VOLUME 1
THE INVESTMENT ENVIRONMENT
OFFICIAL TRAINING MANUAL
EDITION 23

ISBN: 978-1-7384310-6-9

First Edition March 1994; Second Edition May 1995; Third Edition August 1997; The UK Society of Investment Professionals; Fourth Edition February 2001; Fifth Edition August 2004; Sixth Edition October 2007; The CFA Society of the UK; Seventh Edition September 2008; Eight Edition July 2010; Ninth Edition December 2011; Tenth Edition October 2012; Eleventh Edition October 2013; Twelfth Edition October 2014; Thirteenth Edition 2015; Fourteenth Edition 2016; Fifteenth Edition 2017; Sixteenth Edition 2018; Seventeenth Edition 2019; Eighteenth Edition 2020; Nineteenth Edition 2021; Twentieth Edition 2022; Twenty First Edition 2023; Twenty Second Edition 2024; Twenty Third Edition 2025

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The authors would like to thank James Dolman, Chair of the IMC Panel, for his invaluable help in the preparation of this material. In addition, advice was greatly appreciated from IMC Panel members, and academic advisers Dr Isaac Tabner, Loba Van Der Bijl, Michael Budden and Dr James Seaton.

INTRODUCTION

The aim of the Official Training Manual (OTM) is to provide guidance to those undertaking study for the CFA UK Level 4 Certificate in Investment Management (IMC) examination. It provides dedicated coverage of the syllabus and learning outcomes including worked examples, key facts, as well as self-assessment questions and a mock examination. OTM Twenty Third Edition (2025/26) is valid for IMC examinations taken from 1 December 2025. Candidates must check that the version of the OTM they are preparing from is valid for the period when they intend to take the examination.

IMC UPDATE

Changes will be made as necessary to keep the manual up to date. Any required corrections or amendments will be published as an OTM Errata & Addendum document on the CFA Society of the UK's website: www.cfauk.org.

Candidates should check the website on a regular basis to ensure their study material is up to date.

IMC SYLLABUS

The IMC examination is made up of two units, covering the topic areas shown below:

UNIT 1: THE INVESTMENT ENVIRONMENT

1. Financial markets and institutions
2. Ethics and investment professionalism
3. The regulation of financial markets and institutions
4. Legal concepts
5. Client advice
6. Taxation in the UK

UNIT 2: INVESTMENT PRACTICE

7. Quantitative methods
8. Micro-economics
9. Macro-economics
10. Accounting
11. Equity
12. Fixed income
13. Derivatives
14. Alternative investments and private markets
15. Portfolio management
16. Investment products
17. Investment performance measurement

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This edition of the OTM covers the current syllabus and is published in two volumes. Volume 1 contains the materials for topic areas 1 – 6 required for the study of Unit 1: The Investment Environment. Volume 2 contains the materials for topic areas 7 – 17 required for the study of Unit 2: Investment Practice. The IMC examination tests the IMC syllabus rather than the specific wording of the OTM. The OTM offers broad coverage of the syllabus and provides excellent preparation for the examinations. Details of the current syllabus can be downloaded from the Society website: www.cfauk.org

The IMC is developed, administered and awarded by the CFA Society of the UK. CFA UK is recognised as an Awarding Organisation by the Office of Qualifications and Examinations Regulation (Ofqual), for the awarding of the 'CFA UK Level 4 Certificate in Investment Management (RQF)'. CFA UK is also recognised as an Accredited Body by the Financial Conduct Authority. The IMC appears on the FCA's Appropriate Qualifications Tables as meeting the regulatory qualification requirements for undertaking Activities 14 and 10 *Managing investments and/or undertaking the activity of a broker fund adviser.*

LINKS TO THE CFA PROGRAM™

The IMC syllabus contains direct links to the curriculum of the Chartered Financial Analyst Program. These are listed throughout the OTM. The natural progression from the IMC is onwards to the CFA Program (administered by CFA Institute) with the IMC providing a natural stepping stone to CFA Level 1. The IMC refers directly to the CFA Code of Ethics in Topic 2. Additionally, the IMC provides UK-specific syllabus content that can augment the global curriculum of the CFA, and the two are required by many employers in combination. In 2010 the IMC + CFA Level 1 combination was formally listed as meeting the regulatory qualification requirements for those advising and/or dealing in securities and derivatives in the UK.

UNIT 1: CERTIFICATE IN INVESTMENT MANAGEMENT (IMC) THE INVESTMENT ENVIRONMENT V.23 TESTED FROM 1 DECEMBER 2025

UNIT AIMS

By the end of this unit, learners should be able to demonstrate:

- an understanding of the UK financial services industry and international financial markets;
- an understanding of, and ability to critically evaluate, the outcomes that distinguish between ethical and compliance driven behaviour, and apply the CFA Code of Ethics and Standards of Professional Conduct to business behaviours of individuals;
- an understanding of the Financial Conduct Authority's (FCA's) use of principles and outcomes-based regulation to promote ethical and fair outcomes, and the ability to apply the regulatory advice framework in practice for the consumer;
- an ability to analyse the taxation of investments as relevant to the needs and circumstances of individuals and trusts, and an ability to apply the knowledge of personal taxation to the provision of investment advice; and
- an ability to analyse the role and relevance of tax in the financial affairs of individuals and trusts.

QUESTION ALLOCATION:

Question allocation across the syllabus is balanced on the guidance of psychometric and industry specialists. The following question allocation for Version 23 of the IMC is provided as a broad indication of the relative 'weighting' of different parts of the syllabus in IMC examinations from 1 December 2025.

Content area	Topic	Topic name	Question allocation
Financial markets and institutions	1	Financial markets and institutions	10–20
Ethics	2	Ethics and Investment professionalism	5–15
Regulation and legal concepts	3	The regulation of financial markets and institutions	25–35
	4	Legal concepts	
Clients	5	Client advice	15–25
Taxation	6	Taxation in the UK	10–20

OTHER INFORMATION REGARDING THIS UNIT:

Exam format:
- 85 questions.
- Online testing using standard multiple choice, item sets and gap-fill style questions.

Time allowed for exam:
- 1 hour and 40 minutes.

Grades:
- Pass or fail.

Study materials:
- Official Training Manual v.23 is available from the CFA UK website, including revision questions with fully worked calculations.
- Mock exam available on the CFA UK website.

Recommended study hours:
- 100 hours.

Availability of exam sessions:
- Every working day through Pearson VUE testing centres and every day via OnVUE remote proctoring.

TOPIC 1
FINANCIAL MARKETS AND INSTITUTIONS

By the end of this topic, learners should be able to:

- demonstrate an understanding of the UK financial services industry, in its European and global context; and
- demonstrate an understanding of UK and international financial markets.

1.1 INTRODUCTION TO FINANCIAL MARKETS

1.1.1 Explain the functions of the financial services industry in allocating capital within the global economy

1.1.2 Explain the role and impact of the main financial institutions

1.1.3 Explain the role of the government including economic and industrial policy, regulation, taxation and social welfare

1.2 THE ROLE OF SECURITIES MARKETS IN PROVIDING LIQUIDITY AND PRICE TRANSPARENCY

1.2.1 Differentiate between a financial security and a real asset

1.2.2 Identify the key features of an ordinary share, a bond, a derivative contract, a unit in a pooled fund and a foreign exchange transaction

1.2.3 Identify the functions of securities markets in providing price transparency and liquidity

1.2.4 Identify the reasons why liquidity and price transparency are thought to be important for the efficient allocation of capital when trading in securities markets

1.2.5 Identify the types of securities and the market conditions where price transparency, liquidity and depth are likely to be high/low

1.2.6 Define liquidity risk and identify why it is important

1.2.7 Identify, explain and calculate transaction costs and their differences associated with dealing in UK and non-UK equities, fixed income securities, pooled funds and property

1.3 TYPES OF FINANCIAL MARKETS

1.3.1 Identify the main dealing systems and facilities offered in the UK equities market and explain the clearing and settlement procedures for UK exchange-traded securities

1.3.2 Identify the nature of the securities that would be traded on each of the main dealing systems and facilities

1.3.3 Explain the structure and operation of the primary and secondary UK markets for gilts and corporate bonds

1.3.4 Explain the motivations for, and implications of, dual-listing for a company

1.3.5 Compare and contrast exchange-traded and over-the-counter (OTC) markets

1.3.6 Distinguish between the following alternative trading venues: multilateral trading facilities, systematic internalisers, organised trading facilities and dark pools

1.3.7 Distinguish between a quote-driven and an order-driven market

1.3.8 Explain the roles of the various participants in the UK equity market

1.3.9 Explain algorithmic and high-frequency trading, its benefits, risks and regulation

1.4 THE UK LISTING AUTHORITY AND PROSPECTUS REQUIREMENTS

1.4.1 Explain the role of the Financial Conduct Authority (FCA) as the UK listing authority

1.4.2 Identify the listing rules in the Financial Services and Markets Act (FSMA) 2000 as amended

1.4.3 Explain the main conditions for listing on the Official List, AIM and AQSE

1.4.4 Explain the purpose of the requirement for a prospectus or listing particulars

1.4.5 Identify the main exemptions from listing particulars

1.5 INFORMATION DISCLOSURE AND CORPORATE GOVERNANCE REQUIREMENTS FOR UK EQUITY MARKETS

1.5.1 Explain the disclosures required under the disclosure and transparency rules relating to directors' interests and major shareholdings

1.5.2 Explain the purpose of corporate governance regulation and the role of the Financial Reporting Council in promoting good corporate governance

1.5.3 Explain, in outline, the scope and content of corporate governance standards in the UK

1.5.4 Explain the purpose and scope of the Shareholders Rights Directive (SRD II) and its impact on pension schemes

1.5.5 Explain the importance of board diversity in relation to good corporate governance

1.5.6 Explain the London Stock Exchange requirements for listed companies to disclose corporate governance compliance

1.5.7 Explain the continuing obligations of London Stock Exchange listed companies regarding information disclosure and dissemination

1.5.8 Explain, in outline, the UK company law requirements regarding the calling of annual general meetings and other general meetings

1.5.9 Distinguish between annual general meetings and other types of company meetings

1.5.10 Distinguish between the types of resolution that can be considered at company general meetings

1.5.11 Distinguish between the voting methods used at company meetings

1.5.12 Explain the role and powers of a proxy

1.6 INTERNATIONAL MARKETS

1.6.1 Explain the structure, features, and regulatory and trading environment of international markets, including developed markets and emerging markets

1.6.2 Explain the structure and operation of the primary and secondary markets for Eurobonds

1.6.3 Explain the settlement and clearing procedures overseas, including the role of international central securities depositories, and the different settlement cycles and challenges in managing global assets

1.7 THE PRINCIPAL–AGENT PROBLEM: SEPARATION OF OWNERSHIP AND CONTROL

1.7.1 Explain how capital markets allow the beneficial ownership, and the control of capital, to be separated

1.7.2 Distinguish between beneficial owners (principals) and the various agents involved in the capital allocation process

1.7.3 Explain how conflict between the interests of agents and principals gives rise to the 'agency' or 'principal–agent' problem

1.7.4 Identify examples of agency costs such as: expropriation, perquisites, self-dealing and higher cost of capital, which arise when the agency problem is known to exist

1.7.5 Identify the main reasons why it is argued that reducing the agency problem benefits the investment profession and society as a whole

TOPIC 2
ETHICS AND INVESTMENT PROFESSIONALISM

By the end of this topic, learners should be able to:

- demonstrate an ability to critically evaluate the outcomes that distinguish between ethical and compliance-driven behaviour; and
- demonstrate an ability to apply the CFA Code of Ethics and Standards of Professional Conduct to the business behaviours of individuals.

2.1 ETHICAL AND COMPLIANCE-DRIVEN BEHAVIOUR

2.1.1 Describe the need for ethics in the investment industry

2.1.2 Identify positive and negative behavioural indicators

2.1.3 Identify the ethical obligations to clients, prospective clients, employers and co-workers

2.1.4 Critically evaluate the outcomes which may result from behaving unethically – for the industry, individual advisers, the firm and consumers

2.1.5 Critically evaluate the outcomes which may result from limiting behaviour to compliance within the rules – for the industry, individual advisers and consumers

2.2 CFA CODE OF ETHICS AND STANDARDS OF PROFESSIONAL CONDUCT

2.2.1 Identify the elements of the CFA Code of Ethics and Standards of Professional Conduct

2.2.2 Explain the professional principles and values on which the CFA Code of Ethics and Standards of Professional Conduct are based

2.2.3 Apply the CFA Code of Ethics and Standards of Professional Conduct to a range of ethical dilemmas

TOPIC 3
THE REGULATION OF FINANCIAL MARKETS AND INSTITUTIONS

By the end of this topic, learners should be able to:

- demonstrate an understanding of UK and International financial markets;
- demonstrate the ability to apply the regulatory framework in practice;
- demonstrate an understanding of the UK financial services industry, in its European and global context;
- demonstrate an understanding of the Financial Conduct Authority's (FCA) responsibilities and approach to regulation;
- demonstrate an ability to apply the FCA's principles and rules as set out in the regulatory framework and FCA Handbook; and
- demonstrate an understanding of where the Prudential Regulation Authority (PRA) may also be involved for dual-regulated firms.

3.1 UK REGULATION

3.1.1 Describe and distinguish between the roles of the Financial Conduct Authority (FCA), Prudential Regulation Authority (PRA), Bank of England, Financial Policy Committee and HM Treasury

3.1.2 Explain the different roles of the FCA and PRA for dual-regulated investment firms

3.1.3 Explain the scope of the Financial Services and Markets Act (FSMA) 2000 (as amended)

3.1.4 Explain the scope of the Regulated Activities Order 2001 (as amended) in terms of regulated activities and specified investments

3.1.5 Explain the function of the following bodies/persons: the Payments Systems Regulator (PSR), the Competition and Markets Authority (CMA) and the Information Commissioner's Office (ICO)

3.1.6 Explain the function and make-up of the Takeover Panel and how it is financed

3.1.7 Explain the regulatory status of the City Code on Takeovers and Mergers (the City Code)

3.1.8 Explain the main provisions of the City Code, including the bid timetable

3.1.9 Explain the purpose and scope of the main regulations governing occupational pensions

3.1.10 Explain the purpose and scope of the FCA's recognised industry codes

3.2 ASSIMILATED EU LAW AND OTHER INTERNATIONAL REGULATIONS RELATING TO UK FINANCIAL SERVICES

UK and EU financial services relationship

3.2.1 Explain the relationship between the UK and EU financial services regulatory framework and the legal status of EU directives and regulations in the UK.

Retained EU Law

3.2.2 Explain the effect of the Financial Services and Markets Act 2023 (FSMA 2023) and the Retained EU Law (Revocation and Reform) Act 2023 and the role of the FCA and PRA

UK regulation of markets in financial instruments (UK MiFID Framework)

3.2.3 Explain the purpose and scope of the UK MiFID framework

UK regime for Undertakings for Collective Investment in Transferable Securities (UCITS)

3.2.4 Explain the purpose and scope of the UK UCITS regime

Alternative Investment Fund Managers Directive (AIFMD UK)

3.2.5 Explain the purpose and scope of the AIFMD UK

UK European Market Infrastructure Regulation (UK EMIR)

3.2.6 Explain the purpose and scope of UK EMIR

UK Benchmarks Regulation (UK BMR)

3.2.7 Explain the purpose and scope of the UK BMR

US Foreign Account Tax Compliance Act and OECD Common Reporting Standard

3.2.8 Explain the purpose and scope of the Foreign Account Tax Compliance Act (FATCA) and the Common Reporting Standard (CRS)

3.3 THE FINANCIAL CONDUCT AUTHORITY (FCA): OBJECTIVES AND HIGH-LEVEL STANDARDS

3.3.1 Explain the role and statutory objectives of the FCA

3.3.2 Identify and distinguish among the blocks of the FCA Handbook

3.3.3 Identify the FCA's Principles for Businesses (PRIN 2 and PRIN 2A) and explain their application and purpose (PRIN 1.1.1 & 1.1.2)

3.3.4 Explain the consequences of breaching the FCA's Principles for Businesses (PRIN 1.1.7–1.1.9 and DEPP 6.2.14 & 6.2.15)

3.3.5 Explain the purpose and scope of the FCA's rules regarding Senior Management Arrangements, Systems and Controls (SYSC)

3.3.6 Explain the purpose of the principles and rules on conflicts of interest, including: identifying, recording and disclosing conflicts of interest and managing them to ensure the fair treatment of clients (PRIN 2.1.1, Principle 8 & SYSC 10)

3.3.7 Explain, in outline, the procedures for authorisation of firms, including knowledge of the threshold conditions, and liaison with the PRA where relevant

3.3.8 Explain the regulatory requirements on individual accountability under the Senior Managers Regime, Certification Regime and FCA Conduct rules (SUP 10C)

3.3.9 Explain the FCA Conduct rules and their application (COCON)

3.3.10 Explain the requirements relating to training and competence (TC 1–3)

3.3.11 Explain the professionalism requirements that have to be met by retail investment advisers and investment managers (TC 1–3, including appendices)

3.4 REGULATION OF INVESTMENT EXCHANGES AND CLEARING HOUSES

3.4.1 Explain the role of an investment exchange

3.4.2 Explain the need for investment exchanges being recognised by the FCA and how the Bank of England regulates clearing houses in the UK

3.4.3 Explain the purpose of UK MiFID rules on transparency requirements applied to operators in regulated markets including RMs, MTFs, OTFs and SIs

3.4.4 Identify and distinguish the roles of the main bodies involved in securities trading in the UK, including London Stock Exchange Group (LSEG), ICE Futures Europe and ICE Clear Europe

3.4.5 Identify the main features of trading, clearing and settlement of both exchange-traded and OTC derivatives

3.4.6 Explain the arrangements for market transparency and transaction reporting in the main derivative markets

3.5 FCA BUSINESS STANDARDS

Accepting customers for business (client categorisation)

3.5.1 Explain the purpose of client categorisation

3.5.2 Distinguish between a retail client, a professional client and an eligible counterparty (COBS 3.4–3.6)

3.5.3 Apply the rules relating to treating a client as an elective professional client (COBS 3.5.3)

3.5.4 Apply the rules relating to treating a client as an elective eligible counterparty (COBS 3.6.4–3.6.6)

3.5.5 Apply the rules relating to providing clients with a higher level of protection (COBS 3.7)

3.5.6 Apply the rules relating to client agreements (COBS 8A.1)

Financial promotions and other communications with customers, including information about the firm

3.5.7	Explain the purpose and scope of the financial promotion's rules and the exemptions from them (COBS 4.1)
3.5.8	Explain the 'fair, clear and not misleading' rule (COBS 4.2)
3.5.9	Explain the rules relating to communications with retail clients (COBS 4.5A)
3.5.10	Explain the rules relating to past, simulated past and future performance (COBS 4.5A)
3.5.11	Explain the rules relating to direct offer promotions (COBS 4.7)
3.5.12	Explain the rules relating to cold calls and other promotions that are not in writing (COBS 4.8)
3.5.13	Explain the rules relating to systems and controls in relation to approving and communicating financial promotions (COBS 4.10)
3.5.14	Explain the record-keeping requirements relating to financial promotions (COBS 4.11)
3.5.15	Explain the rules relating to distance marketing communications (COBS 5.1 & 5.2)
3.5.16	Explain the rules relating to providing information about the firm and compensation information (COBS 6.1ZA)
3.5.17	Explain the rules on inducements (COBS 2.3A & 2.3B)
3.5.18	Explain the rules on adviser charging and remuneration (COBS 6.1A & 6.4)
3.5.19	Explain the FCA anti-greenwashing rules

Identifying client needs (suitability and appropriateness)

3.5.20	Explain the rules relating to assessing suitability (COBS 9A.2 & 9A.3)
3.5.21	Explain the rules relating to assessing appropriateness (COBS 10A.2)
3.5.22	Explain the rules relating to warning a client (COBS 10A.3)
3.5.23	Identify circumstances when assessing appropriateness is not required (COBS 10A.4 & 10A.6)
3.5.24	Identify circumstances where own authority or expertise is limited and there is the need to refer to specialists
3.5.25	Distinguish between independent advice and restricted advice (COBS 6.2B)

Dealing and managing

3.5.26	Explain the rules relating to best execution (COBS 11.2A)
3.5.27	Explain the rules relating to client order handling (COBS 11.3)
3.5.28	Explain the rules on personal account dealing (COBS 11.7A)

Investment research

3.5.29	Explain the rules relating to investment research produced by a firm and disseminated to clients (COBS 12.2)
3.5.30	Explain the rules relating to the publication and dissemination of non-independent research (COBS 12.2)
3.5.31	Explain the disclosure requirements relating to the production and dissemination of research recommendations (COBS 12.4)

Product governance and disclosure requirements

3.5.32	Explain the rules relating to product governance (PROD 3)
3.5.33	Explain the obligations relating to preparing product information (COBS 13.1 & COLL 4.7)
3.5.34	Explain the FCA's approach to temporary senior managers (PROD 2)
3.5.35	Explain the scope of packaged retail investment products as set out in the Packaged Retail and Insurance-based Investment Products (PRIIPs) regime
3.5.36	Explain the purpose of the FCA Sustainability Disclosure Requirements (SDR) and investment labelling regime
3.5.37	Explain the rules relating to the form and content of a key features document, key information document (PRIIPs) and a key investor information document (COBS 13.2, 13.3, 14.2 & COLL 4.7)
3.5.38	Explain the rules relating to cancellation rights (COBS 15)

Record-keeping and reporting information

3.5.39 Apply the rules relating to record-keeping for client orders and transactions (COBS 11.5A)
3.5.40 Apply the rules relating to occasional reporting to clients (COBS 16A.3)
3.5.41 Apply the rules relating to periodic reporting to clients (COBS 16A.4)
3.5.42 Explain the rules relating to reporting on the progress of an authorised fund to unitholders (COLL 4.5)
3.5.43 Explain the requirements on authorised fund managers to publish an annual assessment of value (COLL 6.6.20R)

Client assets and client money rules

3.5.44 Explain the concept of fiduciary duty
3.5.45 Explain the application and purpose of the rules relating to custody of client assets held in connection with MiFID business (CASS 6.1)
3.5.46 Explain the rules relating to the protection of clients' assets and having adequate organisational arrangements (CASS 6.2)
3.5.47 Explain the rules relating to depositing assets with third parties (CASS 6.3)
3.5.48 Explain the purpose of the rules relating to the use of clients' assets (CASS 6.4)
3.5.49 Explain the rules relating to records, accounts and reconciliations of clients' assets (CASS 6.6)
3.5.50 Explain the application and purpose of the rules relating to the treatment of client money (CASS 7.11)
3.5.51 Explain the rules relating to the protection of client money and having adequate organisational arrangements (CASS 7.12)
3.5.52 Explain the rules relating to the depositing of money with third parties (CASS 7.14)
3.5.53 Explain the rules relating to the segregation of client money (CASS 7.13)
3.5.54 Explain the rules relating to records, accounts and reconciliations of clients' money (CASS 7.15)
3.5.55 Explain the rules relating to mandate accounts (CASS 8)
3.5.56 Explain the rules relating to title transfer collateral arrangements

3.6 FCA SUPERVISION AND REDRESS

3.6.1 Explain the FCA's approach to supervision and the enforcement and disciplinary powers of the FCA
3.6.2 Explain the FCA rules relating to handling of complaints (DISP 1.3)
3.6.3 Explain the role of the Financial Ombudsman Service (DISP Introduction & DISP 2) and the Pensions Ombudsman
3.6.4 Apply the rules relating to determination by the Financial Ombudsman Service (DISP 3.6)
3.6.5 Distinguish between compulsory and voluntary jurisdiction (DISP Introduction)
3.6.6 Explain the procedure and time limits for the resolution of complaints (DISP 1.4, 1.5 & 1.6)
3.6.7 Apply the rules relating to record-keeping and reporting concerning complaints (DISP 1.9 & 1.10)
3.6.8 Explain the purpose of the Financial Services Compensation Scheme (FSCS) (COMP 1.1.7 & 1.1.10A)
3.6.9 Identify the circumstances under which the FSCS will pay compensation (COMP 1.3.3, 3.2.1, 4.2.1 & 4.2.2)
3.6.10 Identify the limits on the compensation payable by the FSCS (COMP 10.2.1, 10.2.2 & 10.2.3)

3.7 FINANCIAL CRIME

3.7.1 Explain the various sources of money laundering and counter-terrorism regulation and legislation (FCA rules, SYSC 6.3, Money Laundering Regulations, Proceeds of Crime Act 2002)
3.7.2 Explain the three stages involved in the money laundering process
3.7.3 Explain the role of the Joint Money Laundering Steering Group (JMLSG)
3.7.4 Explain the main features of the guidance provided by the JMLSG
3.7.5 Explain the five offence categories under UK money laundering legislation
3.7.6 Explain the meaning of 'inside information' covered by the Criminal Justice Act (CJA) 1993

3.7.7	Explain the offence of insider dealing covered by the CJA 1993
3.7.8	Identify the penalties for being found guilty of insider dealing
3.7.9	Explain the FCA's powers to prosecute market abuse (EG 12.3)
3.7.10	Describe the behaviours defined as market abuse (MAR 1.3–1.9 and the Market Abuse Regulation)
3.7.11	Explain the enforcement powers of the FCA relating to market abuse (DEPP 6.5C)
3.7.12	Explain the main features of the Bribery Act 2010, the UK Criminal Finances Act 2017 and the Economic Crime and Corporate Transparency Act 2023

TOPIC 4
LEGAL CONCEPTS

By the end of this topic, learners should be able to:

- demonstrate an understanding of legal concepts relevant to financial advice.

4.1 LEGAL CONCEPTS

4.1.1	Explain legal persons and power of attorney
4.1.2	Explain basic law of contract and agency
4.1.3	Explain the types of ownership of property
4.1.4	Explain insolvency and bankruptcy
4.1.5	Explain wills and intestacy
4.1.6	Describe the main types of trusts and their uses
4.1.7	Explain the purpose and scope of the Trustee Act 2000: the rights and duties of the parties involved, the nature of the trust deed and the investment powers of trustees
4.1.8	Explain the purpose of a Statement of Investment Principles

TOPIC 5
CLIENT ADVICE

By the end of this topic, learners should be able to:

- demonstrate an ability to apply the financial planning process;
- demonstrate an understanding of how the retail consumer is served by the financial services industry; and
- demonstrate an understanding of the range of skills required when advising clients.

5.1 TYPES AND CHARACTERISTICS OF INVESTORS

5.1.1	Describe and compare different types of investors
5.1.2	Explain the obligations of a firm towards retail clients, including the FCA's Consumer Duty rules

5.2 THE CLIENT'S FINANCIAL OBJECTIVES

5.2.1	Explain the main needs of retail clients and how they are prioritised
5.2.2	Explain the importance of establishing and quantifying a client's objectives
5.2.3	Explain the need to prioritise objectives to accommodate a client's affordability

5.3 THE CLIENT'S CURRENT CIRCUMSTANCES

5.3.1	Explain the importance of the fact-find process in establishing a client's current financial circumstances and requirements
5.3.2	Identify the factors shaping a client's circumstances

5.4 THE CLIENT'S RISK PROFILE

5.4.1	Analyse the main types of investment risk as they affect investors
5.4.2	Explain the role of diversification in mitigating risk
5.4.3	Analyse the factors affecting a client's risk profile
5.4.4	Explain the key methods of determining a client's risk profile

5.5 INVESTMENT RECOMMENDATIONS

5.5.1	Explain why asset allocation always comes before investment or product selection
5.5.2	Explain the key roles of fund charges, the use of past performance, the financial stability of the provider, the stability, independence and standing of trustees, fund custodians and auditors as criteria within the fund selection process
5.5.3	Identify benchmarks and other performance measures in relation to client advice
5.5.4	Explain the importance of reviews within the financial planning process

5.6 SKILLS REQUIRED WHEN ADVISING CLIENTS: CASE STUDIES

5.6.1	Describe the need for advisers to communicate clearly, assessing and adapting to the differing levels of knowledge and understanding of their clients
5.6.2	Identify and apply suitable investment solutions to suit the different needs of retail clients

5.7 INSTITUTIONAL INVESTORS: THE OBJECTIVES OF INSTITUTIONAL INVESTORS AND THE FACTORS THAT IMPACT UPON THEIR INVESTMENT DECISIONS

5.7.1 Explain the features and objectives of the following funds in the UK: pension funds (defined benefit (DB) and defined contribution (DC)), life assurance and general insurance

5.7.2 Explain the impact of automatic enrolment in workplace pensions and pension freedom of choice for DC pension schemes

5.7.3 Identify and contrast the risks of DB versus DC pension schemes for the sponsor and beneficiary

5.7.4 Distinguish between the typical asset allocations for DB and DC pension funds, life assurance and general insurance funds

5.7.5 Explain the return objectives of the major fund types

5.7.6 Classify funds by their income/capital growth requirements

5.7.7 Explain the effect of each of the following on a fund's asset allocation: time horizons, liability structure and liquidity requirements

5.7.8 Explain the taxation of the various types of funds in the UK and the effect that taxation legislation may have on stock selection and asset allocation

5.7.9 Identify other types of legal requirements that affect pension funds, insurance funds and retail clients

5.7.10 Identify the constraints that impact the return objectives of pension and insurance funds

TOPIC 6
TAXATION IN THE UK

By the end of this topic, learners should be able to:

- demonstrate an understanding of the UK tax system as relevant to the needs and circumstances of individuals and trusts;
- demonstrate an ability to analyse the taxation of investments as relevant to the needs and circumstances of individuals and trusts;
- demonstrate an ability to analyse the role and relevance of tax in the financial affairs of individuals and trusts; and
- demonstrate an ability to apply the knowledge of personal taxation to the provision of investment advice.

6.1 THE UK TAX SYSTEM AND THE TAXATION OF INVESTMENTS

6.1.1 Describe the principles of income tax applicable to earnings, savings and investment income in the UK

6.1.2 Describe, in relation to income tax, the system of allowances, reliefs and priorities for taxing income

6.1.3 Explain the taxation of the income of trusts and beneficiaries

6.1.4 Describe the system of National Insurance contributions (NICs)

6.1.5 Describe the principles of capital gains tax (CGT) in the UK

6.1.6 Describe the principles of inheritance tax (IHT) in the UK

6.1.7 Explain the limitations of lifetime gifts and transfers at death in mitigating IHT

6.1.8 Explain the implications of residence in relation to liability to income tax, CGT and IHT

6.1.9 Describe the system of UK tax compliance including self-assessment, pay as you earn (PAYE), tax returns, tax payments, tax evasion and avoidance issues

6.1.10 Describe the principles of stamp duty land tax (SDLT) as applied to property purchases (buying, selling and leasing)

6.1.11 Describe the principles of stamp duty reserve tax (SDRT)

6.1.12 Explain how companies are taxed in the UK

6.1.13 Describe, in outline, the principles of value added tax (VAT)

6.1.14 Analyse the taxation of direct investments including cash and cash equivalents, fixed-interest securities, equities and property

6.1.15 Analyse the key features and taxation of indirect investments including pension arrangements, different types of individual savings accounts (ISAs), onshore and offshore life assurance policies, real estate investment trusts (REITs), venture capital trusts (VCTs), enterprise investment schemes (EISs) and business property relief

6.2 INVESTMENT ADVICE AND TAX PLANNING

6.2.1 Evaluate the tax considerations shaping clients' needs and circumstances

6.2.2 Analyse the key principles of income tax planning

6.2.3 Analyse how the use of annual CGT exemptions, the realisation of losses, the timing of disposals, and sale and repurchase of similar assets can mitigate CGT

6.2.4 Calculate the most common elements of income tax, CGT and IHT, including the impact of lifetime transfers and transfers at death

6.2.5 Select elementary tax planning recommendations in the context of investments and pension advice

CONTENTS

CHAPTER 1
FINANCIAL MARKETS AND INSTITUTIONS

Banks, insurance companies, pension funds, savers and other participants in the UK financial services industry all play their own part in allocating capital within the UK and the global economy. This chapter describes how financial markets and the key participants operating within them function.

Bank deposits made by individuals, loans made by banks, portfolios held by insurance companies and capital raised by companies issuing equities and bonds all have a role within a financial market. Understanding the main types of securities traded between participants and how they are issued to raise capital builds a picture of how an efficient market serves both capital-raising bodies and investors.

Participants operate in a market governed by regulations (such as the UK listing rules), legal considerations (such as the principal–agent problem) and administrative processes (such as clearing and settlement).

Financial markets are constantly evolving, and it is important to understand how established trading venues operate (such as the London Stock Exchange) as well as alternative trading venues (such as dark pools).

This chapter gives a broad introduction to the functions served by financial markets and a detailed discussion of key market features, processes and trading venues.

SECTION 1.1
INTRODUCTION TO FINANCIAL MARKETS

THE FINANCIAL SERVICES INDUSTRY

1.1.1 Explain the functions of the financial services industry in allocating capital within the global economy

The financial services industry provides four main functions in an economy:

- financial intermediation;
- pooling and managing risk;
- payments and settlement services; and
- portfolio management.

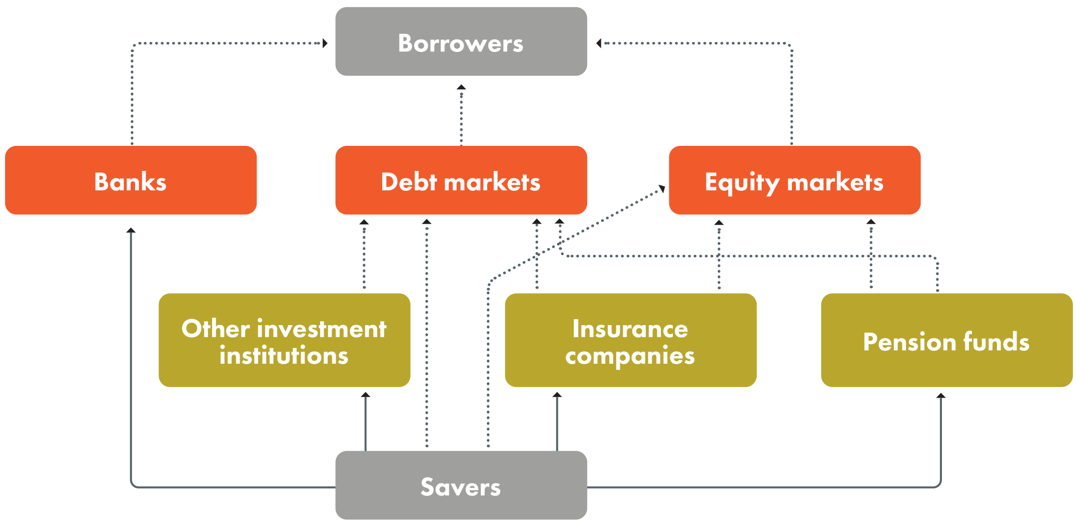
Financial intermediation

A financial system provides channels for funds to move from savers to borrowers. Intermediaries significantly reduce information and transaction costs by:

- providing services and products that allow savers to become investors;
- ensuring the adequate provision of information; and
- allowing borrowers to access a range of savers that can meet a variety of terms.

Figure 1.1 illustrates some of the main flows that occur in a financial system. Savers can supply funds directly by holding the debt and equity securities issued by borrowers (the dotted lines in Figure 1.1) or they can supply funds via an intermediary, such as a bank or investment institution (the unbroken lines). Direct financing through capital markets is sometimes appropriate, although most forms of capital-raising and capital-saving involve intermediaries.

Figure 1.1 **CAPITAL FLOWS**



Banks and other credit institutions, such as building societies, have traditionally been a key source of finance for individuals, companies and other borrowers, and a vehicle through which individuals save. They also perform an intermediation function and, increasingly, the banking sector uses the securities markets to raise capital or to invest in those markets.

Insurance companies, pension funds and other investment institutions or vehicles (such as open-ended investment companies (OEICs) and unit trusts) also perform an intermediation function. Investment companies purchase the securitised assets of banks.

Pooling and managing risk

The financial services industry provides mechanisms that efficiently manage risk. Pooled investment products allow multiple savers to invest in a wider variety of investments than they would be able to individually, which reduces each individual's overall risk exposure. Insurance allows individuals and companies to transfer a risk exposure to an insurance company in return for a premium. Finally, derivatives, such as options and futures, allow investors to manage their risk exposures.

Payments and settlement services

The financial system means money and other financial assets can be managed, transmitted and received. Banks are the main providers of payment systems that allow money to be exchanged and debts to be settled. Settlement services are provided by clearing houses to ensure that buyers and sellers of securities complete a transaction.

Portfolio management

Lastly, the financial system allows investors to manage their wealth by offering access to markets, specialist advice and investment management services. Investment advice and investment management are the two main services provided by the investment industry and are the focus of this volume of the Official Training Manual.

Sustainability and environmental, social and governance (ESG) factors in investing

The focus of incorporating ESG factors into investing has grown rapidly in recent years as investors look to mitigate the risks from the factors to preserve long-term value of their investments. The factor that has been given most prominence is the environmental factor. As most of the major economies have committed to achieve net-zero carbon emissions by 2050, the environmental factor will likely impact companies as governments implement regulations and carbon taxes to achieve the target. Environmental degradation creates risks, not only for the planet, but for companies in terms of regulations and stranded assets (i.e. assets that experience an unanticipated fall in value due to regulations, societal change, etc.). The social and governance factors relate to how a company manages the relationship with its workforce and the corporate governance structures in place. These two areas also pose risks for companies as well as investments.

THE MAIN FINANCIAL INSTITUTIONS

1.1.2 Explain the role and impact of the main financial institutions

A central bank is a financial institution involved in setting the monetary framework within which financial organisations operate. This typically requires the central bank to set short-term interest rates to meet an inflation target. In addition, the central bank will act as lender of last resort to the banking sector, supplying liquidity during times of crisis.

→ *See Chapter 9, Section 9.3 for more on monetary policy and central banks.*

Financial intermediation involves financial institutions facilitating the transfer of funds between surplus and deficit agents. Surplus agents are typically households, and deficit agents are those who need to borrow – primarily firms and governments. A wide variety of financial institutions act as intermediaries, including deposit institutions and investment institutions.

Deposit institutions accept deposits from economic agents. The deposits become liabilities of these institutions, which lend funds as direct loans or investments. Deposit institutions include commercial banks and building societies. However, the banking sector contains different types of banks, such as universal banks, which offer the full spectrum of financial services, combining the deposit and lending facilities of a commercial bank with the services of an investment bank. Investment banks act as brokers, underwriters and advisers. Like banks, savings institutions also accept deposits and make loans, although they usually operate under different rules to banks.

Investment institutions invest the funds they raise in tradable securities such as bonds and equities. Investment institutions include insurance companies that offer protection against unwanted events. Life insurance concerns death, illness and retirement policies, and general insurance involves loss or damage to property, homes, vehicles, etc. The different nature of life and general insurance is reflected in their investment strategies:

- Life insurance policies tend to cover longer periods, so insurers tend to hold long-term assets.
- General insurance companies usually hold shorter-term assets, reflecting their greater need for immediate cash.

Pension funds are now significant institutional investors in many countries, especially with falling State Pension payments and ageing populations.

Many of these institutions operate in the global financial system. A company in one country may choose to list on the stock market in another country in order to raise capital in a market with different characteristics. Companies can also raise capital across borders by issuing bonds in another country (see Section 1.7). This means that investment by savers and capital-raising by firms have a global dimension. The gradual removal of capital controls by individual nation states and the globalisation of the world economy have contributed to the phenomenon of global capital flows.

THE ROLE OF GOVERNMENT

1.1.3 Explain the role of the government including economic and industrial policy, regulation, taxation and social welfare

Broadly speaking, governments perform four functions:

1. Providing services that private firms are either unwilling or not allowed to provide. This is often referred to as 'market failure' and examples include defence, law and order, and maintenance of certain infrastructure. Government policy may involve grants and subsidies to promote certain issues which the market may not be satisfactorily addressing (e.g. 'green' activities), or for which the market does not punish externalities (e.g. carbon taxes).

2. Regulating firms and markets, principally to protect the consumer. This includes regulation to promote competition, prevent fraud, etc. Governments can also regulate markets by restricting entry to them and enforcing rules to govern participants' behaviour. In the UK, the Financial Conduct Authority (FCA), the Prudential Regulation Authority (PRA) and the Financial Policy Committee (FPC) are the main regulatory bodies for financial services.

3. Intervening in the distribution of income generated by private market transactions in order to conform to some criterion of equity, for example, a minimum wage guarantee. Redistribution of income and wealth is also a policy of most governments, and this is often achieved through transfer payments to households – for example, state benefit payments. Taxation is also used to achieve a better distribution of income among the population.

4. Stabilising the economy by attempting to reduce fluctuations in income and employment, and to control movements in the general price level. In many economies today, emphasis is placed on controlling inflation by using interest rates. In the UK, this is carried out by the Bank of England's Monetary Policy Committee (MPC).

→ *The main regulatory bodies for financial services and their remits are covered in Chapter 3.*

SECTION 1.2
THE ROLE OF SECURITIES MARKETS IN PROVIDING LIQUIDITY AND PRICE TRANSPARENCY

TYPES OF INVESTMENTS

1.2.1	Differentiate between a financial security and a real asset
1.2.2	Identify the key features of an ordinary share, a bond, a derivative contract, a unit in a pooled fund and a foreign exchange transaction

One of the main functions of the financial services industry is to provide a link between savers with funds to invest (also referred to as lenders or investors) and borrowers that need funds.

The main lenders in an economy are households – generally, households have a surplus of income after spending. The main borrowers in an economy are typically companies and governments. Direct lending between lenders and borrowers is uncommon, although the growth of peer-to-peer lending has provided some impetus to this type of lending. More commonly, households lend or invest their savings indirectly in a range of assets through intermediaries.

Real assets and financial securities

Assets have value and include real assets and financial assets. Real assets are physical assets such as land, buildings and gold. Financial assets are claims representing the right to some return (such as a bank deposit or a bond) or to ownership of physical assets. For example, a share represents ownership in a company and gives the shareholder rights to some of that company's assets and earnings. We can categorise these two different types of financial assets as debt claims and equity securities:

1. Debt claims are loans made by lenders to borrowers. Lenders expect borrowers to repay the loan and to make interest payments until it is repaid. A simple example is a bank deposit, which may pay a fixed or variable rate of interest over a term. A bank deposit represents a claim the lender has on the bank and is not tradable. Most debt claims are tradable, and one example of a tradable debt is a bond. A tradable claim is also referred to as a security. Bonds are issued by governments and companies and generally pay a fixed rate of interest. As such, they are often referred to as fixed-income securities.

2. Equity securities are also called shares. Like bonds, they are tradable securities. Shareholders have an ownership stake in the company they have invested in. The company has no obligation either to repay the money invested by the shareholders, or to make regular payments known as dividends. However, investors who buy shares expect to make a return by selling their shares at a higher price than they bought them and, possibly, by receiving dividends.

Indirect investment through intermediaries

Savers generally invest in shares and bonds indirectly through intermediaries, such as insurance companies, pension funds and pooled investment vehicles. Savers therefore invest in the products created by intermediaries. The advantage of indirect investment is a reduction in risk due to:

- greater diversification;
- reduced transaction costs as the intermediary can trade at lower cost than the individual saver;
- access to specialist expertise in the financial assets being invested in; and
- the ability to invest in assets that would not be available to an individual investor, such as commercial property.

A unit trust that specialises in UK equities is an example of a pooled investment vehicle. There are three parties to a unit trust:

1. the manager (who operates the trust fund and is responsible for investing cash contributions received from investors);
2. the trustee, who must be unconnected with the manager, and who is entrusted with the custody of the investments held within the trust on behalf of the unit holders; and
3. the unit holders who are the trust beneficiaries.

The main role of the trustee is to ensure that the fund manager runs the trust following the fund's investment goals and objectives. Unit trusts are known as 'open ended'; when investors want to invest, the fund issues new units in exchange for cash paid by the investor. When existing investors want to withdraw, the fund redeems (repurchases) their units and pays out cash. The fund can therefore grow or shrink according to demand for its units. The fund manager invests the cash in UK shares and, if the fund is well managed and the value of UK equities increases, the value of the units in the fund will increase.

→ *Unit trusts and other investment vehicles are covered in Chapter 16.*

Investment intermediaries also use derivative contracts to manage risk. A derivative is a financial contract 'derived' from an underlying asset in such a way that the price movements of the derivative and the underlying asset will be highly correlated over time. Derivative contracts can be used:

- to speculate, i.e. make gains from anticipated movements in the price of an index or asset; and
- if the underlying asset is difficult to buy or has high costs associated with investing in it. For example, buying oil directly is expensive, but purchasing a derivative contract is less costly.

→ *Derivatives are covered in Chapter 13, Section 13.1.*

Foreign exchange market transactions

A foreign exchange market transaction may occur where, for example, a UK-based fund manager wants to purchase US securities. To achieve this, the manager will need to convert pounds sterling into US dollars. This transaction will be carried out in the foreign exchange markets (also referred to as the currency markets). For large value transactions, the purchase of dollars for pounds may take place directly with a dealer. The dealer will quote bid-and-offer prices representing the prices they buy and sell dollars in relation to pounds. For smaller value transactions, the purchase of dollars will take place with a broker who will arrange for the dollars to be purchased.

→ *Chapter 9, Section 9.4 examines the foreign exchange market in more detail.*

THE FUNCTIONS OF SECURITIES MARKETS

1.2.3 Identify the functions of securities markets in providing price transparency and liquidity

Securities are traded in securities markets that bring together buyers and sellers of financial securities. A distinction is generally made between money markets (for securities that have maturity shorter than a year) and capital markets (for securities that have maturity longer than a year).

Together, securities markets perform a number of important functions:

1. Raising capital (in the capital markets). A firm can raise capital by issuing equities (ordinary shares) or bonds (corporate bonds). The funds raised can be used to purchase new machinery or other resources that enable the firm to grow. The other essential part of this process, facilitated by markets, is the mobilisation of savings. The liquidity provided by markets encourages savers to purchase the claims issued by borrowers. This leads to a greater flow of savings into productive investment.

2. Transferring risk (in the derivatives markets). A fund manager can use derivatives to hedge the risk that the value of an equity portfolio may fall by using equity index futures contracts. The fund manager has obtained protection against the risk, but the risk has not disappeared – it has been transferred to the counterparty of the derivative contract. The counterparty would be a trader who expected the equity index to rise in the future and would buy futures contracts to take advantage of that expectation.

3. Price discovery. The orders placed by buyers and sellers in a market leads to the emergence of a price at which both buyers and sellers can agree to trade. In dynamic markets, such as the equity markets, this process takes place continuously while the market is open. If a market is efficient then the equilibrium price will change only when new information arrives in the market.

4. Creating liquidity. Securities markets enable investors who hold investments to sell (liquidate) them. The ability to sell investments quickly makes them more attractive to hold and encourages investors to buy them in the first place. Liquidity in a financial market is typically defined as the ability to sell a security without causing a significant movement in its price and with minimum loss of value. A liquid market is therefore one in which there are many buyers and sellers. A seller is more likely to sell at a price they wish to sell at if there are many buyers willing to trade at the same time.

→ *See Chapter 15, Section 15.4 for more on efficient markets.*

Primary and secondary markets

One important distinction is between primary and secondary markets:

1. Primary markets are those where securities are initially sold to investors. For example, a company may raise capital by issuing new ordinary shares in order to raise capital. Where this is the first issue into the markets, the company is said to be making an initial public offering (IPO).

2. Secondary markets are where any subsequent trading of shares take place. The secondary market plays an important role in providing liquidity to investors. This liquidity provision makes it more likely that issuers of securities can make the first issue to raise capital and may even increase the price by which the securities are initially sold.

Another feature is whether a trader is on the sell-side or the buy-side. Sell-side firms – such as investment banks, brokers and dealers – primarily provide transaction services and investment products. Buy-side firms – investment managers – purchase these services and products.

This classification scheme is not easily applied to many large, integrated firms, because many investment banks have divisions or wholly owned subsidiaries that provide asset management services. These functions are on the buy-side, even though investment banks are sell-side.

→ *A further distinction exists between quote-driven and order-driven markets, and this is discussed in Section 1.3.*

PRICE TRANSPARENCY AND LIQUIDITY

1.2.4	Identify the reasons why liquidity and price transparency are thought to be important for the efficient allocation of capital when trading in securities markets
1.2.5	Identify the types of securities and the market conditions where price transparency, liquidity and depth are likely to be high/low
1.2.6	Define liquidity risk and identify why it is important

Price transparency

As well as determining the equilibrium price, markets also disseminate that price to the public. There are two types of price dissemination:

1. A market is pre-trade transparent if it publishes real-time data about quotes and orders.
2. A market is post-trade transparent if it publishes trade prices and sizes shortly after trades occur.

Buy-side traders value transparency because it allows them to better manage their trading, understand market values and estimate potential transaction costs. Sell-side traders, however, prefer to trade in opaque markets because, as frequent traders, they have an informational advantage over counterparties. Organised markets, such as the London Stock Exchange, tend to be more transparent than an over-the-counter (OTC) market, such as the market for credit default swaps. In Europe, pre- and post-trade transparency for many securities (especially equities) is required under the Markets in Financial Instruments Directive (MiFID) II.

Liquidity

Many investors assess a market's liquidity by looking at bid-ask spreads (also known as bid-offer spreads). This is the difference between the prices quoted for immediate sale (ask or offer) and immediate purchase (bid). Bid-ask spreads tend to be wider in opaque markets because finding the best available price is harder for traders. Transparency reduces these spreads, which benefits investors. Market makers offer to sell securities at a given price (the ask price) and will also bid to purchase securities at a given price (the bid price). In order-driven markets, liquidity can be judged by the difference between the best buy and sell prices in the order book.

A market may also be considered liquid if there are a lot of ready-and-willing buyers and sellers. This is related to market depth which is a measure of the size of order that is needed to move the market (have an impact on price) by a certain amount. Therefore, a deep stock market would have a sufficient volume of pending orders on both the bid and ask sides, preventing a large order from significantly moving the price. An example of a deeply liquid market is the US Treasuries market: the large volume of transactions, low bid-ask spreads and high depth (low market impact of a trade) make transaction costs very low.

An illiquid asset will be difficult to sell because of uncertainty about its future market value or if there is a lack of market depth. Infrequently traded shares, such as some of the shares traded on AIM, are relatively illiquid. During periods of market uncertainty, when most securities are falling in value, those securities may become difficult to sell, as most traders will have similar pessimistic expectations about the future value of those securities.

Investors tend to demand a higher return on securities with low liquidity to compensate for the risk that it may be difficult to sell quickly. Liquidity risk – the risk of not being able to sell quickly, with the potential for loss of value – is generally priced in the security. Liquidity risk therefore tends to be higher in low volume markets and emerging markets.

Well-functioning financial markets that are transparent and liquid provide significant benefits to traders, borrowers and society as a whole. Markets in which trades are easy to arrange with low transaction costs are operationally efficient. Such markets have small bid-ask spreads and can absorb large orders without substantial impact on prices. This will encourage traders to trade and in turn encourage savers to invest their funds in claims issued by borrowers, therefore increasing the flow of capital to productive uses in the economy.

An important by-product of operational efficiency is informational efficiency where trading leads to asset prices reflecting all relevant information about the value of the asset. Informational efficiency is enhanced by price transparency. Where all investors have access to good quality, timely information about securities, then the prices of those securities are more likely to reflect fundamental information about value. If prices reflect the fundamental value of those securities, then investors will direct funds to those securities yielding the highest returns. In well-functioning markets, the highest returns are likely to be earned on securities issued by firms investing in the most productive assets. Thus, funds will be allocated to the most productive uses in society (i.e. there is greater allocative efficiency).

TRANSACTION COSTS

1.2.7 Identify, explain and calculate transaction costs and their differences associated with dealing in UK and non-UK equities, fixed-income securities, pooled funds and property

The cost of trading clearly imposes a drag on the performance of an investment. Trading costs are a critical ingredient of any investment strategy and can make the difference between a successful portfolio and an unsuccessful one. There are some investors who operate under the misconception that the only cost of trading is the explicit brokerage commission that they pay when they buy or sell assets. However, they also incur other implicit trading costs that generally make the commission cost pale into insignificance. These implicit costs are:

- The bid-ask spread. This is set by the dealer in order to cover their own costs and make a profit. The dealer's costs include processing the order and holding stock. Smaller, riskier and less liquid (less frequently traded) stocks generally carry a larger spread.
- The price impact of a trade. Usually, costs go down with larger trades, but not in the case of price impact. When a large volume of stock (relative to the average daily volumes) is bought, for example, it can create an imbalance in demand and supply. This can only be resolved by a price change upwards, to bring in more supply. A market maker, for example, will only trade up to a specified quantity at quoted prices before reserving the right to change the price. The resulting price impact is the deviation of the transaction price from the 'unperturbed' price that would have prevailed had the transaction not occurred (often defined as the volume-weighted average of the transactions surrounding the trade). Price impact can also be caused by the 'information' the trade provides to the market. A large 'buy' may be owing to new positive information that the trader has about a company. This signal creates further demand. Similarly, a reverse argument holds for selling and price falls.
- Opportunity cost. This is the 'cost of waiting'. For example, a buy trade may be spread over a few days to prevent significant adverse price impact. However, over those few days the price rises anyway, so that any value that had been identified in the stock has now been depleted. This results in the full original order now being cancelled while partially complete. Some identified value has therefore not been 'captured'.

Now consider the explicit costs of trading. Trading equities on the London Stock Exchange involves a number of explicit transaction costs. A commission is charged by brokers, which ranges between 10 and 20 basis points for large institutional trades, to between 100 and 150 basis points for smaller trades. However, for very large institutional clients, the commission on some trades can be zero. These commissions do not currently attract value added tax (VAT). Stamp duty reserve tax (SDRT), which is a simple purchase tax, is payable on all transactions by the purchaser and is levied at a rate of 0.5%. For CREST-settled transactions, this SDRT is rounded up to the nearest 1p; otherwise it is rounded up to the nearest £5. CREST is a computerised system that allows investors to hold shares in an electronic rather than paper form. Finally, a further levy of £1.50 on all purchases and sales in excess of £10,000 is charged to finance the Takeover Panel (the PTM levy). Market makers are exempt from paying SDRT and the PTM levy.

Purchasing gilts attracts a number of transaction charges. Commission rates vary from 0.5% to 1% of the value of the purchase for purchases below £5,000, while purchases in excess of £1 million attract no commission charge. Gilts are normally settled on the next business day. Note that purchases on gilts are exempt from SDRT. Other securities purchases exempt from SDRT are loan stocks, foreign securities registered outside the UK, bearer securities and deals in traded options through ICE Futures Europe.

For pooled investments such as unit trusts and OEICs there are generally two transaction costs:

1. an entry cost; and
2. an ongoing charges figure (OCF).

Over time, the OCF will be the highest component of transaction costs. Actively managed pooled investments (funds) charge a higher OCF compared to a fund that simply tracks an index. The *FCA Asset Management Market Study Interim Report* published in November 2016 found that the average OCF for passive funds is 0.15% of the investment and for active funds it is 0.9%.

Transaction costs for direct property investments include stamp duty, legal costs and ongoing maintenance costs.

→ *Stamp duty varies according to the purchase cost and is covered in Chapter 6, Section 6.1.*

Calculating round-trip transactions

As noted earlier, trading securities incurs significant transaction costs, such as brokerage commissions, bid-ask spreads and market impact. Most traders employ brokers to trade on their behalf and pay commission for arranging their trades. Commissions are usually either a fixed percentage of the value of the transaction or a fixed price per share, bond or contract. Brokers also pay exchange, regulatory and clearing fees on behalf of their clients via their commission and fixed transaction charges.

Broker commission varies according to the type of trader and frequency of trading. Retail customers typically pay around £5 to £12.50 per trade (more frequent trading means lower commission). Institutional investors pay significantly less, with typical costs being 10 to 20 basis points for large trades.

Generally, traders who want to trade quickly buy at higher prices than the prices at which they sell. The difference comes from the price concessions that they give to encourage other traders to trade. For small orders, the trader will have to buy at the ask or sell at the bid, thus incurring the bid-ask spread. For large trades, buyers who want to trade quickly must raise prices to encourage other traders to sell to them. Similarly, impatient sellers of large trades must lower prices to encourage other traders to purchase from them. These price concessions, called market impact or price impact, often occur over time as large-trade buyers push up prices and large-trade sellers push them down in multiple transactions. For large institutions, the price impact of trading large orders is generally the biggest component of their transaction costs.

Traders who are willing to wait until other traders want to trade with them generally incur lower transaction costs. In particular, by using limit orders instead of market orders, they can buy at the bid price or sell at the ask price. However, these traders incur the risk that they will not trade when the market is moving away from their orders. The cost of not executing a trade is known as opportunity cost.

Example

Bid-ask spread

A stock is trading with a bid price of £9.95 and an offer price of £10. The bid-ask spread in this case is £0.05. The spread as a percentage is ((£0.05 ÷ £10) × 100), or 0.50%.

A buyer who acquires the stock at £10 and immediately sells it at the bid price of £9.95 would incur a loss of 0.50% of the transaction value due to the spread. The purchase and immediate sale of 100 shares would entail a £5 loss, while if 10,000 shares were sold, the loss would be £500. The percentage loss resulting from the spread is the same in both cases.

Traders choose their order submission strategies to minimise both their transaction costs and their opportunity costs. Market participants can use various techniques to reduce their transaction costs. They employ skilful brokers, apply electronic algorithms to manage their trading and use hidden orders or dark pool trading systems to hide their size.

Example

Tax and other charges

UK traders purchasing shares pay SDRT of 0.50% of the transaction value. A further levy of £1.50 on all purchases and sales of shares in excess of £10,000 is levied to finance the PTM levy.

Example

Total round-trip transaction costs

Round-trip transaction costs are the total costs of completing a transaction, including bid-ask spread, commissions and taxes. The assumption made in this example is that the purchase and sale occur simultaneously so the quoted bid and ask prices are used as buying and selling prices.

For a retail investor that wants to purchase 5,000 shares in XYZ PLC, assume the current bid-ask quotes for this order quantity are 213.75p – 213.85p and commission per trade is £5. The total round-trip transaction costs will be:

Element	Cost
Buy 5,000 shares at 213.85p	£10,692.50
Sell 5,000 shares at 213.75p	(£10,687.50)
Commission (for two trades)	£10.00
SDRT	£53.46
PTM levy for two trades	£3.00
Net cost (absolute)	£71.46
Net cost (percentage)	0.67%

SECTION 1.3
TYPES OF FINANCIAL MARKETS

THE UK EQUITY MARKET

1.3.1	Identify the main dealing systems and facilities offered in the UK equities market and explain the clearing and settlement procedures for UK exchange-traded securities
1.3.2	Identify the nature of the securities that would be traded on each of the main dealing systems and facilities

Equity trading in Europe changed with the implementation of MiFID in 2007, which created harmonised regulation for investment services for all European Economic Area (EEA) states. Three types of order execution venues are permitted under MiFID:

1. regulated markets;
2. multilateral trading facilities (MTFs); and
3. systematic internalisers.

A further trading venue – an organised trading facility (OTF) – was introduced with MiFID II. All four of these trading venues are covered in this section.

The greater competition across trading venues has led to fragmentation of trading, with the London Stock Exchange's (main market) share of trading volume declining to around 55% by late 2015, then marginally increasing to around 60% by 2024.

This section focuses on the trading systems offered by the London Stock Exchange, which is the main regulated market in the UK. The London Stock Exchange offers two market models for trading UK shares: SETS and SETSqx.

SETS

SETS is an electronic limit order book used to trade stocks including FTSE 100, FTSE 250 and FTSE Small Cap constituents, as well as many of the most-traded AIM and Irish securities. In addition, exchange-traded funds (ETFs) and exchange-traded products (ETPs) are traded on SETS.

Liquidity on SETS throughout the trading day is underpinned by the provision of market maker electronically executable quotes. This ensures that traders can trade at least one exchange market size (EMS). The EMS is set by the London Stock Exchange and is the 'normal market size' for orders, and a market maker is obliged to quote bid/offer prices that are firm for order sizes up the EMS. Auctions on SETS are conducted at the opening and closing of the day (7:50am and 4:30pm) to establish the opening and closing price. Matching bids and offers are executed in a limited timeframe (ten minutes at opening and five minutes at closing). These periods of time are known as the 'call period'. A matching algorithm considers the orders that have been entered and calculates the price that the maximum amount of shares can be executed. The goal here is to find the most popular price, rather than the highest or lowest price. At the end of this call period, orders that can be matched are executed in an event referred to as an uncrossing.

There are also unscheduled auctions that trigger when the price crosses the percentage threshold since the previous uncrossing trade. An uncrossing trade is where buyers on the bid and sellers on the ask match together in a single trade at the end of an auction period. Unscheduled auctions can be triggered when intraday news is announced from the RNS feed (the news service of the London Stock Exchange), and the price moves significantly.

SETSqx and SEAQ

SETSqx is a trading platform for stocks that are less liquid than those covered by SETS. It combines a periodic electronic auction book with non-electronic quote-driven market making. Several uncrossings take place each day, which allow order-book execution through auctions at 8am, 9am, 11am, 2pm and at closing. Investors therefore have a choice of trading in either the quote-driven or order-book auction service. Note that many SETSqx stocks have very low liquidity so a market maker will cover their risk by setting a wide bid-ask spread.

SEAQ is a quote-display system used as the price reference point for telephone execution between market participants and registered market makers. It is used for fixed-interest securities and AIM securities that are not traded on either SETS or SETSqx.

LCH is the central counterparty to all SETS and SETSqx trades at the point of execution. This ensures that clearing members acting on behalf of firms trading on SETS are not exposed to any risk in the event that a clearing member defaults. LCH assumes the risk itself but manages it by collecting margin from members.

International trading

International securities are traded on the London Stock Exchange through:

- The International Order Book – an electronic order book for trading international securities in the form of a depository receipt on the London Stock Exchange.
- The European Quoting Service (EQS) – a quote-driven market making and trade-reporting platform that supports all EU liquid securities (excluding those traded on SETS and SETSqx). With this platform, market makers enter non-electronically executable quotes during the mandatory quote period.

  The European Reporting service, provided by the London Stock Exchange, allows clients to meet their MiFID post-trade reporting obligations whether trading on- or off-exchange. This is achieved either by:

  - on-exchange, off-book trade publication – for all trades regulated under the exchange's rules; or
  - OTC trade publication – for any unregulated trades executed away from the exchange's markets, whether acting as a systematic internaliser or not.

The current standard settlement of London Stock Exchange equity transactions is T+2 (trade date plus two working days) and settlement is made through CREST. However, the US equity markets moved to T+1 settlement in May 2024 and the UK intends to move to T+1 settlement in October 2027.

The settlement of gilts is also carried out through CREST, which operates a computerised settlement system for its members, including gilt-edged market makers (GEMMs) and large banks. The settlement period is T+1.

Since the implementation of MiFID in 2007, there has been a rapid growth in equity-trading channels and clearing venues. As well as trade execution, many platforms may provide services in addition to trade execution, such as order management. CCPs offer counterparty risk-clearing, including preparing transactions for settlement, netting transactions and settlement instruction. Management of failed trades is also provided.

Settlement itself involves pre-settlement positioning (i.e. making sure the buyer has the necessary monies and the seller has the securities available) and the completion of the transaction through transfer of ownership and monies. This process is initiated once the trade has been cleared by the central counterparty. Such activities are provided directly via CSDs.

THE UK GILT AND CORPORATE BOND MARKET

1.3.3 Explain the structure and operation of the primary and secondary UK markets for gilts and corporate bonds

Gilts

UK Government bonds are commonly referred to as 'gilt-edged' securities or 'gilts'. Although the issued bonds carry a variety of names (e.g. Treasury, Exchequer), all bonds are the direct obligation of the UK Government. Gilts, which usually pay gross coupons (interest) semi-annually, are used to finance the shortfall between government expenditure and government revenue. Management of the UK Government's debt is carried out by the Debt Management Office (DMO), an agency of the Treasury.

The DMO typically issues gilts via auction, which is also the preferred method in a number of other countries, most notably the USA. Gilt settlement is made via CREST.

The main holders of gilts are UK pension funds, UK insurance companies, overseas investors, UK banks and building societies, and private individuals.

The key participants in the market for UK gilts are GEMMs who are required by the DMO to 'make on demand and in any trading condition, continuous and effective two-way prices in gilts at which they stand committed to deal'. This means that GEMMs must continually quote bid and ask prices for gilt issues and must trade at these prices so that investors always have a source of liquidity. In addition, the GEMMs are expected to participate in primary gilt issuance, provide the DMO with relevant data about the gilts market, and accept the DMO's monitoring arrangements. They are also required to provide real-time prices or accurate mid-market indications to at least one wire services provider and/or electronic trading platform. In return for these obligations, GEMMs enjoy the privilege of being eligible to submit competitive bids at gilt auctions directly to the DMO. This means that in almost all of its gilt market operations, the DMO transacts only with the GEMMs. Additional dealing privileges associated with GEMM status include the right to strip and reconstitute gilts through CREST.

Corporate bonds

When corporate bonds are issued, they may be sold as an open offer for sale or directly to a small number of professional investors (a so-called 'private placing').

An open offer for sale involves a syndicate of banks, with one as lead manager buying the bonds and then reselling them to investors. The sale of the bonds is therefore underwritten by the banks (who charge for this service). If the lead bank buys all the bonds and sells them to the syndicate this is called a 'bought deal'. The syndicate members could then sell the bonds at varying prices. More commonly, the lead manager and the syndicate buy the bonds together and offer them at a fixed price for a certain period, known as a 'fixed-price re-offering'.

Corporate bonds mainly trade in decentralised, dealer-based, OTC markets. Market liquidity is provided by dealers and other market participants committing risk capital. When an investor buys or sells a bond, the counterparty to the trade is almost always a bank or securities firm acting as a dealer.

The London Stock Exchange operates an electronic Order Book for Retail Bonds (ORB). This order-driven trading service offers retail investors access to a select number of government and UK corporate bonds.

In October 2024, 72 UK Government bonds and 36 corporate bonds were available for trading on the ORB. The ORB offers an electronic model similar to SETS with continuous two-way pricing provided by market makers (submitted as named executable quotes). Other market participants are able to enter market orders and limit orders.

→ *The characteristics of both gilts and corporate bonds are discussed in Chapter 12, Section 12.2.*

DUAL LISTING

1.3.4	Explain the motivations for, and implications of, dual listing for a company

A dual-listed company (DLC) is a corporate structure in which two corporations function as a single operating business through a legal equalisation agreement, but retain separate legal identities and stock exchange listings.

Virtually all DLCs are cross-border and have tax advantages for the corporations and their shareholders. Equalisation agreements are legal contracts that specify how ownership of the corporation is shared and are set up to ensure equal treatment of both companies' shareholders in voting and cash-flow rights.

Usually, the two companies share a single board of directors and have an integrated management structure. Some examples of DLCs and the countries where the two corporations making up the DLC listed are:

- Carnival Corporation & plc (USA and UK).
- Investec (South Africa and UK).

One important advantage of a dual-listed structure is tax. Capital gains tax could be payable if an outright merger took place, but no such tax consequence arises with a DLC deal.

The shares of the DLC parents represent claims on exactly the same underlying cash flows. This implies that in efficient financial markets, stock prices of the DLC parents should be the same. In practice, however, large differences between the prices of the two parents can arise. For example, in the early 1980s, Royal Dutch Shell NV was trading at a discount of approximately 30% relative to Shell Transport and Trading plc. This creates arbitrage opportunities for investors, assuming the two prices eventually converge. The evidence on DLC mispricing is that convergence can take many years and therefore an arbitrage strategy of this kind would require a very long investment horizon.

EXCHANGE TRADING, OVER-THE-COUNTER AND ALTERNATIVE TRADING VENUES

1.3.5	Compare and contrast exchange-traded and over-the-counter (OTC) markets
1.3.6	Distinguish between the following alternative trading venues: multilateral trading facilities, systematic internalisers, organised trading facilities and dark pools

Exchange-traded and over-the-counter markets

Trading on exchanges, such as stock markets like the London Stock Exchange, set the institutional rules that govern trading and information flows about that trading. They are closely linked to the clearing facilities through which post-trade activities are completed for securities and derivatives traded on the exchange. An exchange centralises the communication of bid-and-offer prices to all direct market participants, who can respond by selling or buying at one of the quotes or by replying with a different quote. Depending on the exchange, the medium of communication can be voice, hand signal, a discrete electronic message, or computer-generated electronic commands. When two parties reach agreement, the price at which the transaction is executed is communicated throughout the market. The result is a level playing field that allows any market participant to buy as low or sell as high as anyone else as long as the trader follows the exchange rules.

The advent of electronic trading has eliminated the need for exchanges to be physical places. Indeed, many traditional trading floors are closing, and the communication of orders and executions are being conducted entirely electronically.

An OTC market involves the trading of securities in a decentralised way, usually via telephone, fax or electronic network. This contrasts with trading on a physical trading floor or other centralised meeting place.

The securities may not be listed on an exchange, and trading takes place via dealers who carry inventories of the securities to satisfy buy and sell orders. OTC refers to a bilateral contract in which two parties agree on how a trade or agreement is to be settled in the future. In terms of equity trading, this type of trade is referred to as an off-book trade (or 'upstairs trade') and these types of trades are typically large and traded off the exchange, so the trade does not move the price (i.e. has no price impact).

Multilateral trading facilities

MTFs are trading platforms organised by investment firms or market operators which bring together third-party buyers and sellers – often banks and large institutional investors. MTFs can be operated both by the operator of a regulated market or an investment firm. The distinction between a regulated market and an MTF is rather blurred as they both have to follow the same regulatory standards on transparency and rulebooks.

Since the introduction of MiFID in 2007, a large number of MTFs have been established by investment banks to compete on trading cost with existing exchanges, such as the London Stock Exchange. Two of the largest MTFs merged to form BATS Chi-X Europe. Demonstrating the blurred line between MTFs and regulated markets, BATS Chi-X Europe (now known as CBOE Europe) became a recognised investment exchange in 2013. MTFs can also be owned by conventional exchanges (e.g. Turquoise is owned by the London Stock Exchange).

Systematic internalisers

A systematic internaliser is an investment firm which deals on its own account by executing customer order flows in liquid shares outside either a regulated market or an MTF. MiFID requires such a firm to publish and honour buy and sell prices up to standard market size. This means they are not able to improve their price when dealing in retail size or with retail clients.

Organised trading facilities

An OTF is a multilateral system which is not a regulated market or MTF and in which multiple third-party buying and selling interests in bonds, structured finance product, emissions allowances or derivatives are able to interact in the system in a way that results in a contract. This is a new category of trading facility introduced in MiFID II and is designed to capture trading in bonds and certain kinds of derivatives that would not be traded on organised markets or MTFs. Also, trading on regulated markets and MTFs is governed by rules whereas trading on OTFs is discretionary.

Dark pools

Dark pools are electronic crossing networks that provide liquidity which is not displayed on a conventional order book of an organised exchange. As neither the price nor the identity of the trader is displayed, dark pools are useful for traders wishing to buy or sell large numbers of shares without revealing themselves on the open market.

Dark pools are typically MTFs that have opted out of the requirements for pre-trade transparency. They are an alternative to off-market trades in that they allow large trades to be traded without price impact, but they trade in a market (rather than bilaterally), thus potentially getting a better price.

FCA guidance on when a firm's activities constitute those of a trading venue that requires authorisation came into effect in October 2023. In this guidance the FCA has sought, among other things, to clarify its view of what constitutes a 'multilateral system' and how this concept should be applied to specific types of arrangements in financial markets.

The term 'trading venue' covers the three types of venues discussed earlier – regulated markets, multilateral trading facilities and organised trading facilities. Common to all three types of trading venue is the operation of a multilateral system, which has four elements:

i. it has the characteristics of a trading system or facility;
ii. it comprises multiple third-party buying and selling trading interests;

iii. it allows trading interests to interact in the system; and

iv. those trading interests are in financial instruments.

Essentially, the guidance makes it clear that in determining whether a given system is considered multilateral or bilateral turns on whether the system, at the point of entry, enables one person to interact potentially with multiple others. The guidance also clarifies that the execution of a transaction does not need to take place within the system in order to meet the threshold for trading interests to 'interact' in the system.

QUOTE-DRIVEN AND ORDER-DRIVEN MARKETS

1.3.7	Distinguish between a quote-driven and an order-driven market
1.3.8	Explain the roles of the various participants in the UK equity market

An important distinction exists between quote-driven and order-driven markets. SEAQ is quote-display, while SETS is an order book – i.e. an order-driven system.

Order-driven systems are used for securities that are highly liquid – i.e. traded in large volumes, so that when an investor wants to buy a stock then a counterparty can be readily found. Moreover, the price the buyer is willing to pay is acceptable to the seller. Under order-driven systems, orders from all customers are input to an electronic order book, where there are two main types of order: market and limit orders.

- Market orders are orders that specify a quantity to be traded, but not a price. They are then matched with the best order in the order book at that time. So, an order to buy 100 ABC shares will be matched with an order to sell 100 ABC shares with the lowest price.
- With a limit order, buyers state the quantity and price they are willing to pay. Similarly, sellers state the prices they are willing to accept.

Orders are automatically 'matched' and then proceed to the settlement system. Limit orders will only be matched once the quantity and price stated in the order are available on the other side of the trade. Remainders of orders, where not fully matched, may be left on the system until completed. The priority for matching is first by price, and then by the time the order was input – i.e. on a first-in-first-out basis.

Example

A simplified example of an order book for XYZ's shares is as follows:

Buy		Sell	
Volume	Price	Volume	Price
5,000	303	12,100	304
10,880	303	650	305
4,666	303	18,221	305
10,000	302	4,326	306
860	301	14,100	307
5,000	301	1,500	307

The table in the previous example shows the volume of shares for each order, the prices buyers are willing to pay and the prices sellers are willing to accept. Note the orders in the order book are made up of limit orders. As well as the volumes and prices, the times that the orders are entered would also be recorded.

The orders shown in the example table are those that have not been matched – the highest price buyers are willing to pay (303p) is below the price that sellers are willing to accept (304p). If an order is entered to buy 10,000 XYZ shares 'at best' (i.e. a market order) then this will be matched against the selling order at the top of the right-hand column with a price of 304p.

Quote-driven systems require market makers to maintain liquidity and efficiency in trading. An electronic order-driven system automatically gives investors the best price available, but this is not the case with quote-driven systems.

Market makers are financial institutions that have an obligation to continually quote bid and ask prices for a given security and be ready and able to buy or sell at those publicly quoted prices. Of course, if the market maker does not want to trade in a particular security, it will not quote a good price. Market makers in equities in the UK may elect which securities they wish to trade in.

Market makers must indicate firm prices up to a required volume (set by exchanges). For example, the London Stock Exchange sets the minimum volume in the UK (known as the normal market size). For volumes greater than this, market makers may give indicative prices. Market makers input their prices to a central market system (e.g. SEAQ), which market participants have access to view. Broker-dealers can then identify the market maker that gives their most favourable price and can call that market maker to strike a deal. The market maker will then update the system as required.

HIGH-FREQUENCY TRADING

1.3.9 Explain algorithmic and high-frequency trading, its benefits, risks and regulation

Algorithmic trading, also known as automated trading, refers to the use of electronic platforms for entering orders whereby an algorithm decides on aspects of the order, such as timing, price or volume. In many cases, the order is initiated without human intervention. Algorithmic trading is widely used by institutional buy-side traders, such as pension funds and mutual funds, to divide large trades into several smaller trades. This manages market impact and risk. Sell-side traders, such as market makers and some hedge funds, also generate and execute orders automatically and in doing so provide liquidity to the market.

Under MiFID II, a firm engaging in algorithmic trading must enter into a binding written agreement with the trading venue to make markets for a specified period of time. This is to improve the availability of liquidity in the markets, particularly in times of high volatility. The firm is also required to have in place effective systems and risk controls to ensure its trading systems are resilient and have enough capacity, are subject to appropriate thresholds and limits which prevent sending erroneous orders, do not function in a way that contributes to a disorderly market and cannot be used for any purpose that is contrary to the rules of a trading venue to which it is connected. In addition, firms must have effective business continuity arrangements to deal with any system failure and ensure their systems are tested and monitored. Trading venues will also be required to have systems to ensure that algorithmic trading cannot create or contribute to disorderly trading on the market. These will include systems to limit the ratio of unexecuted orders to transactions, slow down order flow and regulate minimum tick sizes. Trading venues will be required to provide facilities for their members to test algorithms and to identify orders generated by algorithmic trading, different algorithms used and the persons initiating the orders.

High-frequency trading (HFT) is a kind of algorithmic trading in which computers make decisions to initiate orders based on information that is processed more quickly than human traders are capable of doing. The growth of HFT has resulted in a dramatic change in the market microstructure, particularly in the way liquidity is provided. HFT essentially looks to identify predictable patterns in financial data. The trading is characterised by short portfolio holding periods (often just a few seconds or even milliseconds) and very large volumes.

There are four key HFT strategies:

1. market-making based on order flow;
2. market-making based on tick data information;
3. event arbitrage; and
4. statistical arbitrage.

As HFT is a subset of algorithmic trading, persons engaging in HFT techniques must abide by the general rules which apply to algorithmic traders, as well as specific rules for HFT. Under MiFID II, HFT firms will be required to store time-sequenced records of their algorithmic trading systems and trading algorithms for at least five years. The European Securities and Markets Authority (ESMA) proposes that the records should contain sufficient detail to enable monitoring by the competent authority and include information such as details of the person in charge of each algorithm, a description of the nature of each decision or execution algorithm, and the key compliance and risk controls. The records must be made available to the competent authority on request.

HFT has been the subject of public focus since the US Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) stated that both algorithmic trading and HFT contributed to volatility in the 2010 Flash Crash. At 2:42pm on 6 May 2010, the US stock market began to rapidly fall, and dropped 600 points in five minutes. By 2:47pm, the market had an almost 1,000-point loss on the day. Twenty minutes later, the market had regained most of the 600-point drop. According to the joint SEC/CFTC investigation, at 2:32pm, against a 'backdrop of unusually high volatility and thinning liquidity', 'a large fundamental trader (a mutual fund complex) initiated a sell program to sell a total of 75,000 E-Mini S&P 500 contracts (valued at approximately US$4.1bn) as a hedge to an existing equity position'. The investigation states that this was an unusually large position and that the computer algorithm used to trade the position was set to 'target an execution rate set to 9% of the trading volume calculated over the previous minute, but without regard to price or time'.

As the seller's trades were executed in the futures market, buyers included HFT traders, and these HFT firms also started aggressively selling the long futures positions they first accumulated mainly from the mutual fund. HFT traders then began to quickly buy and resell contracts to each other, generating a 'hot potato' effect as the same positions were rapidly passed back and forth. The combined sales by the large seller and HTF traders quickly drove the market down.

However, this version of events has been challenged by the exchange the contracts were traded on, and by a number of academic papers. Despite these rebuttals, HFT is still likely to have played a prominent role in driving the market down so rapidly.

Another example of the risks involved in HFT occurred in August 2012, when Knight Capital Group experienced a problem with its automated trading system. The problem was related to Knight's installation of trading software and resulted in it sending numerous erroneous orders in New York Stock Exchange (NYSE)-listed securities into the market. Knight has since traded out of its entire erroneous trade position, which resulted in a realised pre-tax loss of approximately US$440m.

SECTION 1.4
THE UK LISTING AUTHORITY AND PROSPECTUS REQUIREMENTS

THE UK LISTING AUTHORITY

1.4.1	Explain the role of the Financial Conduct Authority (FCA) as the UK listing authority
1.4.2	Identify the listing rules in the Financial Services and Markets Act (FSMA) 2000 as amended

Public companies are defined as those that seek finance from the investing public. Private companies, on the other hand, are generally forbidden to raise capital in this way. A further distinction is that public companies who wish to have their securities listed on the London Stock Exchange must comply with the Stock Exchange's rules. The advantage of a stock exchange listing is that the shares are freely marketable, which makes them more attractive to investors.

In the UK, the FCA is the 'competent authority' (or, colloquially, the UK listing authority) to decide on the admission of securities to the Official List. The listing authority makes rules governing admission to listing and the continuing obligation of issuers. These rules are collectively known as the listing rules, and the power to create the rules comes from the Financial Services and Markets Act 2000 as amended. The listing rules also implemented the EU Prospectus Regulation and the Transparency Directive. These EU Regulations/Directives have been retained as UK law following the UK's withdrawal from the EU. The UK is implementing a new prospectus regime in early 2026, replacing the existing UK Prospectus Regulation. This new regime, along with the Public Offers and Admissions to Trading Regulations 2024, will shift the focus from a prescriptive approach to a more flexible one, potentially impacting how companies issue securities and what information is required in prospectuses.

The FCA introduced major changes to the UK listing regime in July 2024. These changes replaced the previous regime of two listing categories:

1. Premium listing is typically used by large firms looking to benefit from an increased profile and a highly liquid market.
2. Standard listing is for firms that meet lighter requirements laid down by listing regulations.

Under the new rules, there is one category of listing for commercial companies called equity shares (commercial companies) or ESCC. Other specialist categories will continue to exist for, for example, closed-ended investment funds (investment trusts). The reforms are motivated by the view that the current listing regime is burdensome for companies and overly restrictive. The aim is to create a simpler, less burdensome listing regime that will boost IPOs and capital raising.

To appeal to a wider range of companies operating in growth sectors of the global economy, IPO eligibility requirements will be relaxed, with the removal of the current premium listing requirements for a three-year historical financial information requirement and a 'clean' or unqualified working capital statement.

A listed company would choose to admit to trading on the main market (Official List) of the London Stock Exchange (or alternatively the Aquis Stock Exchange (AQSE) Main Market). All companies with shares in the new ESCC category or the closed-ended investment fund category will be potentially eligible for inclusion in the FTSE UK Index Series. This is important for companies seeking liquidity for their listed securities, particularly given that tracker funds' investments are driven by FTSE indexation.

LISTING RULES AND PROSPECTUS REQUIREMENTS

1.4.3	Explain the main conditions for listing on the Official List, AIM and AQSE
1.4.4	Explain the purpose of the requirement for a prospectus or listing particulars

Conditions for listing

The listing authority sets out various conditions for listing. For an ESCC listing, the most important conditions are:

- A company must normally have published accounts that cover at least three years.
- The expected aggregate market value of all the securities to be listed must be:
  - at least £30 million for shares; or
  - at least £200,000 for debt securities.
- Overall, 10% of the listed securities must be held by the public by the date of admission.
- A sponsor is required in connection with the admission for listing.

Under the listing rules, no securities may be admitted unless the listing authority has approved either listing particulars or a prospectus, and these documents must have been published.

In general, a prospectus is required whenever an application for listing is made and the securities are to be offered to the public before admission to listing. Where the securities are not to be offered to the public, a prospectus is not required but listing particulars still need to be approved and published by the listing authority.

The UK prospectus regulations also require publication of a prospectus where:

i. securities are admitted to trading on a regulated market in the UK or admitted to listing in the UK; or

ii. a firm is making a public offer in the UK.

This is wider than the normal concept of listing, as it includes securities traded on 'second markets' and on other trading facilities.

The prospectus rules specify the content of a prospectus (or the listing particulars), which vary according to the nature of the company applying for listing. In general, the prospectus should disclose:

- all information that an investor would reasonably require regarding the assets and liabilities, financial position, profits and losses; and
- prospects of the issuer; and
- the rights attached to the securities.

Listing on AIM

AIM does not stipulate minimum criteria for company size, trading record or number of shares held by the public.

Companies need a nominated adviser (a 'nomad') from an approved register, who is responsible to the London Stock Exchange for ensuring that all applicants are suitable for admission to AIM and are ready to be admitted to a public market. Companies must produce an admission document that includes information about their directors, promoters, business activities and financial position.

AIM companies are required to disclose details of their financial performance through scheduled interim and full-year results, together with disclosures on an ongoing basis regarding developments which could affect company performance. AIM is not part of the Official List, but is classified as a MTF (see Section 1.3).

A further segment of the London Stock Exchange main market was the High Growth Segment (HGS) which was intended to attract listings by medium- and high-growth companies that did not meet the requirements of the old premium listing segment. With the new single ESCC category the HGS became redundant and has ended.

Listing on Aquis Exchange (AQSE)

An alternative route to admission to the Official List in the UK is to seek a listing on the AQSE Main Market. The eligibility for such a listing is the same as for the Official List described above. AQSE also operates the AQSE Growth Market. The Growth Market is for unlisted securities. It is a Multi-lateral Trading Facility (MTF) and a Recognised Growth Market. The market is divided into two segments – Apex for larger, more established companies and Access for smaller companies at an earlier stage in their development.

EXEMPTIONS FROM LISTING PARTICULARS

1.4.5 Identify the main exemptions from listing particulars

There are a number of exemptions from the obligation to produce a prospectus, including:

1 Where the offer is made to 'qualified investors'. Qualified investors are those who are, or may elect to become, professional clients or eligible counterparties. Retail clients who elect to become professional clients must meet at least two of the following criteria:

   (a) have carried out transactions of a significant size (over €1,000) on securities markets at an average frequency of, at least, ten per quarter for the last four quarters;

   (b) have a security portfolio exceeding €500,000; and/or

   (c) work, or have worked for at least a year, in the financial sector in a professional position which requires knowledge of security investment.

2. Where the offer is made to fewer than 150 persons (other than qualified investors) in the UK.

3. Where the minimum consideration per investor, or the minimum denomination per unit, is greater than €100,000.

4. Where shares representing less than 20% of the number of shares of the same class are already admitted for trading on the same regulated market (note this is planned to increase to 75% when the new UK prospectus regulation is implemented in early 2026).

Note that the final point only relates to an admission to trading, not to a public offer. Therefore, a rights issue to the public, at whatever level, requires a prospectus.

SECTION 1.5
INFORMATION DISCLOSURE AND CORPORATE GOVERNANCE REQUIREMENTS FOR UK EQUITY MARKETS

DISCLOSURE OF DIRECTORS' INTERESTS IN SHARES

1.5.1 Explain the disclosures required under the disclosure and transparency rules relating to directors' interests and major shareholdings

The UK Market Abuse Regulation (UK MAR) sets out the reporting of transactions in a company's securities, including derivatives, by 'persons discharging managerial responsibilities' (PDMRs), which includes directors. PDMRs and their connected persons must notify the listed company concerned and the FCA within three working days of a transaction (both sale and purchase).

The listed company must notify the market within two working days of receiving the notification. This notification must be through a primary information provider. The aim of this reporting requirement is to help prevent insider dealing.

DISCLOSURE OF MAJOR INTERESTS IN SHARES

1.5.1 Explain the disclosures required under the disclosure and transparency rules relating to directors' interests and major shareholdings

Major shareholders in listed companies can be in a position to influence company management. The DTRs apply to substantial individual interests in shares carrying unrestricted voting rights. The aim is to ensure that directors, shareholders and employees of a public company can ascertain, for example, the identity of any person who is in the process of buying shares in the company through nominees to gain control of it. As such, an investor must notify a company within two business days when it acquires 3% or more of that company's shares. Further disclosures are required at increments of more than 1% above the initial 3%.

A further provision relates to 'concert parties'. Concert parties are groups of individuals acting in agreement for the purpose of acquiring interests in shares. The aim of this provision is to prevent control 'in concert'. That is, a group of individuals secretly agreeing that, while each person only openly acquires less than the 3% threshold, they will actually use the combined interest to gain control, or to ensure a takeover or a special resolution at the meeting of a company.

The Companies Acts require that each individual in such an agreement must have the interests of the other members of the concert party added to their own interest. If the total then exceeds 3%, a disclosure must be made. Also, each person must notify that they are party to such an agreement and must give the details of it.

An individual is also subject to the disclosure rule where they are deemed to personally have control over the exercise of any rights conferred by holding those shares, even where they are not the registered holder. This rule is used to expose any agreement which otherwise might be used to conceal an interest requiring disclosure.

A public company must keep a register of interests in shares disclosed. A company may require a person who is known to have had an interest in its shares during the previous three years to indicate whether they hold or have held such an interest. This provides a public company with the power to probe and discover the true beneficial owner of its shares. Such information must also be recorded in the register.

Persons with significant control (PSC) within a company or limited liability partnership (LLP) must be registered in a statutory register, which most UK companies and LLPs are required to keep. This is to ensure that the individuals who are a company's ultimate beneficial owners and controllers are identified, and details of their holdings made public. The aim of the PSC register is to combat tax evasion, money laundering and terrorist financing. The rules apply to all UK companies, except those subject to DTR 5 as these companies are already subject to extensive disclosure requirements.

UK CORPORATE GOVERNANCE REGULATIONS

1.5.2	Explain the purpose of corporate governance regulation and the role of the Financial Reporting Council in promoting good corporate governance
1.5.3	Explain, in outline, the scope and content of corporate governance standards in the UK
1.5.4	Explain the purpose and scope of the Shareholders Rights Directive (SRD II) and its impact on pension schemes

Corporate governance refers to the way in which companies are directed and controlled and is the way the affairs of corporations are handled by their corporate boards and officers. Corporate governance essentially involves balancing the interests of a company's many stakeholders, such as shareholders, management, customers, suppliers, financiers, governments and the community.

Corporate governance originated in response to the separation of ownership and control following the formation of joint stock companies. The owners or shareholders of these companies, who were not involved in day-to-day operational issues, required assurances that the directors and managers, who were in control of the company, were safeguarding their investments and accurately reporting the financial outcome of the business's activities. The corporate governance system in the UK has traditionally stressed the importance of internal controls and the role of financial reporting and accountability, rather than external legislation.

The Financial Reporting Council (FRC) is currently the body responsible for setting corporate governance standards in the UK, such as the UK Corporate Governance Code and the Stewardship Code, discussed further on in this section. The FRC is also responsible for setting UK financial reporting standards and the standards governing auditing and actuarial work. The work of the FRC came under scrutiny in 2018 following the collapse of Carillion and an independent review recommended its replacement with a regulatory body with stronger powers. The new Labour Government in 2024 indicated it is planning to bring forward a bill to strengthen audit and corporate governance in the UK.

The UK Corporate Governance Code

The UK Corporate Governance Code was published in June 2010, with updates in 2012, 2014, 2016, 2018 and 2024. The 2024 Code is effective from January 2025 and makes minor changes to the 2018 Code.

The main principles of the Code

Section 1: Board Leadership and Company Purpose

A. A successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company, generating value for shareholders and contributing to wider society.

B. The board should establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned. All directors must act with integrity, lead by example and promote the desired culture.

C. The board should ensure that the necessary resources are in place for the company to meet its objectives and measure performance against them. The board should also establish a framework of prudent and effective controls, which enable risk to be assessed and managed.

D. In order for the company to meet its responsibilities to shareholders and stakeholders, the board should ensure effective engagement with, and encourage participation from, these parties.

E. The board should ensure that workforce policies and practices are consistent with the company's values and support its long-term sustainable success. The workforce should be able to raise any matters of concern.

Section 2: Division of Responsibilities

F. The chair leads the board and is responsible for its overall effectiveness in directing the company. They should demonstrate objective judgement throughout their tenure and promote a culture of openness and debate. In addition, the chair facilitates constructive board relations and the effective contribution of all non-executive directors, and ensures that directors receive accurate, timely and clear information.

G. The board should include an appropriate combination of executive and non-executive (and, in particular, independent non-executive) directors, such that no one individual or small group of individuals dominates the board's decision-making. There should be a clear division of responsibilities between the leadership of the board and the executive leadership of the company's business.

H. Non-executive directors should have sufficient time to meet their board responsibilities. They should provide constructive challenge, strategic guidance, offer specialist advice and hold management to account.

I. The board, supported by the company secretary, should ensure that it has the policies, processes, information, time and resources it needs in order to function effectively and efficiently.

Section 3: Composition, Succession and Evaluation

J. Appointments to the board should be subject to a formal, rigorous and transparent procedure, and an effective succession plan should be maintained for board and senior management. Both appointments and succession plans should be based on merit and objective criteria and, within this context, should promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths.

K. The board and its committees should have a combination of skills, experience and knowledge. Consideration should be given to the length of service of the board as a whole and membership regularly refreshed.

L. Annual evaluation of the board should consider its composition, diversity and how effectively members work together to achieve objectives. Individual evaluation should demonstrate whether each director continues to contribute effectively.

Section 4: Audit, Risk and Internal Control

M. The board should establish formal and transparent policies and procedures to ensure the independence and effectiveness of internal and external audit functions and satisfy itself on the integrity of financial and narrative statements.

N. The board should present a fair, balanced and understandable assessment of the company's position and prospects.

O. The board should establish procedures to manage risk, oversee the internal control framework, and determine the nature and extent of the principal risks the company is willing to take in order to achieve its long-term strategic objectives.

Section 5: Remuneration

P. Remuneration policies and practices should be designed to support strategy and promote long-term sustainable success. Executive remuneration should be aligned to company purpose and values, and be clearly linked to the successful delivery of the company's long-term strategy.

Q. A formal and transparent procedure for developing policy on executive remuneration and determining director and senior management remuneration should be established. No director should be involved in deciding their own remuneration outcome.

R. Directors should exercise independent judgement and discretion when authorising remuneration outcomes, taking account of company and individual performance, and wider circumstances.

The UK Corporate Governance Code applies to all companies listed as commercial companies or in the closed-ended fund category, whether they are based in the UK or not.

The Code is not a rigid set of rules. It consists of principles (main and supporting) and provisions. The listing rules require companies to apply the main principles, and report to shareholders on how they have done so.

The Code therefore operates on a 'comply or explain' approach.

SHAREHOLDER RIGHTS DIRECTIVE

1.5.4	Explain the purpose and scope of the Shareholders Rights Directive (SRD II) and its impact on pension schemes

The Shareholder Rights Directive (SRD II) was implemented in the UK in 2019 and then onshored following the UK's withdrawal from the EU. The directive aims to tackle a perceived lack of shareholder engagement in the stock market by requiring asset managers and institutional investors to put in place a shareholder engagement policy and to improve the transparency of their investment policies.

For occupational pension schemes, SRD II requires trustees to publish online information regarding the development and implementation of their shareholder engagement policy. It also requires them to publicly disclose details of their investment strategy and the scheme's arrangement with their asset manager. This information should be published by the scheme's trustees in a Statement of Investment Principles (SIP).

From 1 October 2020, trustees were also required to produce an implementation statement setting out how they acted on policies in the SIP. Climate reporting obligations for pension schemes were introduced in 2021 under the Pension Schemes Act 2021. These now apply to all pension schemes with assets under management of greater than £1 billion.

Trustees of schemes in scope are required to implement appropriate governance arrangements to manage climate-related risks.

The Climate Change Governance Regulations were updated in October 2022 and require trustees to calculate a new 'portfolio alignment' metric, setting out the extent to which the scheme's investments are aligned with the Paris Agreement goal of limiting global warming to well below 2°C, and pursuing efforts to limit global temperatures to 1.5°C above pre-industrial levels.

BOARD DIVERSITY

1.5.4	Explain the purpose and scope of the Shareholders Rights Directive (SRD II) and its impact on pension schemes
1.5.5	Explain the importance of board diversity in relation to good corporate governance

Diversity and inclusion considerations and requirements have become more prominent within the FRC's Corporate Governance and Stewardship Codes since their launch, and other regulators, too, are focusing more closely on diversity and inclusion within financial services firms and on the attention that financial services firms give to diversity and inclusion within their investee companies.

Section 3 of the UK Corporate Governance Code highlights the importance of promoting diversity of gender, social and ethnic backgrounds, as well as cognitive and personal strengths when considering the composition of the board.

Directors are responsible for devising strategies through analysis. One potential problem in the decision-making process in the boardroom is 'groupthink', which can be described as a psychological behaviour of minimising conflicts and reaching a consensus decision without critically evaluating alternative ideas.

It can be argued that a diverse group of directors with different skills, backgrounds and experiences may approach problems from a greater range of perspectives and raise challenging questions. This may help to minimise the risk of groupthink.

Diversified board members are more likely to possess different personal characteristics, leading to dissimilar leadership, thinking, emotional styles, risk preferences and behaviours. This diversity is likely to foster creativity in identifying solutions to problems and provide a more comprehensive oversight to the operations of the organisation and the company's sensitivity or propensity to risk, such as reputational and compliance.

To date, the UK Government approach to achieving greater diversity of board membership has been through voluntary target setting. The UK Government set up a commission to examine gender representation on company boards (the Walker review (2011) followed by the Hampton-Alexander review (2016 with an update in 2021)). The 2011 report set a voluntary target of 25% women on boards of FTSE 100 companies. This was met in 2015. The 2016 report set a voluntary target of 33% women representation on FTSE 350 company boards. A 2025 report by FTSE Women Leaders Review found just under 45% of FTSE 100 company board members and 43.4% of FTSE 350 company board members were women.

A review of ethnic diversity on UK company boards (the Parker review) was published in 2017 with updates on progress every year after 2020. The review set a voluntary target for all FTSE 100 boards to have at least one director from an ethnic minority background by December 2021. By March 2021, 81 FTSE companies had met this target. In 2025, 95 FTSE 100 companies met the target.

REMUNERATION REPORTING REGULATIONS

Regulations on remuneration reporting for large and medium-sized companies and groups were introduced in October 2013 and updated in June 2019. The regulations require the remuneration report of a company to be in two parts:

1. A policy report setting out the company's remuneration policy and key factors that were taken into account in setting that policy.
2. An implementation report setting out actual payments to directors and details on the link between company performance and pay for the financial year. The implementation report is published annually.

In particular, the regulations provide detail on how the pay for executive directors is to be calculated. The remuneration policy will include details of the policy on payments to recruit directors, and payments made on directors leaving the company. The separate remuneration policy and implementation reports must be put to shareholder vote at the annual general meeting (AGM). Shareholders will have a binding vote on the remuneration policy. The policy should then be put to a shareholder vote at the AGM at least every three years. If shareholders do not approve the policy, a company must put forward a new policy at the next general meeting. The last approved policy will remain in place until a new one is approved.

The June 2019 changes included additional reporting requirements for quoted companies with more than 250 employees. They must now publish, in their directors' remuneration report, the ratio of their CEO's 'single figure' total remuneration to the median, 25th and 75th percentile total remuneration of their full-time equivalent UK employees. The ratios will be calculated on a group-wide basis by reference to UK employees only.

SECTION 172 REPORTING

Section 172(1) of the Companies Act requires a director to act in the way he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole. In exercising that duty, there is a non-exhaustive list of matters to which the director must have regard. These include the interests of the company's employees and the need to foster the company's business relationships with suppliers, customers and others.

All UK-incorporated companies (other than small and medium-sized companies) will be required, therefore, to publish in their strategic report a separately identifiable statement describing how the directors have had regard to the matters set out in section 172(1) of the Act in fulfilling their statutory duty. These requirements took effect for the financial year starting on or after 1 January 2019 (i.e. for annual reports written from 2020 onwards).

Government guidance states that the content of this statement will depend on the individual circumstances of each company, but companies will probably want to include information on some or all of the following:

- the issues, factors and stakeholders the directors consider relevant in complying with section 172(1) and how they have formed that opinion;
- the main methods the directors have used to engage with stakeholders and understand the issues to which they must have regard; and
- information on the effect of that regard on the company's decisions and strategies during the financial year.

UK STEWARDSHIP CODE

In addition to the UK Corporate Governance Code, the FRC also operates the UK Stewardship Code. The Code was originally released in 2012 but was updated in 2020 and again in 2025. The 2025 version applies from 1st January 2026. It comprises a set of 'apply and explain' Principles, as follows:

- Six Principles aimed at:
  i. asset managers (i.e. those who have day-to-day responsibility for managing assets, e.g. BlackRock); and
  ii. asset owners (i.e. institutional investors responsible for protecting and enhancing assets on behalf of beneficiaries, e.g. occupational pension schemes).
- Four Principles aimed at service providers (i.e. organisations that do not manage investments directly but play a key role in providing services that enable clients to deliver quality stewardship including, but not limited to, investment consultants, proxy advisers, and data and research providers).

Stewardship as defined in the Code is the responsible allocation, management and oversight of capital to create long-term sustainable value for clients and beneficiaries.

All Signatories are expected to submit a Policy and Context Disclosure. This should describe an organisation's stewardship policies, governance structures and other contextual information. This will typically be updated every 4 years. In addition, signatories should submit an Activities and Outcomes Report. This annual submission should focus specifically on stewardship activities conducted during the year and their outcomes. It should demonstrate the practical application of stewardship policies and explain how these activities supported the delivery of long-term sustainable value for clients and beneficiaries.

The six Principles applying to asset managers and asset owners are:

1. Signatories integrate stewardship and investment to deliver long-term sustainable value for their clients and beneficiaries.
2. Signatories identify and respond to market-wide and systemic risks to promote well-functioning financial markets.
3. Signatories engage to maintain or enhance the value of assets.
4. Signatories actively exercise their rights and responsibilities.
5. Signatories integrate stewardship considerations into their selection and oversight of external managers.
6. Signatories monitor and hold to account stewardship service providers.

INFORMATION DISSEMINATION AND DISCLOSURE BY LISTED COMPANIES

1.5.6	Explain the London Stock Exchange requirements for listed companies to disclose corporate governance compliance
1.5.7	Explain the continuing obligations of London Stock Exchange listed companies regarding information disclosure and dissemination

When a company is listed on the London Stock Exchange, it agrees to abide by the continuing obligations of listed companies. These requirements are designed to keep shareholders of a listed company properly informed, and require the listed company to:

- submit drafts to the UK-listing authority for approval of all meetings and all circulars (except those of a routine nature) to holders of securities; and
- notify the market of profit announcements, dividend declarations, material acquisitions, change of directors, change in major shareholdings, and any other information necessary to enable holders of securities and other members of the public to appraise the position of the company and avoid the establishment of a false market in the securities. Such information is to be given to the market as a whole.

When making an announcement, issuers may use a third-party firm that has demonstrated that it can distribute information in accordance with the transparency regulations. Issuers using an approved firm to distribute information do not have to make an annual declaration to the FCA about their compliance. Instead, if an issuer decides not to use an approved firm, it must record how each announcement complies with the transparency regulations and report on its compliance to the FCA annually or whenever it is required by the FCA. A number of firms are currently approved by the FCA, including the Regulatory News Service of the London Stock Exchange.

The UK-listing authority provides guidance rules on the dissemination of price-sensitive information by companies. These rules are intended to aid compliance with the insider dealing regulations of the Criminal Justice Act 1993, Part V, and the Market Abuse Regulation.

In summary, the rules encourage companies to release new information to the market on a regular basis. Companies should have a consistent procedure for both determining what information is price sensitive and for releasing it. Where companies issue lengthy releases that include comments on current or future trading prospects, this information should be given due prominence. If price-sensitive information is inadvertently released to, say, analysts or journalists, then a company should take immediate steps to ensure that the whole market has access to the information. A company should also correct a public forecast as soon as possible if the outcome is significantly different. However, a company has no obligation to tell individual analysts that their forecast is wrong.

GENERAL MEETINGS

1.5.8	Explain, in outline, the UK company law requirements regarding the calling of annual general meetings and other general meetings
1.5.9	Distinguish between annual general meetings and other types of company meetings
1.5.10	Distinguish between the types of resolution that can be considered at company general meetings
1.5.11	Distinguish between the voting methods used at company meetings
1.5.12	Explain the role and powers of a proxy

Annual general meetings

The Companies Act 2006 sets out requirements relating to the calling and conduct of company general meetings. Every public company is required to hold an AGM within six months of the end of their financial year, and the interval between AGMs must not be more than 15 months. The directors of the company must call the meeting, and it must be called by giving not less than 21 calendar days' written notice.

Although there are no items of business which the Companies Act require to take place at the meeting, certain items are dealt with by convention, such as:

- declaring a dividend;
- considering the financial statements;
- considering the reports of the directors and auditors;
- electing directors in place of those retiring; and
- appointing and remunerating auditors.

Other meetings

Any meeting of a company other than an AGM is called a general meeting. General meetings must be called by giving no less than 14 calendar days' written notice, and companies are permitted to communicate with their shareholders electronically (for example, by email, posting a note on a website or by telephone). For the purposes of electronic communication, a notice is deemed to be sent when the electronic notice is first transmitted and delivered 48 hours after being sent. Any notice period therefore runs from the delivery date, i.e. 48 hours after being sent

The directors of a company may call a general meeting whenever they see fit. The directors are also bound to call such a meeting when 5% or more of the shareholders (i.e. representing 5% of the total value of the shares) request it, given that twelve months have elapsed since the last general meeting. If the directors fail to call a general meeting within 21 calendar days of such a request, then the shareholders may convene the meeting themselves, providing it is within three months of the request. Directors must also call a general meeting in the event of a serious loss of capital.

Normally, the chairman of the board of directors will act as chairman of a general meeting. It is the duty of the chairman to:

- preserve order;
- see that the proceedings are conducted;
- take care that the sense of the meeting is properly ascertained; and
- decide incidental questions arising for decision during the meeting.

A resolution put to a meeting is sometimes decided in the first instance by a show of hands. A more accurate method of ascertaining the wishes of the members of a company is to take a poll. This allows proxy votes to be counted and pays due regard to a member holding a large number of shares (who would have only one vote on a show of hands). A poll can be demanded by five members having the right to vote, by one or more members having 10% of the total voting rights, or by the chairman. A proxy may demand, or join in demanding, a poll.

There are two main kinds of resolution that can be considered at a general meeting:

1. An ordinary resolution is the standard type and requires a simple majority of those voting in order to be passed.
2. A special resolution is required before any important constitutional changes can be undertaken and requires a 75% vote in favour to be passed.

Proxy votes

Any member entitled to attend and vote at a company meeting may appoint another person (the proxy) to attend and vote on their behalf. A proxy has the right to vote on a show of hands and in a poll. A proxy is valid for the general meeting and any adjournment, and can take one of two forms:

1. A general proxy, appointing a person to vote as they think fit, bearing in mind what is said at the meeting.
2. A special proxy, appointing a person to vote for or against a particular resolution (termed a 'two-way proxy').

Each person entitled to vote at the meeting must be sent a proxy form when they are sent the notice convening the meeting. The form must state that a shareholder is entitled to appoint a proxy of their own choice. Where a proxy form is returned without an indication as to how the proxy is to vote, then the proxy is deemed to be a general proxy. It is the duty of the chairman of the meeting to decide on the validity of the proxies.

SECTION 1.6
INTERNATIONAL MARKETS

INTERNATIONAL SECURITIES MARKETS

1.6.1 Explain the structure, features, and regulatory and trading environment of international markets, including developed markets and emerging markets

Both retail and institutional investors invest in overseas securities markets. There are potential diversification benefits for investors where the returns on domestic and overseas securities are less than perfectly correlated. Emerging markets such as Brazil and China outperformed developed markets before 2008 and, since then, other emerging markets in Southeast Asia have, at times, delivered significantly higher returns than developed economies.

One specific concern with overseas investment is foreign exchange risk. This means that investors have to take into account changes in the value of the domestic currency with the currency of the market where the investment has taken place. This can increase or reduce actual returns on an overseas investment.

Retail investors are more likely to achieve international exposure through mutual funds and ETFs, whereas institutional investors may seek international exposure by buying securities in overseas markets. This brings additional considerations and/or risks as the structure and regulation of overseas markets are likely to be different. However, it is less of an issue in European equity markets where a number of Directives, including MiFID and the Prospectus Directive, have harmonised regulations across the EU.

Most trading of equities on European securities markets takes place on electronic order-matching systems. In the USA, the largest equity market, the NYSE, operates a floor-based specialist system of stock trading. On the trading floor, there are several trading posts, and each stock traded is centralised at that stock's assigned trading post. The designated market makers (DMMs), who are assigned specific trading posts (and thus specific stocks), act in a way that maintains an 'orderly market'. Member firms' floor brokers and 'local' brokers all trade through these DMMs.

The primary order processing system in the NYSE is the Universal Trading Platform (UTP). The UTP supports equity trading on the trading floor and provides the NYSE with the current status of any equity order. NYSE member firms can input orders (in a similar way to SETS) and these go directly to the trading post where the security is traded.

Investing in emerging equity markets presents a number of unique challenges. Primarily, the quality of market regulation, corporate governance, transparency and accounting standards is often below developed markets. These factors make it harder to appropriately price securities and, as such, increase the risk of mispricing. Additionally, there are more likely to be political risks in emerging markets, whether it is from corruption or even coups and civil wars (Ukraine and Syria are two recent examples).

For these reasons, stock market returns in emerging markets are more volatile. Emerging markets are also seen as risky by overseas investors. As such, in strained global macroeconomic situations, investors from developed countries – who often own a lot of stock in emerging markets – will abandon their positions in emerging markets first, which causes volatility in emerging market indices. Emerging market indices tend to rise faster than developed markets during periods of strong global market sentiment but fall faster when that sentiment turns negative.

Other issues with investing in emerging markets include regulatory limits on overseas investments that can change at short notice, making it difficult to sell a security. More generally, emerging markets may be less liquid than developed stock markets.

EUROBOND MARKETS

1.6.2 Explain the structure and operation of the primary and secondary markets for Eurobonds

Eurobonds are bonds that are denominated in a currency other than that of the country in which they are issued, for example, a bond issued by a Russian corporation in London, denominated in US dollars. Like most bonds, Eurobonds are usually fixed-rate, interest-bearing notes, although many are also offered with floating rates and other variations.

→ *Eurobond characteristics are discussed in Unit 2, Chapter 12, Section 12.2.*

Eurobonds are so-called 'bearer bonds' – they are not registered centrally, so whoever holds or bears the bond is considered the owner. Their 'bearer' status also enables Eurobonds to be held anonymously. It is difficult to determine the client base for these securities, but it is generally agreed that holders of Eurobonds include both private individuals seeking to mitigate liability to tax, and institutional investors who hold them as part of diversified portfolios.

Since it began in the 1960s, the market for Eurobonds has grown dramatically. By some measures it is now the largest capital market in the world. A variety of institutions raise money through the issue of Eurobonds, including industrial corporations, banks, public sector bodies and supranational organisations. Eurobonds are not regulated by the country of the currency in which they are denominated.

There are several participants in issuing Eurobonds:

- The issuer, or borrower, that needs to raise funds by selling bonds. The borrower approaches a bank and asks for help in issuing its bonds.
- This bank is known as the lead manager and may ask other banks to join it to form a managing group that negotiates the terms of the bonds and manages the issue. The managing group sells the bonds to an

underwriter or directly to a selling group. The three levels – managers, underwriters and sellers – are known collectively as the syndicate.

- The underwriter will actually purchase the bonds at a minimum price and assume the risk that it may not be possible to sell them on the market at a higher price. The underwriter (or the managing group if there is no underwriter) sells the bonds to a selling group that then places bonds with investors.

The syndicate companies and their investor clients are considered the primary market for Eurobonds. Once they are resold to general investors, the bonds enter the secondary market. Participants in the market are organised under the International Capital Markets Association (ICMA). In the secondary market, Eurobonds are traded OTC. Major markets for Eurobonds exist in London, Frankfurt, Zurich and Amsterdam.

SETTLEMENT IN OVERSEAS SECURITIES MARKETS

1.6.3 Explain the settlement and clearing procedures overseas, including the role of international central securities depositories, and the different settlement cycles and challenges in managing global assets

There are many different features for dealing and settlement in overseas markets. Settlement systems are national, and each country has its own settlement arrangements for different types of instruments. Participation is generally limited to locally regulated participants.

As a general rule, government and quasi-government bills, bonds and notes are traded OTC between banks, and settled through settlement systems operated by central banks. These systems may not provide a guarantee, i.e. they are not linked with a clearing company or a central counterparty, though they do have a link for payment into real-time gross settlement systems where they exist. Corporate bonds are generally listed and traded through the central clearing depository systems associated with the exchange. Many of the central securities' depositories are linked with the international depositories.

Some countries (e.g. South Korea) settle bond transactions on a rolling basis and T+1 to facilitate use of a delivery versus payment settlement system: obligations are calculated on a gross trade-by-trade basis without netting for both securities and cash. The G30, a consultative group on international economics, has published recommendations for good practice in this area, including T+3 settlement for equities. In some countries, such as Thailand, shares are registered in a central depository and a matching system for trading exists to ensure transactions are settled as agreed. Settlement is at T+2.

In general, a local custodian is responsible for the safekeeping of securities in a given national market, while a global custodian co-ordinates and supervises the safekeeping of securities in local depositories. Links between the different parties reduce the risk of errors and are not as well developed in emerging markets as in mature ones.

Non-electronic settlement systems are still used in some markets, and securities are physically transferred between buyer and seller. Many emerging markets do not have a central depository. Clearly, ownership rights for securities should be exchanged simultaneously with payment and cannot be reversed.

Eurobond settlement

There are currently two systems available to investors for settling Eurobond transactions: Euroclear and Clearstream. Both provide:

- securities clearance and settlement services;
- money transfer and banking services associated with securities settlement;
- custody services;
- securities lending; and
- borrowing services.

ICMA rules currently specify settlement on T+2, but all trades should be confirmed on T+1. Once reported, the trade is validated and then matched to await execution. Euroclear and Clearstream are linked electronically, which allows member organisations to use either system.

SECTION 1.7
THE PRINCIPAL–AGENT PROBLEM: SEPARATION OF OWNERSHIP AND CONTROL

THE PRINCIPAL–AGENT PROBLEM

1.7.1	Explain how capital markets allow the beneficial ownership, and the control of capital, to be separated
1.7.2	Distinguish between beneficial owners (principals) and the various agents involved in the capital allocation process
1.7.3	Explain how conflict between the interests of agents and principals gives rise to the 'agency' or 'principal–agent' problem
1.7.4	Identify examples of agency costs such as: expropriation, perquisites, self-dealing and higher cost of capital, which arise when the agency problem is known to exist
1.7.5	Identify the main reasons why it is argued that reducing the agency problem benefits the investment profession and society as a whole

Stock markets allow for the ownership of a company to be separate from its control. Where the owner of a company also manages it, then ownership and control are aligned. However, where the ownership of a company is dispersed through the issue of shares, then it is not possible for the owners to control the company. Instead, owners appoint managers to run the company on their behalf. This gives the managers discretion over use of the owners' invested funds. The owners are the principals in the relationship, and the managers are the agents of the owners. Generally, managers do not own significant amounts of shares in the company.

This separation leads to the principal–agent problem (also called the agency problem), which arises because owners and managers generally have different interests. Owners want to maximise the value of the firm, while managers want to maximise their own interests such as salary, vanity projects and expenses. It is unlikely that the managers' pursuit of their own interests will maximise a firm's value. Managers may use the discretion they have for self-dealing, that is, to divert corporate wealth to themselves. They may expropriate owners' funds by, for example, embezzling funds or transferring ownership of assets to themselves or family members. This form of 'agency cost' is generally low in developed countries but is still a problem in developing countries where investor protection regulation is less developed. A more common form of agency cost in developed countries is the allocation of owners' funds for managers' personal consumption or perquisites, such as bigger expense accounts or corporate jets.

Solutions to the principal–agent problem include:

- aligning incentives of managers and owners by compensating managers partly in the form of shares (or future shares in the case of stock options). This means managers are incentivised to make decisions that lead to a rise in the share price as they, along with the owners, will benefit;
- managers being monitored by the board of directors. Owners appoint board members to look after their interests and the board can remove underperforming managers;
- introducing external pressure by selling shares if the managers are running the company badly. If enough shareholders sell shares, the price will fall, which could make the company a takeover target. The threat of takeover (which often results in the incumbent management losing their jobs) gives managers the incentive to look after the interest of shareholders; and

- shareholder activism – where groups of shareholders (often large fund managers) voice their concerns to directors – has become more prevalent in recent years.

Many of these solutions introduce costs, for example the cost of giving share options to managers. Such costs are referred to as 'agency costs'.

The principal–agent problem occurs in many areas of the investment industry. For example, an investor (the principal) who appoints a broker (the agent) to obtain the best price in a trade expects the agent to act in their interest, but the agent may pursue their own self-interest. The broker, on receiving a large order to buy, may place an order to buy for themselves to take advantage of the rise in price anticipated by the large order from the client (a practice known as front-running).

Where a firm operates as both a broker and a dealer, it is said to have dual capacity. Such a firm is referred to as a broker-dealer. Firms operating with dual capacity expose themselves to the conflict-of-interest problem just described, i.e. the principal–agent problem. The duty as a broker is to act in the best interest of the client. As a dealer, they are acting in their own interest or the interest of their owners.

In most situations, the investment professional puts the interests of the client first, but this has not always happened. Many examples of investment professionals pursuing their own interests ahead of their clients exist, such as Bernard Madoff turning a wealth management scheme into a Ponzi scheme (where the cash invested by new investors was used to pay the returns to existing investors).

When financial services professionals pursue their own interests and cause harm to their clients, this can lead to a lack of trust in the products and processes in the entire industry. This, in turn, may lead savers to not lend as much, which reduces funds for companies that need to borrow and can slow the rate of growth in the economy. Such unethical behaviour can be mitigated by regulation or by raising ethical awareness and standards in the industry.

→ *See Chapter 2 on raising awareness and standards in the industry, and Chapter 3 on how unethical behaviour is mitigated by regulation.*

CHAPTER 1
KEY FACTS

1.1 Introduction to financial markets

1. The financial services industry provides four main functions:

   i. financial intermediation;

   ii. pooling and managing risk;

   iii. provision of payment and settlement services; and

   iv. portfolio management.

2. The main types of financial institutions are:

   » central banks;
   » deposit institutions (such as banks); and
   » investment institutions (such as insurance companies, collective investment funds and pension funds).

3. Governments perform four important economic functions:

   i. the provision of certain goods and services (e.g. defence);

   ii. regulation of markets to protect consumers;

   iii. improving the distribution of incomes through taxation and welfare payments; and

   iv. maintaining economic stability.

1.2 The role of securities markets in providing liquidity and price transparency

1. Real assets are physical assets such as land, buildings and gold. Financial assets are claims representing the right to some return (such as a bank deposit or bond) or to ownership of physical assets.

2. The main functions of securities markets are:

   » raising capital;
   » transferring risk;
   » price discovery; and
   » creating liquidity.

3. Primary markets are where initial sales of securities are made. Subsequent trading takes place in the secondary market.

4. Round-trip transaction costs are the total costs of completing a transaction, including bid-ask spread, commissions and taxes.

1.3 Types of financial markets

1. The London Stock Exchange operates an order-driven system called SETS for FTSE 100, FTSE 250 and FTSE Small Cap constituents, and a quote-display system called SEAQ for fixed-interest securities and AIM securities.
2. Less liquid stocks, listed on the main market, are traded on SETSqx, which combines a periodic auction book along with quote-driven market making.
3. UK Government bonds are known as 'gilts', and the Debt Management Office (DMO) is the department of His Majesty's (HM) Treasury responsible for gilt issuance, usually via an auction.
4. Corporate bonds may be issued via an open offer or private placement. The former can involve a bought deal or fixed price re-offer.
5. Dual listing is when two corporations function as a single operating business but retain separate legal identities and stock exchange listings.
6. An over-the-counter (OTC) market involves trading in a decentralised way rather than on an exchange.
7. CREST is the London Stock Exchange's electronic settlement system, which settles on a T+2 basis for equities and a T+1 basis for gilts.

1.4 The UK listing authority and prospectus requirements

1. In the UK, the Financial Conduct Authority (FCA) is the 'competent authority' (or, colloquially, the UK-listing authority), which decides on the admission of securities to the Official List.
2. Listing on the main market requires over £30 million of listed stock or £200,000 of debt securities.
3. AIM is regulated by the London Stock Exchange, and there is no minimum criterion for size, trading record or shares in public hands.

1.5 Information disclosure and corporate governance requirements for UK equity markets

1. Directors, major shareholders and concert parties must declare share interests.
2. The corporate governance system in the UK has traditionally stressed the importance of internal controls and the role of financial reporting and accountability, rather than external legislation.
3. When a company is listed on the London Stock Exchange, it agrees to abide by the continuing obligations of listed companies. The rules encourage companies to release new information to the market on a regular basis.
4. Every public company is required to hold an annual general meeting (AGM) within six months of the end of their financial year, and the interval between AGMs must not be more than 15 months.
5. Any meeting of a company other than an AGM is called a 'general meeting'. General meetings must be called by giving no less than 14 calendar days' written notice, and companies are permitted to communicate with their shareholders electronically.
6. Any member entitled to attend and vote at a company meeting may appoint another person (the proxy) to attend and vote on their behalf.

1.6 International markets

1. Government bond trading in other countries often involves local banks trading OTC, with settlement via the central bank. Corporate bonds are often listed and traded through central clearing depositary systems associated with local exchanges.

2. Euroclear and Clearstream are the two main systems currently available for settling Eurobond transactions. All trades must be confirmed T+1 and settled T+2.

1.7 The principal–agent problem: separation of ownership and control

1. The separation of ownership and control leads to the principal–agent problem.

2. In capital markets, shareholders act as principals and delegate control to managers, who are agents.

3. Other forms of principal–agent relationship in the investment industry include fund advisers or managers acting as agents for investors.

4. Solutions to the agency problem incur agency costs, and include:

   (a) aligning the interests of managers and owners through remuneration of the former in shares or stock options;

   (b) boards of directors looking after the interests of shareholders; and,

   (c) external control through active groups of shareholders or the threat of takeover.

CHAPTER 1

SELF-ASSESSMENT **QUESTIONS**

1. **Which of the following is a deposit-accepting institution?**
   - (a) A mutual fund.
   - (b) A commercial bank.
   - (c) An investment trust.
   - (d) A pension fund.

2. **How is the process for trading ordinary FTSE 100 shares best described?**
   - (a) Quote-driven.
   - (b) Order-driven.
   - (c) Open outcry.
   - (d) Price-driven.

3. **UK gilts usually pay:**
   - (a) Gross coupons annually.
   - (b) Net coupons annually.
   - (c) Net coupons semi-annually.
   - (d) Gross coupons semi-annually.

4. **SETSqx is a London Stock Exchange trading system for trading:**
   - (a) International securities.
   - (b) Retail bonds.
   - (c) Less liquid equity securities.
   - (d) Equity derivative securities.

5. **The issuance of gilts is managed by which of the following bodies?**
   - (a) The Gilt-Edged Market Makers Association (GEMMA).
   - (b) The Central Gilts Office (CGO).
   - (c) CREST.
   - (d) The Debt Management Office (DMO).

6. The standard settlement time for gilts is:

(a) Same day.

(b) T+1.

(c) T+2.

(d) T+3.

7. What term best describes the settlement procedure for CREST?

(a) Physical settlement.

(b) Certified settlement.

(c) Paperless settlement.

(d) Materialised settlement.

8. Which organisation is responsible for setting rules for trading in the Eurobond market?

(a) International Capital Markets Association (ICMA).

(b) Euroclear.

(c) The Financial Conduct Authority (FCA).

(d) The Securities and Exchange Commission (SEC).

9. Somebody who wants to appoint another person to vote as they think fit on their behalf at a company meeting would appoint:

(a) Two-way proxy.

(b) General proxy.

(c) Agent proxy.

(d) Special proxy.

10. The Financial Reporting Council (FRC) principles aim to make institutional investors actively engage in corporate governance in the interests of their beneficiaries. These are known as:

(a) The UK Corporate Governance Code.

(b) The Agency Code.

(c) The Takeover Code.

(d) The UK Stewardship Code.

11. An investor would be required to notify the company if their stake goes from:

(a) 3.1% to 4.2% of company shares.

(b) 3.1% to 3.9% of company shares.

(c) 1.9% to 2.7% of company shares.

(d) 10.9% to 10.1% of company shares.

12. A company wishing to list shares on the main market must ensure these securities have a minimum market capitalisation of at least:

(a) £1 million.

(b) £30 million.

(c) £50 million.

(d) £70 million.

CHAPTER 1

SELF-ASSESSMENT **ANSWERS**

1. (b) Only banks accept deposits to fund their assets. All the other institutions are investment institutions.

2. (b) FTSE 100 shares are traded on the Stock Exchange Trading Service (SETS), which is an electronic order matching system. Trading is order-driven.

3. (d) UK gilts pay interest semi-annually and pay interest gross on new holdings unless the holder indicates otherwise.

4. (c) SETSqx is a trading system for less liquid equity securities.

5. (d) The DMO is the body responsible for gilt issuance and general management of the UK Government issued debt.

6. (b) The standard settlement time for gilts through CREST is T+1 (i.e. one working day after transaction).

7. (c) Settlement through CREST is electronic and hence paperless.

8. (a) Eurobonds are normally traded over the counter and the rules for trading are set by the ICMA.

9. (b) There are two main types of proxy – a general proxy and a special proxy. A general proxy is able to vote as they see fit at the general meeting, whereas a special proxy has to vote in a way specified before the meeting takes place.

10. (d) The UK Stewardship Code aims to make shareholders, who manage other people's money (institutional shareholders), active and engage in governance in the interests of their beneficiaries.

11. (a) Shareholders who already have a stake in the company above 3% are required to notify the company when their stake increases by more than 1%.

12. (b) For a listing on the main market, the minimum value of the shares listed must be £30m.

Link to CFA Level 1

The material in this chapter is mainly UK-focused and is therefore not covered in CFA Level 1.