorised persons may wish to obtain permission to carry on the new activity. These might include operators of SIPPs (who would typically be the trustees). For such persons, the costs of entering the field of regulated activity for the first time would be more substantial, reflecting the moderately complex nature of the activity. The FSA propose that the application fee (based on 2006/07 rates) would be £5,000. In addition, it is proposed that firms applying for permission to advise on, promote or arrange rights under personal pension schemes would pay a fee of £1,500.

Additional One Off Costs

Some persons in the above categories may also need to obtain permission to carry on other regulated activities – such as dealing in, arranging and advising on investments (Articles 14, 21, 25 and 53 of the RAO - which will be extended to cover personal pensions). In the large majority of cases, those wishing to carry on these activities would already have permissions that cover the activities (because they already arrange and advise on stakeholder pensions, or investments such as insurance policies and unit trusts). Where there is a charge for obtaining permission for one of these activities, it would be £2,500 (as for other variations to permissions).

In addition, there would be some stationery costs. The newly regulated person would be required under FSA rules to disclose the regulated status, meaning that the firm's headed letter paper (and perhaps other documentation) would have to be amended to show this.

Additional Ongoing Costs

There are also some ongoing costs. Any person who has obtained permission would have to pay a periodic fee each year to the FSA, and also levies to the FSCS and FOS: details of how these fees are structured can be found on the FSA website.

How fees for the new regulated activity might be structured is addressed by the FSA in its consultation paper. Additional ongoing FSA fees and FOS/FSCS levies would be incremental for existing firms,

[18] FSA fees are generally set under a system of fee blocks, each block applying to a particular sector of the financial services industry. For example, there are separate fee blocks for deposit takers, life insurers and fund managers.

[19] Capital adequacy requirements ensure that a firm's financial resources provide a suitable level of protection against the risks associated with its business activities.

based mostly on a sliding scale related to the increase in the size of funds under management, or the total funds for firms new to FSA regulation.

The FSA propose that firms (other than life insurers, banks or building societies) obtaining the new permission would pay fees under the A9 fee block (which currently applies to operators, trustees and depositaries of collective investment schemes. **Annex 1** gives examples of the indicative fees. These may be supplemented by some ongoing management costs of supervising approved individuals.

For newly authorised persons, costs are likely to be incurred in providing customers with product disclosure information, and in relation to cancellation rights and the retention of adequate capital. These factors are considered in more detail in the Cost Benefit Analysis within the FSA's Consultation Paper.

Information from the SIPP industry suggests that a typical SIPP operator, new to regulation, would face total costs associated with regulation of around £100,000 in the first year, and £50,000 ongoing annual costs thereafter. But many SIPP operators have indicated that they intend to apply for the new permission.

It should be noted that the FSA's own costs may increase as a result of taking on regulation of a new activity. These may be mitigated by the number of new firms across whom any additional FSA resources might be spread. The extent of these additional costs would therefore be dependent on the number and type of firms wishing to obtain permission for the new activity, and the extent of the supervisory actions that the FSA consider appropriate.

Firms that are newly regulated to operate pension schemes may have to employ or engage a manager to oversee ongoing compliance with the regulation. The annual cost of an employee (including salary, national insurance contributions, pension contributions and accommodation) in a medium-sized firm may be in the region of £100,000. For a large firm, which may need to employ a team of people, the cost would be correspondingly greater. Persons or firms in the market may elect to pass any additional costs onto their customers (consumers) in the form of higher charges, although larger firms may be able to absorb the additional costs without having to raise charges.

Summary

On balance, and subject to the associated costs not constituting a significant barrier, the Government recommended Option 3. It was prepared to consider Option 4, however, should respondents indicate the advantage of opening up the market earlier outweighs the disadvantages of a two-stage amendment to tax law and a year's delay in bringing certain activities within the scope of FSA regulation.

6. Small Firms Impact Test

Most businesses affected by these proposals will be large firms in the financial services sector. By contrast, however, a great many of the 80 or so SIPP operators are small or medium-sized firms. (For these purposes, a small firm has fewer than 50 full-time employees or equivalent, while a medium-sized firm has between 50 and 250 such employees.) Although it is also possible that some firms wishing to move into the pensions market will also be small or medium-sized, it is anticipated that most such firms will be large well-established businesses looking to expand into a new market by using packaged investments. But there is also anticipated growth in the number of small SIPP operators from within the pensions industry. Therefore, this impact assessment concentrates on the SIPP industry.

The following information is derived from informal consultation with the Association of Member-Directed Pension Schemes, and is based partly on feedback from 56 (about 70%) of its member firms.

Around 50% of SIPP operators are small firms (taking into account all their activities), and about a further 20% are medium-sized. One reason for the high proportion of smaller firms is that a number of insurance companies outsource their SIPP operations to small specialist companies.

Even within the larger firms, the "in-house" operation of SIPPs is generally a discrete area of activity. A majority of SIPP operators are currently unregulated.

SIPP operators say that it is difficult to determine with any certainty the impact of regulation and additional operating costs. But operators are concerned that they may be required to provide illustrations and other features in a uniform format, which may be suitable for collective investments but unworkable for specific investments within SIPPs. If this is what transpires, it could entail significant investment in new systems without any obvious benefit to SIPP holders or operators. This aspect is explored further within the FSA's own consultation paper.

7. Competition assessment

An intended effect of this measure is to increase competition within the personal pensions market. At present, twenty insurance companies have around 90% of the market (with the largest five having about 50%), and levels of market concentration have been increasing over recent years. It is not expected that the market will change greatly as a direct consequence of these proposals being implemented. But as a key purpose of the measure is to widen the market, the outcome is expected to be a greater and more diverse range of providers in the longer term.

As an effect of this measure, new firms entering the market are likely to face higher costs than those already with a market share. But because there is pressure from such firms to gain entry to the market, it is expected that many would be prepared to bear these costs, which will be offset by profits from this new area of business.

8. Enforcement, sanctions and monitoring

The FSA will be responsible for granting any new permission, monitoring subsequent activity, and generally ensuring that any persons who are subject to regulation are appropriately authorised. New schemes will register with HMRC via on on-line application process. As part of that process, the scheme administrator will be asked whether the person establishing the scheme is entitled to do so under the tax rules. HMRC can then check with the FSA Register that the person has the appropriate permission. If the establisher is not in possession of that permission, the scheme will cease to be registered, which means that it will not be entitled to tax privileges.

For tax purposes, possession of the FSA permission would be a key entry qualification. But the test would only apply as a filter at the point of registration, and continued possession of the permission would not be a tax requirement. That is because once a scheme has become registered by HMRC, it would be subject to the tax rules in FA 2004 (which, for example, prevent payments out of the scheme before the member's retirement or death). In the event of non-compliance, HMRC would be able to impose tax charges and possibly penalties or (in the most serious cases) withdraw the scheme's registered status so that it loses tax privileges.

If the proposals are implemented, it is intended that the overall outcome would be reviewed after five years. This review would consider whether the objectives at paragraph 1 had been met. In particular, the review would focus on the number of new pension providers and the range of pension products on the market. The intention would be to publish the findings.

9. Implementation and delivery plan

A formal Government consultation response was issued on 23 March 2006[20] announcing that following widespread industry support, Government will be creating a new FSA regulated activity related to personal pensions.

The timetable for implementing this new activity from April 2007 will involve several key milestones for both Government and FSA, and is set out here.

Before the summer recess (July 26th 2006), Government will be proposing to amend the Financial Services and Markets Act (FSMA) 2000 Regulated Activities Order (2001) to include a new activity of 'establishing, operating or winding up a personal pension scheme' to take effect from 6 April 2007. The Government will also be amending Finance Act 2004 to make any person having secured this permission eligible to establish a registered pension scheme.

The first proposed amendment would require a debate (before recess) in parliament whereas the second will be done in finance bill 2007. This final RIA will accompany the laying of the statutory instruments.

In April 2006 the FSA[21] began consulting with industry on the detailed rules required to implement the new activity, and also to seek views on proposed fee and prudential capital requirements for the new activity.

The FSA Consultation will close for comments on 2 July 2006. (As is standard the consultation on proposed fees closed earlier on 30 May 2006.) FSA intend to have published a Policy Statement and final rules to implement the changes by October 2006. The latter will set out the precise scope of the proposed new activity in terms of activities and persons covered.

In September 2006 FSA expect to publish their application pack for personal pensions business, so that from 2nd October 2006 they can begin to consider applications for authorisation in respect of the new activity to take effect from 6 April 2007.

This timetable allows sufficient time for persons to apply for permission to carry on the new activity before the new rules come into force. It will also allow existing providers time to adapt their internal systems and processes.

All firms with permission to carry on regulated activities pay FSA regulatory fees, which enable them to recover the costs of carrying out their statutory functions. In addition, firms may be liable for levies to fund the operation of the Financial Services Compensation Scheme (FSCS) and the Financial Ombudsman Service (FOS). FSA will seek industry views on proposed fee structure. FSA approach to fees is in line with better regulation principles and as such should be proportional and not act as a barrier to entry. Industry will have had a full opportunity to comment on FSA fee structures.

The majority of personal pension schemes are already regulated under FSMA – for example those run by life insurers or established as authorised unit trusts. Overall, such schemes are likely to see little or no change to either their fees or capital requirements after April 2007.

Government is keen to minimise industry burdens in the run up to 2007 and will be providing transitional provisions to allow an authorised firm with existing stakeholder pension scheme related permission to be able to continue their activities in relation to personal pension schemes without needing to apply (and pay a fee) to the FSA for 'Variation of Permission' ('VoP').

[20] 'Proposed changes to the eligibility rules for establishing a pension scheme, Government response'. http://www.hm-treasury.gov.uk/media/26B/9C/consult_pensionresponse230306.pdf
[21] CP06/5: 'The regulation of personal pension schemes including SIPPs', http://www.fsa.gov.uk/pages/library/policy/cp/2006/06_05.shtml

If a firm is already authorised but does not have stakeholder pension scheme related permission, it will only need to apply to the FSA (and hence pay a fee) for a variation of permission ('VoP') if it wishes to undertake the new regulated activity relating to personal pensions from 6 April 2007.

Government will also be providing interim permission for the new regulated activity to cover those firms already operating in the personal pension market but who might not manage to secure permission before 6 April 2007. Interim permission will enable the firm to undertake the personal pensions activity for which it has applied until its application has been finally determined.

The FSA's April 2006 consultation also covers capital requirements that are important to provide a minimum level of protection against the risks of a firm failing. Most regulated firms will already be subject to prudential requirements that are at least equivalent to those FSA feel are appropriate for a firm engaged in operating a personal pension, such as those investment firms subject to full risk-based requirements of the Capital Requirements Directive and insurance companies. FSA is not proposing additional capital requirements for them.

For newly regulated firms (now eligible to offer tax privileged pension schemes), FSA are proposing to set capital requirements broadly equivalent to those already set for investment managers and operators of collective investment schemes. These will be consistent with better regulation principles in terms of proportionality. Again industry will have had a full opportunity to comment.

10. Post-implementation review

Government is wholly committed to reviewing all legislative changes in line with better regulation principles. As part of the final RIA, therefore, Government is required to set out a detailed post implementation plan.

The main aim of making changes to pension scheme eligibility rules was to deregulate the personal pension market by sweeping away the outdated restrictions on those who could offer tax-privileged schemes. A further aim was to make regulation of personal pension operators more transparent and comprehensive (a benefit for consumers).

It was anticipated that the first objective would be achieved within five years of implementation in April 2007. The second objective should be achieved from the point of implementation in April 2007. As such Government stated in the original consultation document on pensions scheme eligibility rules that any rule changes would be reviewed after five years[22]. This would consider whether the objectives of the preferred option (as in the Regulatory Impact Assessment) had been met.

The post-implementation review will assess whether the introduction of the new activity related to personal pensions has led to an increase in competition, choice and innovation in the personal pensions market. It would also assess whether regulation of personal pension operators had became more transparent and comprehensive (a benefit for consumers) after April 2007. As noted in the original consultation document, the Government's intention would be to publish these findings.

Government stated in the formal consultation response that reform of the eligibility rules was an extension of pensions tax simplification and wholly in line with the deregulation agenda. Government set a programme for monitoring the pensions simplification reforms after A-day, involving external research, analysis of administrative data and secondary analysis. Government

[22] 'Proposed changes to the eligibility rules for establishing a pension scheme' – September 2005.

will therefore be reviewing the introduction of the new activity in the context of pensions simplification agenda, and involving the financial services industry and the FSA.

All firms regulated by the FSA are subject to ongoing monitoring and are required to meet the standards set out in the Handbook of Rules and Guidance and to supply FSA with information to monitor their business. FSA monitor firms in a variety of ways and apply risk-based approach to supervision[23]. FSA fees are also reviewed on an annual basis – providing Industry with the opportunity to comment on these annually.

11. Summary and recommendation

Underlying the support for changes to the existing eligibility rules on establishing registered pension schemes, just three respondents supported Option 1 of 'do nothing'. Consequently Government will be making changes to eligibility rules.

Around three-quarters (19 of the 25) of all respondents supported the option of allowing persons to establish a registered pension scheme only if they have permission to carry on a new FSA regulated activity that is related to personal pension schemes (as set out in Options 3 or 4).

Seventeen of these nineteen respondents favored the Government's preferred Option 3 of introducing such an activity from April 2007. This included the support from large trade and professional bodies. In several cases this support was given with additional comments. Accordingly, Government has decided to make the changes to eligibility rules as set out in Option 3.

Only two respondents unequivocally supported the Option 4 variation that included a temporary amendment to tax law (to refer to permission to carry out an existing regulated activity) for one year, 2006-7, before the introduction of the new regulated activity from 2007. A further three identified it as a second choice subject to several technical / timing concerns.

Only one respondent supported Option 2 of basing eligibility on existing permissions to carry on investment-related regulated activities.

Two respondents did not express a preference for any of the four options proposed.

[23] As outlined in the 'Being regulated" section within the "Doing business with FSA' See http://www.fsa.gov.uk/