Financial Regulation international

Worldwide regulatory developments and their implications for the financial services industry

Outsourcing and operational risk management

Risk management is of critical importance to financial institutions, financial markets, and the regulators and supervisors charged with preserving the safety and soundness of the financial system. In light of recent shocks, represented in part by the failures at Enron and WorldCom (and Barings, Long Term Capital Management, BCCI and others before that), there has been a surge in regulatory initiatives focused on financial institution risk.

In this context, operational risk management (process, technology, people, and external event risk) is a relatively new subject of supervisory focus. International banking is now in the process of developing and rolling out new systems for assessing and managing operational risk, driven by the new Basel Capital Accord. Learning from past experience and recognising the fast changing nature of financial services, regulators have chosen risk-based supervision over myriad point regulations as the better means of discharging their duties.

Given the widespread attention that has been focused on the rise of outsourcing, it was only a matter of time for a debate to begin on its relative costs and benefits. Key questions being debated are whether outsourcing can enable financial institutions to reach the efficient frontier of risk management, or whether outsourcing can be a source of risk. Upon examination, it is clear that it is possible to answer both with a 'yes'.

While outsourcing has recently been a media focus, it is important to recognise that it has been a vital part of the banking world for decades. For example, banks do not generally print their own cheques. They rely on others to perform credit checks and to operate credit card payment systems. The majority of banks in the United States, albeit the smaller ones, utilise major providers to perform many of the services at the core of their operations (for example, CHECK BYSIS and FISERV). A strong argument can be made that outsourcing in financial services provides a substantial public service by enabling new entrants and smaller payers to credibly provide a reliable and trusted service. The benefits to the public are reflected in greater marketplace competition and the survival of community-based banks.

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Over the past years, the face of financial services, like virtually other industry, has been transformed by rapid advances in information technology. Consumers have enthusiastically embraced online banking, online trading, and a host of new financial products made possible by powerful new technology. The markets have also imposed a more stringent discipline on financial institutions, focusing on efficiency and profitable growth. This has forced banks and others to look at their assets and resources and determine how best to employ scarce capital to the best effect.

Under the new supervisory goals for operational risk, leading banks and others are charged with assessing and managing the risks they face. Once an institution understands the risks, it has a range of choices:

- do nothing;
- hedge the risk with investment in business processes, new technology and infrastructure;
- transfer risk via vehicles such as insurance or securitisation;
- outsource to a provider with a better risk profile; or,
- exit the activity or business generating the risk.

Obviously, each approach has an implication for a bank's risk position. Opinion however, is divided on which approach is best to mitigate risk.

Part of the debate about outsourcing is reflected in a point of view, where the focus is on whether you should ever outsource core operations. This can quickly break down into a business school style debate on strategies for success and case studies.

There is also debate based on first-hand experience and what circulates in the press, as well as some analysis. A recent European Central Bank (ECB) report found that the majority of banks that have outsourced are already achieving expected results, and the remainder indicate that it is still too early to tell. The UK's Financial Services Authority (FSA) recognises both the financial benefits of outsourcing, and its capability to reduce the level of operational risk faced by a firm. In this regard, it provides guidance on the ways that banks select and then manage the outsourcing relationship. This is also the experience in the United States.

An approach to outsourcing consistent with risk based supervision indicates that an institution cannot avoid the risk of an important activity by having someone else do the job. The institution retains responsibility for the activity, no matter where it may be handled and as such it needs to understand the risk characteristics of the outsourced provider and monitor them. Verification and inspection are always prudent and regulators want to do it themselves as part of the examination process.

In this circumstance, what are the arguments against outsourcing? From the viewpoint of operational risk, there is the chance that the outsourced provider will not do a good job. Under risk based supervision, institutions need to pay attention to this, make the appropriate decision, and be prepared to respond to regulators and examiners. To date, there is no reason to suspect that institutions are not capable of making correct decisions. There is also little reason to suspect that clients that are unhappy with the delivered service cannot or will not vote with their feet. Outsourcing actually supports choice, as it can level the technology playing field for smaller players.

Another argument voiced is over concentration risk. Perhaps too much work will be absorbed by a single outsource provider, which might fail to deliver in a way that impacts safety and soundness. There are tools to deal with this, however. These range from business impact analyses to control evaluations, and to systems to preserve business continuity by enabling operations to resume remotely at intercontinental distances within a matter of hours in the event of a disaster. As these are the tools used by very large financial institutions that can easily present much greater risks to safety and soundness than outsource providers, their availability should similarly reduce the risk posed by large outsourcers.

The adoption of outsourcing by many financial institutions over a period of time suggests that the purchasers of these services have found a benefit for themselves and their stakeholders in so doing. The advent of risk based supervision provides both financial institutions and regulators with the means of assessing the risks being run via outsourcing. So, is there more that might be done to manage operational risks in this area?

The field of operational risk is young. There is a lot of room for education. There needs to be a greater understanding of the risks that make up operational risk, as well as the events that drive risk, and the methods for controlling or mitigating risk as it is realised. There is also room for systems that can detect, identify, assess and prioritise events as they occur and trigger appropriate responses. And the regulators have said that there needs to be greater sharing of data describing loss events. While this data is useful for calculating loss distributions that form the basis for capital charges, it would provide a broader systemic benefit if it were available to help understand and remediate operational weaknesses.

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Outsourcing does, of course, pose logistical and jurisdictional challenges for regulators. This seems to be an area that regulators express a desire for more thought to be developed. But given the public benefits provided by outsourcers, the desire of financial institutions to utilise their services and the rapid development of operational risk management and risk based supervision, there does not appear to be an overriding reason to prevent financial institutions from utilising outsourcing as a means of optimising their risk profiles.

A study that will be launched shortly has found that banks fail to adequately account for risk in their IT investment, and that returns could be improved if CIOs learned from portfolio theory.

The study initiated by ING and executed by IBM has found that governance of IT investments and the management of associated risks and constrained capital are the most pressing challenges that banks face in improving IT project performance. The study, which looked at 165 large IT projects (of up to €150 million) at leading financial services companies, found that for a variety of reasons one-third of projects run over time, one-fifth run over budget and one-fifth fall short of planned functionality.

Participants acknowledged their own responsibility for project underperformance, attributing it to overly optimistic business cases or unforeseen internal factors at least half of the time. Even worse, most financial institutions lack both the data and the business-oriented metrics needed to measure returns on IT investments.

While banks are usually good at evaluating and prioritising business cases, few firms develop structured risk assessments and determine risk mitigation measures (and the costs of such measures) prior to the execution of IT projects. Even fewer use risk assessment to evaluate business cases and determine priorities.

Banks have lots of experience in applying advanced portfolio management to reducing risk and improving returns on invested assets, but too few are applying these same disciplines to their IT investments.

__Jonathan Rosenoer__, Global Head of Operational Resilience and Risk Solutions, IBM Financial Services Sector. The full report will be available shortly from IBM.

Jersey

Regulatory pace and an island economy

The financial services legislation in Jersey has undergone radical changes over the last five years. These changes have been designed to ensure that Jersey has a legal and regulatory framework for financial services in keeping with their importance to the Island's economy. The finance industry accounts for over 55% of its GDP and keeps pace with the evolving international standards set by bodies such as the Basel Committee, IOSCO and the FATF. Although Jersey is not a member of the EU it also has to pay increasing regard to the regulations that flow from Brussels, since these set the ground rules for firms wishing to do business with EU member countries.

The dilemma for a small jurisdiction like Jersey, which recognises that financial businesses do have a choice as to where they set up shop, is to put in place a regulatory regime that is effective in reducing risk to the public and to the Island's reputation, while allowing business to develop and flourish with the minimum of bureaucracy. This is not an easy task, and any temptation to cut corners in terms of applying international standards must be curbed, not least because of the detailed scrutiny which financial centres in general, and offshore centres in particular, are now under from international assessors such as the IMF.

The body tasked with performing this difficult balancing act in Jersey is the Jersey Financial Services Commission, a statutory body corporate set up under the Financial Services Commission (Jersey) Law 1998. That law established the Commission as an independent body with various statutory functions, including the supervision and development of financial services on the Island. The Commission is accountable for its overall performance to the Island's parliament – the States of Jersey.

In carrying out its regulatory and supervisory functions, the Commission is required by law to have regard to three guiding principles:

- The reduction of risk to the public of financial loss due to the dishonesty, incompetence, malpractice or the financial soundness of financial service providers;
- The protection and enhancement of Jersey's reputation and integrity in commercial and financial matters; and
- The best economic interests of the Island.

The concept of balance is thus built into the Commission's statutory remit.

Trusts: pioneers

The centrepiece of the regulatory laws administered by

the Commission is the Financial Services (Jersey) Law 1998. In its original form it only covered investment business, which became regulated under the Law from July 1999 onwards. In November 2000, the scope of the Law was extended to cover the regulation of trust and company service providers. This is an area where Jersey has been a pioneer and reflects the importance of trust companies to the finance industry in Jersey, as service providers in their own right and as the introducers of business to other parts of the industry, such as the banks and investment managers. It is the trust sector which is at the heart of Jersey's distinctive character as a financial centre.

Other parts of the finance industry – banks, funds and insurance companies – are presently regulated under their own separate pieces of legislation. It has to be acknowledged that this is not a totally satisfactory situation. While the various laws are reasonably consistent with one another, they are not completely so, having been enacted at different times over the years. One of the objectives of the Commission therefore is to consolidate the various laws, to the greatest extent possible, into the Financial Services (Jersey) Law 1998. The objective would be to produce a 'one-stop shop' for the laws administered by the Commission, making life easier for all the various users of the laws, including the lawyers who have to advise their clients on their regulatory obligations.

Insurance: timing

The problem is finding the time to do this among other priorities, some of which are dictated by external events. A case in point is the forthcoming regulation in Jersey of general insurance broking and intermediation, which is being achieved through an amendment to the Financial Services (Jersey) Law 1998. This is something that may well be desirable in its own right, but the precise timing is being driven by changes to the UK's financial services legislation, which if not acted upon, could deny Jersey-based intermediaries access to UK insurance companies and the Lloyd's insurance market.

The changes to the UK legislation have been driven in turn by the EU Insurance Mediation Directive, which was issued in December 2002 and has as its objective the harmonization of general insurance regulation throughout the EU.

As noted earlier, despite its non-EU status, Jersey cannot afford to stand aloof from initiatives such as these if it wants to continue to do business outside its own shores.

While the industry in Jersey sees the need to regulate general insurance mediation, the cost of regulatory compliance is a lively topic for discussion in the Island, just as it is elsewhere.

Efficient and effective

It is worth noting at this point that the Commission is wholly financed by the industry through fees. It receives no financial support from the government; and while most people would accept that the success of Jersey as a financial centre hinges at least partly on the quality of its regulation, they want to be sure that they are getting value for money and that the regulation is being delivered as efficiently and effectively as possible.

Efficiency and effectiveness are two related but distinct concepts. The former relates to the *outputs* of the Commission, for example, the number of supervisory meetings and examinations that the Commission conducts and how quickly and accurately the Commission can process applications for new licences and registrations. Performance targets have been set for the various administrative tasks that the Commission has to perform. Partly, these measure internal efficiency. But they can also be a powerful tool to increase the attractiveness of Jersey as a place to do business.

A good example of this is the regime for 'expert funds' that was introduced in February of this year. The new regime provides for a streamlined authorisation process for funds that are directed at 'expert' investors – individuals with high net worth or institutions – and the aim is to give the necessary regulatory approvals within 72 hours. This is an important consideration in a segment of the industry where the time to market is important.

This serves to show that efficiency is, or should be, a means to an end. What matters is the achievement of effective *outcomes* at the lowest possible cost. The result of effective regulation should be a reduction in risk in an environment that permits business to grow.

A modern and relevant legal framework for financial regulation is one of the ingredients for this, and some of the steps that Jersey has been taking to achieve this have already been described. Also important is that the regulator should be structured in a way that enables it to deliver effective regulation.

In this connection, the Commission has recently implemented a restructuring of its supervisory wing into four specialist divisions, dealing with banking, securities, trust companies and insurance. Each of these divisions is headed by an executive director. Previously, the Commission had used 'mixed' supervisory teams,

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each responsible for supervising a variety of financial services businesses.

The new structure is intended to be more transparent and to create clear leadership and accountability within the Commission for each industry sector. It should also help to promote greater industry expertise among Commission staff because they will be specialists in the sector under their responsibility.

In a nutshell, the new structure should help the Commission to get closer to industry. This is important when the Commission, like other regulators, is increasingly trying to apply a risk-based approach to regulation. This means trying to focus our attention to a greater extent on those institutions, products and customer relationships that are higher risk. We must know which of our regulated entities fall into the higher risk category so that these can be subject to closer scrutiny, for example when we plan our programme of on-site visits.

The risk-based approach also applies to our regulatory policies, for example, devising a set of guidelines for anti-money laundering that apply higher standards of due diligence to the serious players whose activities might threaten the Island's reputation, while protecting the man in the street from unnecessary red tape when using financial services.

This is another example of balance in the regulatory approach. Provided the Commission can strike the right balance – and this is central to everything we try to do – Jersey should be able to achieve the twin objectives of maintaining a competitive industry while complying with the international standards for effective regulation.

David Carse OBE, Director General of the Jersey Financial Services Commission

Europe

FSAP, Comitology and Lamfalussy: Europe's trilogy for financial services regulation

A fundamental objective of the European Union (EU) is establishing and developing the single market in financial services. Whilst the founding Treaty, the Treaty of Rome of 1958, established the four fundamental freedoms: free movement of persons, free provision of services, free movement of goods and freedom of establishment, it was left to the Treaty on European Union, the Maastricht Treaty of 1992, to provide for a further freedom - the freedom of movement of capital and payments. Maastricht laid the foundations for the introduction of the single European currency and the development of a single European capital market (although the bare Treaty provisions could never achieve this alone). The introduction in 1999 of the single European currency, the euro, within 12 (of the then 15) member states of the EU, served to reinforce the importance of the development of the single market in financial services and made those remaining barriers more prominent.

A single European market in financial services

The single European market in financial services[1] would allow financial institutions authorised to provide financial services in one member state to provide the same services in every member state of the EU without the need to comply with different entry requirements, and to be subject to a level playing field within a consistent regulatory environment. Not only would this support the development of the single European capital market and provide competitive access to capital; the potential economic gains are substantial in terms of the productivity of capital and labour, and in turn, GDP growth.

While the euro focused market participants' attention on the potential benefits of the single market in financial services, the European Commission's ongoing objective to ensure the consistent and prompt implementation of European law at a member state level was thrown into sharp focus. This momentum provided the perfect opportunity to create the legislative structure required to allow the single market to develop its full potential. To that end, the Financial Services Action Plan was drawn up.

The Financial Services Action Plan

In 1998, the Commission was invited to table a 'framework for action' to develop the single market in financial services. The resulting Financial Services Action Plan (FSAP), published in 1999, contains a set of 42 original measures (comprising Directives, Regulations,

1 For these purposes, the concept of financial services within Europe is not confined to the field of investment services. It has been accepted over the last 15 years or so as extending to (amongst other things) banking, securities markets, admission to listing, insider dealing and market abuse, clearing and settlement, electronic commerce, accounting standards, pensions and consumer protection.

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Communications and Recommendations) and a further six supplementary measures, intended to remove the remaining barriers to the single market in financial services and fill certain gaps, so as to provide a comprehensive legal and regulatory environment that would support the integration of European financial markets. An end-2005 deadline was set for member states' implementation of the legislative provisions of the FSAP. Practically, this meant that each piece of legislation contained in the FSAP (some three-quarters of its measures) would have to be finalised and adopted by around mid-2004 to allow member states the required 18 months in which to draw up national implementing measures.

Each measure of the FSAP falls within one of three strategic objectives as follows:

- **A single EU wholesale market.** The first objective is designed to allow securities issuers to raise finance in a competitive Europe-wide market and to enable single point-of-entry access for investors. It would also allow investment services to be offered throughout the EU within a sound prudential framework, and create legal certainty for securities trading and settlement. Amongst others, the Prospectus Directive, Market Abuse Directive, the proposed Transparency Obligations Directive and the Directive on Markets in Financial Instruments are all designed to achieve this objective.
- **Open and secure retail markets.** The second objective is aimed primarily at giving consumers information and safeguards to enable them to participate in the single financial market, but also at ensuring that barriers are removed to the cross-border provision of consumer financial services (with the necessary legal and regulatory protection) and at facilitating small-value cross border payments within the EU. Two measures which are designed to fulfil this objective are the Communication on a Single Market for Payments and the Directive on Distance Selling of Financial Services.
- **State of the art prudential rules and supervision.** The third objective is focused on ensuring that no lacunae remain in the EU prudential framework and that the framework itself is capable of successful enlargement. In addition, it attempts to set rigorous standards that will sustain stability in the EU financial market. The proposals for implementing 'Basel II' within the EU provide an excellent example of the Commission's work in developing state of the art rules (particularly given that those Directives are not subject to the 'Lamfalussy process' - as to which, see below).

Lamfalussy

Recognising that cumbersome legislative measures have done little to improve the efficiency and speed of the European legislative process (by way of example, the proposed Takeover Directive has been negotiated for 15 years to date!), the EU's Economic and Finance Ministers set a mandate in 2000 for a 'Committee of Wise Men' to review the EU regulatory framework and the legislative processes for the securities markets, and produce a report by early 2001.

The final Report of the Committee of Wise Men (chaired by Baron Alexandre Lamfalussy and thus referred to as the 'Lamfalussy Report'), published in 2001, proposed new legislative techniques for the reformation of European financial services and securities law. This was the first attempt to address the problems of incoherent, ambiguous and out-of-date legislation that failed to operate effectively at a national level. Indeed, the Lamfalussy Report specifically referred to the FSAP as being designed to fill the lacunae in European financial services and securities regulation. However, it also recognised that the 2005 deadline was highly ambitious - not least because of the lack of basic legislative techniques designed to simplify and speed up the process of adoption of European legislation.

The new legislative techniques proposed in the Lamfalussy Report focused not only on speed, but on quality, flexibility, consistency, transparency and efficiency. The Committee of Wise Men suggested separating the 'principle' of legislation from the 'detail' in order to minimise ambiguity - thereby allowing detailed technical rules to emerge from the underlying principles.

To that end, the Lamfalussy Report proposed a new four-level approach to the adoption, implementation, evolution and enforcement of legislation within EU member states (hence the term 'Lamfalussy process'):

Level 1

This comprises primary legislative acts, Directives and Regulations that define the broad framework principles, or 'essential elements' of each piece of legislation. The Commission, European Council and European Parliament agree on the key political orientation for each Directive or Regulation (and also the nature and extent of the Level 2 implementing measures), with advice from the European Securities Committee (ESC).

The traditional method of agreeing and adopting legislation at this level utilises the long-used co-decision procedure whereby the Commission, Council

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and Parliament must all agree on the final text of a piece of legislation. This process takes on average three years to complete and usually involves a number of readings of a proposed text, followed by lengthy consultation periods, and then by numerous rounds of amendments. Even when, for example, a Directive has proceeded through the co-decision procedure and takes effect within member states, if it is required to be amended, the proposed amendments are subject to a full-blown consultation under the co-decision procedure - a lengthy and somewhat onerous process.

Under the Lamfalussy process, the co-decision procedure will be restricted to agreeing the key political orientation of a piece of legislation and agreeing on a short-form text. This will leave the detail to the Level 2 implementing measures, thus cutting down the time spent on reaching agreement using the co-decision procedure.

Level 2

Level 2 measures comprise technical implementing measures for the Level 1 legislation that will be adopted by the Commission with the assistance of, and advice from, the Committee of European Securities Regulators (CESR). The Level 2 measures will contain the detail of the legislation that has been left out at Level 1 and are designed to ensure the speedy adoption of legislation, as well as to avoid the lengthy consultation process involved in amending the Level 1 measures. Ensuring that these Level 2 technical provisions can be quickly and easily amended means that EU legislation is able to keep pace with market developments. This method, which involves the Commission agreeing upon detailed implementing measures with the assistance of one or both of these Committees, is known as the 'comitology' procedure. Comitology forms the core of the Lamfalussy process. It will have an increasing impact on the shape and substance of EU financial services legislation; indeed, use of the process was extended in early 2003 from the securities field to the banking and insurance sectors.

The Level 2 implementing measures for the Directives agreed using the Lamfalussy process take the form of Directives and Regulations, although the Lamfalussy Report urges the use of Regulations rather than Directives. Regulations have the benefit of being directly applicable within member states' legal systems without the need for member states to draft implementing legislation. Directives leave the form and method of implementation to the member states. Thus there are timing implications where Directives are the chosen form of implementing measure. Although they are said to be the best way to achieve harmonisation of member states' local laws, the heavy use of Directives pre-Lamfalussy (and indeed, in non-Lamfalussy measures) has led to inconsistent implementation of EU legislation and has also meant that the Commission is unaware of whether correct and consistent implementation is being achieved in each member state.

Level 3

Level 3 is designed to improve co-operation between national regulators to ensure consistent transposition and interpretation of the Level 1 legislation and Level 2 implementing measures. This involves CESR operating in a different capacity than under its Level 2 responsibilities - CESR will act as a regulatory committee within Level 3, ensuring consistent implementation of the Level 1 and 2 measures. This will be done through the development of CESR 'Guidance' covering national implementing measures, the issuing of interpretative recommendations and the setting of common standards where there are gaps in the legislation, together with the comparison and review of regulatory practices to define best practice and ensure consistent application.

Level 4

Enforcement action by the Commission (or even the threat of it) is recognised as the best way to ensure consistent and timely implementation of legislation within member states. None of the measures progressing under the Lamfalussy process are (at the time of writing) in force, and, although Levels 1 and 2 are in place for many (with Level 3 Guidance being consulted on by CESR), we are not yet in a position to see the operation of Level 4. It is expected that Level 4 will involve the Commission conducting rigorous checks on the texts of national implementing measures and their application and taking action in the form of infringement proceedings against any member state found not to be correctly (or promptly) implementing any piece of legislation.

The Securities Committees - the ESC and CESR

The Lamfalussy Report recommended the creation of the ESC and CESR, which will act as advisory committees to assist the Commission in implementing the four-level approach. The roles of the two committees are similar yet different - broadly, the ESC operates mainly in an advisory capacity at Level 1 while CESR operates mainly in a regulatory capacity at Levels 2 and 3.

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The ESC is composed of high-level representatives of the member states. Its work is twofold, as the Committee acts in both advisory and regulatory capacities. In its advisory capacity, the ESC advises the Commission on the adoption of Directives or Regulations at Level 1 and may be consulted by the Commission before it mandates CESR to provide technical advice on Level 2 implementing measures. In its regulatory capacity, the ESC assists the Commission in exercising the Level 2 implementing measures.

CESR is an independent advisory body composed of representatives of the national supervisory authorities in the securities field of each member state. Its primary role is to assist the Commission in the preparation of Level 2 implementing legislation. The Commission will issue detailed mandates to CESR to prepare implementing measures within defined time limits. CESR will also play a role in ensuring consistent day-to-day implementation of the Level 1 and 2 measures at Level 3, through CESR Guidance.

The filter through into UK legislation

The end-2005 deadline for implementation of the FSAP means that all member states should have begun consultations on implementing the first major proposals under the FSAP by the end of 2004. In turn, this means that the outstanding measures under the FSAP should have been finalised and adopted by mid-2004. However, there is still a lot of work to be undertaken in relation to various aspects of the FSAP, including parts of the company law framework, and to the finalisation of the Directives on Transparency Obligations, Consumer Credit and Money Laundering, all of which (at the time of writing) have missed the mid-2004 target for adoption.

It is worth remembering that, while the Level 1 Directives require timely implementation, so do the Level 2 Directives (the Level 2 Regulations will be directly applicable in member states). Even before implementation, the drafting of national legislative provisions involves public and industry consultation, feedback and re-drafting.

The FSA and HM Treasury are already consulting on the implementation of some major aspects of the FSAP within the UK, such as the review of the listing regime required to implement a number of the FSAP proposals and the implementation of Basel II within the EU through the revised Capital Adequacy and Banking Consolidation Directives. Certain parts of the FSA Handbook (the medium through which most of the FSAP Directives will be implemented in the UK) will require substantial amendment, including the Interim Prudential Sourcebooks for Banks, Insurers and Investment Businesses (soon to become the Integrated Prudential Sourcebook), the Conduct of Business Rules, the UKLA Listing Rules and the Market Conduct Sourcebook.

Some conclusions

The ambitious 2005 deadline for the finalisation of the FSAP leaves EU companies and financial institutions juggling various different regulatory deadlines. Given that many EU companies and institutions will also be struggling to cope with the added burden of compliance with International Accounting Standards/International Financial Reporting Standards from 1 January 2005 and Basel II from 2007, it may be unrealistic to expect full and consistent application of all aspects of the FSAP from 2005.

Some interesting issues arise in relation to the Accession Countries that joined the EU on 1 May 2004. Those countries, subject to certain transitional periods, are required to implement the entire FSAP into their national legislative systems within a very short timeframe. Furthermore, local legal, tax and accounting frameworks will all require a degree of harmonisation, even before the provisions of the FSAP can be considered for implementation in Accession countries. The 10 countries' successful integration into the single market will undoubtedly depend on their ability to plan and prepare for the introduction of an entirely new system of financial services regulation.

***Katie G McCaw**, professional support adviser to the International Securities Group, with particular specialisation in international banking, securities and financial services regulation at Norton Rose.*

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UK

Consumer Credit Act 1974 – the revised advertising regime

In December 2003 the UK Government published proposals for the modernisation of the Consumer Credit Act 1974. The White Paper, *"Fair, Clear and Competitive – The Consumer Credit Market in the 21st Century"* set out wide ranging proposals to increase fairness and transparency in the UK consumer credit market as well as to strengthen and modernise the licensing regime. The UK Government recognised that its proposals would run in parallel with the update to the Consumer Credit Directive but felt compelled to bring forward reforms ahead of any finalised Directive because of concerns over the level of UK consumer debt and the apparent lack of transparency in the market.

The first wave of reforms is now in place. On 31 October 2004, The Consumer Credit (Advertisement) Regulations 2004 applying to all consumer credit or hire advertisements came into force. The new Advertising Regulations aim to simplify the advertising regime for consumer credit and to allow easier comparisons between lenders' offers. They will be followed in May 2005 by changes to the form and content of consumer credit and hire agreements, a requirement to provide customers with pre-contract information in certain situations and changes to how lenders must calculate rebates for customers who settle early. There will also be changes implemented later this year or early next year to allow lenders to conclude agreements over the internet.

The Regulations apply to all adverts for credit and hire other than those offered exclusively to business borrowers or residential loans offered by mortgage lenders. Residential mortgage loans are now the subject of direct regulation by the Financial Services Authority (FSA) and fall within the financial promotions regime with detailed requirements for advertising set out in the FSA Handbook. There are some significant differences between the Advertisement Regulations and the Financial Promotions regime. Whether this will lead to consumer confusion is still an open question.

All adverts must be in plain and intelligible language, be easily legible (or audible if appropriate) and specify the name of the advertiser. There are certain trigger items of information which, if included in the advert, require the lender to include additional prescribed information, including the annual percentage rate (APR). The APR will also need to be included if the advert offers any incentives, such as cash back or indicates that it is on more favourable terms than other products. New prominence requirements coupled with a reduction in the amount of information that must be included in an advert should mean that the amount of small print is greatly reduced and may even be phased out altogether.

The Regulations seek to ensure greater consistency between lenders in the use of the 'typical' APR. This must now be the rate at or below which the lender expects 66% of agreements to be concluded as a result of the advertisement. This is likely to mean that credit will appear more expensive from 1 November as adverts reflect the change in the way the typical APR is calculated, especially for those lenders that operate risk based pricing. There may also be some circumstances where the Regulations will have the effect of making certain products look disproportionately expensive.

The Regulations introduce significant changes to advertisements for credit cards with new requirements for calculating and quoting the APR. For many years credit card companies have been using a number of methods to calculate the APR. The nature of a credit card product means that assumptions must be used when calculating the APR. These assumptions are set out in the Consumer Credit (Total Charge for Credit) Regulations 1980 (as amended) but differences on interpretation have lead to different companies applying different assumptions. This practice has recently been highlighted before the Treasury Select Committee, which has been carrying out a detailed review of the Credit Card Industry in the UK. The Regulations contain new assumptions which will hopefully clarify the calculation and, perhaps most visibly to the consumer, only the APR applicable to purchases can be quoted. Again to increase transparency the calculation of the purchase APR cannot take into account any introductory period and must be based on the highest rate of interest applying during the first three years of the agreement. The Regulations do not specify how rates should be quoted for other balances, such as the cash advance balance or balance transfers, and there is already debate within the industry as to whether interest rates should be quoted on a simple or compounded basis.

OFT frequently asked questions

In October 2004, the Office of Fair Trading (OFT) published a list of Frequently Asked Questions setting out its initial views about questions raised by

advertisers on its interpretation of the Regulations. The need for this again highlighted issues with the clarity of the drafting of the Regulations. Certain views expressed by the OFT have caused concerns among lenders, particularly where it has adopted what appear to be more restrictive interpretations to those adopted in the past. An example of this is the interpretation of the phrase 'together as a whole'.

The Regulations specify that the required information must be contained 'together as a whole'. Under the previous Regulations, lenders would commonly set out the required information in one area of the document but would commonly intersperse information with certain banner advertisements rely on a click through to comply. The OFT has questioned this approach by stating that the information should not be interspersed and, perhaps more surprisingly, by stating that all of the required information must be repeated whenever trigger information is mentioned. It appears to be of the view that this is the only way to satisfy the requirement for equal prominence of the required information, leaving very little scope for advertisers to achieve equal prominence on other ways. This interpretation is, however, likely to lead to repetition of information and may adversely affect the transparency of the advertisement.

How will the regulations be enforced?

Breach of the regulations is a criminal offence. The regulations are enforced by the OFT and local trading standards offices. It was a clearly stated aim of the Department of Trade and Industry that enforcement would be strengthened. Certain weaknesses in the drafting of the previous regulations meant that prosecutions were relatively rare. However, in recent months the OFT has been making increasing use of its powers under the Enterprise Act 2002 to force lenders to withdraw misleading advertising campaigns.

Conclusions

The new Regulations do introduce some improvements for borrowers in terms of clarity and prominence and should make it easier for borrowers to make meaningful comparisons between different lenders' adverts. They may also herald the death of small print. However, consumers generally have a poor understanding of what the APR is and what it means and this has not been dealt with by the new Regulations. It therefore remains to be seen whether they will actually make advertisements more comprehensible for consumers. Lenders will however need to carefully review how they market their products. There is likely to be a significant impact on the sorts of messages that lenders can headline with and there may also be an impact on how certain types of adverts, such as banner adverts on the internet, can be used.

***Julie Patient**, Consultant, Financial Institutions Group, Lovells*

UK

Betting scheme contravenes Financial Services and Markets Act 2000

On 21 October 2004 the Chancery Division of the High Court gave judgment in the case of *Financial Services Authority v Fradley (trading as Top Bet Placement Services) and another*. This case raised some interesting issues on the scope of the definition, contained in section 235 of the Financial Services and Markets Act (FSMA) 2000, of a collective investment scheme.

The defendants to this application for summary judgment brought by the FSA were a Mr Fradley, who traded as Top Bet Placement Services (TBPS), and a Mr Woodward, who had been a director and company secretary of a company called 147 Racing Ltd (147). A betting scheme was operated from August 2002 by 147, pursuant to which unsolicited mail shots were sent to members of the public inviting them to 'invest in horse racing'. Members were to provide a minimum betting bank, monthly contributions and were initially able to use the services of TBPS for bet placement. If they used TBPS's services they were sent TBPS's terms and conditions, which provided that the monies representing the member's betting bank would be held in TBPS's client account. The conditions also stipulated that payments could only be made out of this account for the purpose of payments to bookmakers, repayment to the member or payment of TBPS's management fees and the placement levy.

The scheme operated in this way until October 2002 and the Court referred to this as the scheme's 'first period'. In October 2002, Mr Woodward resigned as director and secretary of 147 and the scheme documentation was revised so that it became compulsory for members to use TBPS's services. This remained the case until February 2003 and this was referred to by the Court as the scheme's 'second period'.

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In February 2003, the FSA got involved in discussions concerning the scheme as it took the view that the scheme may have been an authorised collective investment scheme and it sought undertakings from 147 and TBPS that they would cease trading. The defendants stated (and the Court accepted) that the scheme did not operate from early February until early March 2003 ('the third period'). After that period, the scheme documentation was revised again so that new members were informed that they had the option to place their own bets. TBPS's terms of business were revised so that bets would be placed strictly in accordance with the member's instructions and in accordance with a mandate from the member, and that members' monies were to be held on trust. Similar changes were made to TBPS's terms for existing members.

This documentation was used from early March until April 2003 ('the fourth period'). On 4 April 2003, Mr Fradley moved to Dublin and continued operating the scheme until 21 August 2003 ('the fifth period'), at which point the FSA obtained injunctions against him and 147 (which was subsequently wound up). During the time the scheme operated: £1,415,000 was invested, with £425,000 being lost on bets; 147 received membership fees in excess of £293,000; TBPS received fees and levies in excess of £145,000; and insufficient money remained to repay members' betting banks.

The FSA claimed that the betting scheme amounted to a collective investment scheme within section 235 of the FSMA 2000. This meant, it argued, that Mr Fradley had been carrying on a regulated activity without either authorisation or exemption under FSMA 2000 and had therefore contravened section 19 thereof.

The FSA claimed that Mr Woodward was knowingly concerned in Mr Fradley's contraventions and was thus liable to the same extent. The FSA sought with respect to both defendants: declarations of the contraventions, restitution orders and an account of profits already made under section 380(2) of the FSMA, and injunctions to restrain any future contraventions.

Court's Ruling

In holding that the scheme was a collective investment scheme during the first and second periods of its operation, the Court addressed itself to several detailed and refined legal arguments advanced by the counsel for Mr Fradley, who attempted to argue that the scheme fell outside the definition of a collective investment scheme.

Firstly, as it had been argued that monies derived from betting winnings did not constitute 'property' within the meaning of section 235(1) of the FSMA, there must be some separate underlying property other than money. However, the Court disagreed, stating that the terms of section 235(1) were wide enough to encompass this scheme since it referred to 'any arrangements' relating to property of 'any description'. The Court stated :

> *"The wording [of section 235(1)] is, as the FSA claims, entirely apt to cover Mr Fradley's scheme: there were arrangements with respect to property (being the contributions themselves) whose purpose was to enable the participants to receive profits arising from the management (by placing bets) of that property. I see no reason why betting winnings should not be regarded as profits, and no reason why placing bets out of contributions should not be regarded as management of those contributions. In my view, the scheme falls within subsection (1)."*

Secondly, it was argued that, since during the first period at least, members had the option of placing their own bets, then one of the key requirements of the definition of a collective investment scheme was absent from these arrangements. This meant that the participants did not have day-to-day control over the management of their contributions. It was argued that, because some participants did have such control at the outset of the scheme, this took the arrangements outside of section 235(2). However, the Court rejected this argument as too artificial:

> *"As to [the argument that not all contributors used TBPS's services but rather placed bets directly], it seems to me essential if a scheme is to fall outside the subsection that all the contributors should have day-to-day control: if some do and some do not, the scheme is within the subsection. That is because the application of subsection (2) to a scheme requires an answer to the question 'Do the participants have day-to-day control?'; and if the answer is 'No' – as it will be if some participants have control and others do not – the scheme is within the subsection. There may, of course, be circumstances in which there is in reality more than one scheme; but in the present case the terms of the scheme were the same for all participants, and there plainly was only one scheme. I do not think it possible to have one scheme which is partly a collective investment scheme and partly not; so that as soon as one participant chose to use the services of TBPS he relinquished control, and the scheme became a collective investment scheme as regards all its members."*

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Therefore, with regard to the first and second periods of its operation, the scheme fell within section 235(2).

Thirdly, the Court was satisfied that the requirements in section 235(3) that, for a scheme to be a collective investment scheme, contributions had to be pooled and managed as a whole was also satisfied when members' monies were paid into one account and large bets were placed using more than one participant's money. One collective bank account was used for bets and winnings and the fact that in the fourth and fifth periods that account was a trust account made no difference to the point. The bank had one customer, Mr Fradley, who managed the account on a pooled basis as a whole.

Finally secondary legislation provides an exemption from the scope of section 235 for 'common accounts' defined as:

"(a) …. arrangements under which the rights or interests of participants are rights to or interests in money held in a common account; and
(b) [where] money is held in the account on the understanding that an amount representing the contribution of each participant is to be applied -
(i) in making payments to him;
(ii) in satisfaction of sums owed by him; or
(iii) in the acquisition of property for him or the provision of services to him."

Counsel for Mr Fradley had argued that these three conditions were fulfilled by TBPS's client account and that the arrangements ought therefore to be exempt. The Court disagreed for two reasons. Firstly, it argued that the fact that monies in the account could be used for the placing of bets (which are technically void contracts under the Gaming Act) meant that condition (iii) was not satisfied, since the placing of bets was neither the acquisition of property nor the provision of services.

Secondly, the whole purpose of this common account exemption was directed towards accounts akin to a solicitor's client account, where monies from different individuals was temporarily co-resident for mere administrative convenience rather than, as here, where it was for the collective purpose of onward investment. Hence this 'common accounts' exemption did not save the betting scheme from illegality either and the Court declared that it was an unauthorised collective investment scheme during the first and second periods. This meant that Mr Fradley was indeed, as the FSA had claimed, in contravention of section 19 of the FSMA. It also granted the declaration and injunction sought against Mr Woodward, since it took the view that all that was required for him to be 'knowingly concerned' in the contravention was knowledge of the facts relating to the scheme's operation, which rendered it a collective investment scheme. He did not have to know of the fact of illegality itself, simply the component elements of that illegality.

This decision illustrates the width and reach of the provisions relating to collective investment schemes. The fact that gaming activity is itself already subject to a bespoke regulatory regime does not mean that those who, by way of business promote collective gambling activity, will not be caught by the financial regulatory net as well.

***Joanna Gray**, University of Newcastle-upon-Tyne*

UK

Implementation of the DMD

The EU has for many years recognised the need to ensure consumers entering into any type of agreement at a distance have adequate protections. The Distance Selling Directive introduced protections covering many products and services. The Distance Marketing of Consumer Financial Services Directive (DMD)[1] extends the regime to all consumer financial services. It sets common standards for the provision of pre-contract and contractual information to consumers prior to a contract being concluded at a distance and contains provisions for withdrawal rights in many circumstances. The DMD was adopted in September 2002 with Member States required to bring it into effect in October 2004.

The DMD came into force in the UK on 31 October 2004. For products and services regulated under the Financial Services and Markets Act 2000, the Financial Services Authority (FSA) has implemented the required changes through amendments to its Handbook of Rules and Guidance, most notably to the Conduct of Business sourcebook. For all other financial products and services, the Financial Services (Distance Marketing) Regulations 2004 (SI 2004/2095) apply. Both sets of regulation largely adopt

1 *Directive 2002/65/EC concerning the distance marketing of consumer financial services (OJL 271/16, 9/10/2002) and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC.*

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a 'copy out' approach, which is now the standard approach to implementing this type of directive.

The DMD potentially applies to any financial services contract concluded at a distance by a consumer. To understand the full scope of the DMD it is important to understand the key definitions of 'consumer', 'financial service' and 'distance'.

A consumer is "any person who, is acting for purposes which are outside his trade, business or profession." This is a standard EU definition used in other consumer protection directives. Unlike the structure of the FSA's rules, this definition does not include any recognition of sophistication. Potentially, an individual making a multi-million pound investment in an investment fund will be subject to the same protections as an investor placing £5 in an instant access savings account, so long as the investment is not one related to their trade or business.

A financial service is "any service of a banking, credit, insurance, personal pension, investment or payment nature". This is a very broad definition, although interestingly some financial service products are purposefully omitted, for example, occupational pension schemes. The definition also brings into regulation a number of products and services which have previously been free from regulation – such as consumer lending products for amounts over £25,000 and general insurance products – although these are to be the subject of more specific future regulation. The broad range of products means that there are a number of different regulators ensuring compliance with the new regime – the FSA, the Office of Fair Trading and the Treasury - depending on the nature of the product or service.

A 'distance contract' is any contract for financial services "concluded between a supplier and a consumer under an organised distance sales or service scheme run by the supplier who for the purposes of that contract, makes exclusive use if one of more means of distance communication." This definition has been the subject of much debate in the UK and is particularly important for providers using a number of different delivery channels, including branch premises. The DMD makes reference to "no simultaneous physical presence" and the question arose as to whether "simultaneous physical presence" needed to be some form of meaningful discussion between the supplier or intermediary and the consumer. The FSA's current view is that in order for a contract to fall within the meaning of a distance contract: (a) firms must have put in place facilities which are designed to enable a retail customer to deal with the firm exclusively at a distance (such as by post, fax, internet, telephone or by direct offer advertising); and (b) there must have been no simultaneous physical presence of the firm (or the intermediary) and retail customer throughout the offer, negotiation and conclusion of the contract. It is yet to be seen whether the Office of Fair Trading - or indeed the courts – will adopt the same interpretation.

There are two main requirements. Certain information must be given to the consumer about the firm, the service, the contract and complaints procedure. The consumer must also be informed of the existence or absence of a withdrawal (or cancellation) right. The DMD requires all contractual terms to be provided unless an exemption applies.

Consumers will have a period of 14 (or in some cases 30) calendar days to withdraw from the contract, without the obligation to give any reason. The right of withdrawal does not apply to all distance contracts such as: those secured by a mortgage on land; those of life insurers, operators of collective investment schemes and trustees; services related to foreign exchange, money market instruments, transferable securities and units in collective investment undertakings. There are also no withdrawal rights for contracts whose performance has been fully completed by both parties at the consumers' request before the consumer exercises his right of withdrawal. Exercising the right of withdrawal terminates the contract. Any sums paid by the customer must be returned immediately and where monies have been supplied to the consumer, these must be repaid within 30 days of cancellation.

It is interesting to note that the withdrawal regime of the DMD overlaps with the cancellation provisions of the Consumer Credit Act 1974. Although the cancellation regime of the Consumer Credit Act is triggered where there are face to face negotiations it is not uncommon for lenders to treat all of their agreements as cancellable. The risk of choosing the wrong option under the Consumer Credit Act can be complete unenforceability. Applying both regimes to the same agreement can cause difficulties - under the Consumer Credit Act if a borrower cancels and repays in full by the first instalment date then interest cannot be charged. Under the DMD interest can be charged if the borrower specifically requests that the funds are advanced before the end of the cancellation period. Is it open to a lender to charge interest under one regime when they are not permitted to do so under the other? How will a lender know which regime the consumer has used to cancel the agreement?

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The requirements on their face value do not appear onerous but for many institutions achieving compliance has been a challenge. Processes can be highly automated – introducing a new step or changing an existing process can cause significant issues. It is not uncommon for the full terms and conditions relating to a financial product to be disclosed after the conclusion of the contract with suppliers relying on contract or pricing summaries. This will no longer be sufficient.

The DMD states that 'sanctions must be effective, proportional and dissuasive.' In the UK, enforcement in relation to any alleged breach will be carried out by either the FSA or the OFT depending on which authority is the responsible regulator for the particular distance contract. No details of specific penalties have been published.

The DMD has been implemented on a country of origin basis in the United Kingdom. However, HM Treasury has acknowledged that the DMD is ambiguous as to whether the responsibility for enforcement would be on a 'host state' or a 'home state' basis. Its interpretation is based on an analysis of Article 16, which contains a transitional basis permitting Member States to impose provisions in the Directive on a host state basis where the Member State of origin of the supplier has not yet implemented the DMD. HM Treasury's view is that a country of origin basis must be correct since, under a home state interpretation, Article 16 would be redundant. The effect of this is that the UK DMD provisions apply to a supplier established in the UK when it provides services to a customer in the UK or in another EEA country. The rules of the other EEA country may also apply if this country has implemented the DMD on a host state basis. The UK's provisions do not apply to marketing into the UK from an EEA firm entering into a distance contract for financial services from an establishment in another Member State where that Member State has also implemented the DMD on a country of origin basis. The UK rules do, however, apply if that Member State has failed to implement the DMD. Given what appears to be patchy compliance across the EU, this may well mean that the UK provisions will apply to in-coming EEA firms.

If regulated activity takes place in the UK, the DMD will apply to a non-EEA firm unless an exception for overseas firms applies under the terms of the Regulated Activities Order.

The DMD does not use the concept of residency and leaves open the issue of whether UK firms providing outbound financial services to non-EEA customers have to apply DMD requirements. However, the FSA has made it clear in COB that some of the DMD requirements do not apply in relation to outbound financial services from a UK firm to non-EEA customers. In particular, the cancellation rights in COB do not apply to non-EEA customers, although the pre-contractual information requirements generally do.

The DMD introduces important new rights into consumer financial services agreements and imposes additional obligations on financial service providers. Complying with the new regime has been a challenge for many service providers with considerable amounts of documentation requiring amendment. It remains to be seen whether transition to the new regime has been successful and whether consumers will notice any significant benefits.

***Julie Patient**, Consultant, Financial Institutions Group, Lovells*

UK

Implementing the Market Abuse Directive

In order to implement the Market Abuse Directive (MAD) the FSA has drawn on its experiences in prosecuting both firms and individuals. The result is a substantial change to the Code of Market Conduct (MAR). Once the proposed rule changes are finalised in November 2004, the market abuse regime will have a much broader scope than it has at present and will significantly extend the requirements on regulated firms to demonstrate that controls exist within their businesses to prevent market abuse. This includes the requirement to report suspicious transactions to the FSA.

In implementing its revised rules, the FSA will still expect firms to implement their own risk management processes within the framework provided by them. This however, may create difficulties for some institutions as to what to do at a practical level. There is no prescriptive answer to the question 'what do I need to do now?' The issue is much more one of 'what am I currently doing?', 'how does this fit in with the MAR?' and 'what further steps do I now need to take?' Whatever decisions are taken, firms need to be mindful of the reputational risk issues that can arise by failing to adhere to the spirit as well as the detail of the rules.

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This article presents some of the issues facing senior management in financial services firms and the practical steps which now need to be taken to address the provisions of MAR.

One of the FSA's four statutory objectives is the reduction of financial crime. The FSA has indicated that it expects firms to have in place, at all times, policies, procedures and controls to prevent financial crime. It also expects the executive management of regulated firms to be fully engaged with the issues. The rulebooks currently used by the FSA to enforce its approach to detecting and preventing financial crime are the Money Laundering Sourcebook (ML) and the Code of Market Conduct.

The Money Laundering Sourcebook provides prescriptive requirements and guidance in respect of systems and procedures that a firm is required to have in place in order to prevent detect and report money laundering. The proposed Code of Market Conduct outlines the FSA's approach to preventing insider trading and market manipulation.

In order to implement the directive and related regulations the FSA proposes to make a number of changes to: listing rules; MAR; COB; and price stabilisation rules.

The regime remains a behaviour-based regime and will continue to require firms and individuals to be aware, in all their dealings, of the Approved Persons Code, the FSA Principles and the detailed rulebooks.

The rule changes are substantial, but the spirit of the resulting regime remains in essence the same as the present regime. What has not changed is that the burden of proof that market abuse was not the intended outcome of a particular behaviour or series of trades remains with the 'defendant'. This therefore puts pressure on senior management to ensure that the appropriate controls exist within an organisation to be able to justify, after the event and should the need arise, the bona fide purposes of any actions taken.

Individual traders and line management must, when in the middle of a transaction, always be aware that the unseen consequences of those actions might in the future be interpreted as being abusive. The FSA is keen to emphasise that, notwithstanding the rule changes, if a behaviour is prohibited now it will remain so once the new rules come into force.

The Market Abuse Regime

There are some key changes under the new rules:

- The present code identifies four relevant behaviours. Under the Code there are eight relevant behaviours;
- All EEA regulated markets are covered;
- The range of equity, debt and derivative investments is being extended to include any instrument that is admitted to trading; and
- In order to incorporate abuses arising from inappropriate management of conflicts of interest, the range of activities covered by the Code has been expanded.
- The current four offences are being replaced by two – insider trading and market manipulation.

The FSA accepts that there is a need, under certain circumstances, for exemptions to the rules (safe harbours). These safe harbours are permitted providing that the controls around the management of them can be demonstrably seen to be working.

However, the safe harbours under the Directive have a narrower and more specific meaning than the present regime; therefore the FSA will need to make some changes to its safe harbour provisions.

In having to implement MAD, the FSA has been presented with an opportunity to revisit, with renewed vigour, its approach to combating market abuse within its managing of financial crime obligations. In ensuring that regulated firms are controlling market abuse risk and that compliance with the new rules is embedded within their businesses, the FSA would expect senior management to be taking action now. This action needs to:

- Reassess documented processes that are in place to identify possible areas of market abuse risk, and documentary evidence of the extent of market abuse risk.
- Determine and confirm that compliance and control resources are adequate to address market abuse risk in an appropriate manner.
- Review monitoring programmes to aid in identifying market abuse risk, and ensure that the reporting of any suspicious transactions to the FSA will occur.
- Confirm that accurate, timely and up to date management information is available on market abuse risks.
- Review training of key staff throughout the business on market abuse issues.
- Develop on-going awareness through monthly compliance briefings on market abuse issues.

Management actions

The extent of required actions is hugely influenced by what steps have already been taken by firms since N2 to implement the Code of Market Conduct:

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- Firms will need to review their safe harbour controls to be able to demonstrate that they are meeting at least the minimum standards expected under the Code.
- Compliance may require the establishment or enhancement of existing market abuse controls.
- Controls and relevant management information relating to prescribed markets will need to be extended from the present narrow base to include a much wider range of markets.

One of the most important factors in the avoidance of market abuse is the development of a good compliance culture. To comply with the Code fully, related controls need to be embedded throughout the organisation.

Some of the controls may well be in the business already but the key is now to link the controls in such a way as to be able to meet the requirements of the Code. Management may need to enforce the Code through behaviour change and awareness training. Senior management will need to realign existing controls to ensure that market abuse behaviour under the Code is prevented and appropriately managed. This may involve linkages with financial crime controls and existing suspicious reporting mechanisms.

Minimum controls

In order to avoid enforcement, senior management needs to invest in controls which demonstrate that market abuse risk is appropriately managed. Examples of minimum controls and procedures include:

- restricted lists;
- minutes confirming the basis of investment decisions/investment actions;
- details of post trade date transaction amendments;
- details of off-market trades;
- details of volume inducing sales;
- correlation reports between the placing of buy/sell orders and changes to market sentiment;
- counterparty trading pattern matching;
- transaction pattern matching reports; and
- suspicious transaction reports.

Conclusion

As a result of the FSA's consultation paper on implementing the Directive, the financial services industry and listed corporates now know what the Code is likely to look like once the Directive comes into force. The Code does not require senior management to remove the risk of market abuse from their businesses, but expects them to manage the risks appropriately.

Senior management needs to review the extent of its existing controls around market abuse in order to gain comfort that they will still meet the FSA minimum standards under the new Code. Most firms are likely to need to make some changes to the control framework they have in place. For any firms which have neglected this area in the past now is the time to ensure that suitable market abuse controls are implemented.

Andrew Clark *(020 7804 5761) and* ***Jason Dalrymple*** *(020 7804 7228), PricewaterhouseCoopers*

China

Moving China's Goalposts

The forthcoming reform of China's bankruptcy sector will have some major implications, not just for China, but also for international business and Hong Kong SAR. Many would argue that the People's Republic of China will be the World's next economic superpower. Some would say that it is already. However, scraping beneath the veneer reveals serious structural shortcomings, both in the legal system, financial system and in the transparency of commercial trade, where the obligation of a government agency to economic entities established by it, such as Hong Kong-based window companies, is often opaque.

This really should be no surprise from an enormous country, with a population approximately equating to one quarter of the entire planet's, which only 30 years ago had no private companies at all. It has been an impressive transition towards a market based economy by anyone's benchmark. No longer just a source of cheap labour, goods and services, China has become a major marketplace, craving all kinds of foreign products and investment. As China strides towards its WTO goal of a socialist market economy, through gradual reform and restructuring, opportunities are abound for international businesses, and pressure afoot 'to be there'. For such companies, the management of risk when investing in or doing business in China is increasingly relevant. A strong bankruptcy regime, and knowing how to use it, is one central aspect of risk management in any jurisdiction.

The introduction of a new draft bankruptcy law to China's top legislature on 21 June 2004 could mark the beginning of major changes to China's investment climate.

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This article looks at the current state of play, the policy issues under debate, and the relevance that its enactment could have on international business tomorrow.

The need for reform

The current bankruptcy regime in China is a long way from being satisfactory. Whether managing risk, contemplating recovery, or considering China's own aspirations, namely the development of a market economy, conducive to free enterprise, foreign competition and a 'survival of the fittest' culture, it is clear that a major overhaul and modernisation is required. The potential benefits to China's economy of a more efficient bankruptcy system, under which unviable economic resources can be closed down and redeployed to more viable segments of the economy, and where businesses can be reorganised and rescued, each in a way that promotes optional market activity and investment, but nevertheless safeguards employment and social stability, are obvious. What is not obvious, however, is how to achieve these goals within China's existing legal, institutional and cultural framework.

The problems with the current bankruptcy framework in China are numerous, but in very general terms could be summarised as follows:

- Depending upon the type of entity in question, the approval of the Ministry of Commerce, or of some other governmental or regulatory body, may be required before bankruptcy procedures can be initiated.
- The rules and regulations focus on the issues of resettling employees and reallocation of existing business/assets to other economic usage - only left-overs are paid to creditors.
- Creditors have very few legal rights or remedies, and very limited opportunity to participate in the bankruptcy process. As a result, laws enabling pre-bankruptcy transfers defrauding stakeholders to be reversed are not always enforced in practice. Similarly, disposals of assets in the bankruptcy are not always handled in a way aimed at maximising recoveries.
- There is limited involvement of the courts and in any event there is no independent judiciary with legal or other expertise in bankruptcy matters.
- The current bankruptcy laws lack detail and depth in many aspects and have to some extent become outdated.
- China's laws and regulations are not generally conducive to corporate restructuring or reorganisation.

The Chinese authorities' decision in 1998 to formally place Guangdong International Trust and Investment Corporation (GITIC) into bankruptcy proved a particularly painful experience for China. Many foreign banks had made loans on the understanding that such loans were backed by the provincial government, only to find that the provincial government was not prepared to stand behind GITIC and repay them. One result of this was a reappraisal of risk management by foreign banks. Further, the inefficiencies, opacity and creditor unfriendliness of China's existing bankruptcy framework were exposed for the world to see.

Chinese authorities recognise that the current bankruptcy system is not adequate to meet the needs of China's economic system today and that an efficient system is an essential cornerstone of China's effort to build a market economy.

However, the need to first improve and reform China's social security structure, to cater for the millions of workers who might be laid off through bankruptcy procedures, with consequential risk of social unrest, has been given priority over reform in the bankruptcy sector. Another priority has been the need to reform (through corporatisation, privatisation or internal restructuring) many state-owned enterprises (SOEs) (including state-owned financial institutions) into viable enterprises, capable of surviving a market economy, private-sector competition and an efficient bankruptcy regime.

Now that reforms in these areas have been on-going for a number of years, a draft of a new and comprehensive law, currently entitled the *PRC Enterprise Bankruptcy and Reorganisation Law* (DBL), has recently been brought before the Standing Committee of the National People's Congress, China's top legislature, for the first of three hearings. The fact that the DBL has now been brought before China's legislature may indicate the government's confidence that the reforms to social security and SOEs are now sufficiently advanced, such that the time has arrived for comprehensive reform in the bankruptcy sector. If the DBL is enacted in 2005, as many commentators and officials predict, it would represent a major step in the bankruptcy reform process.

Baker Tilly Hong Kong and Freshfields Bruckhaus Deringer have each been close observers and commentators on the various drafts of the DBL as it has evolved. This draft legislation has been undergoing drafting and consultation for around 10 years. Some commentators suggest that such a long delay indicates how fiercely Chinese officials have been divided over whether social stability should have priority over market considerations.

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However, this would appear to unnecessarily politicise what is a matter of necessity for any developed economy – there must be a social security 'safety net' before, or as part of, an efficient bankruptcy process.

The current move towards reform in China's bankruptcy sector also coincides with a more general need to enhance protection of creditors' rights, which has recently assumed greater importance in light of China's post-WTO urgency to progress financial institution reform and commercialisation of the major state-owned banks. A bankruptcy system providing more creditor protection will improve the recovery rates of state-owned banks in their efforts to resolve their significant non-performing loan ratios (through disposition, settlement or otherwise) and generally reduce the lending risk of such institutions. Recently published estimates have placed non-performing loans in China at around US$600 billion!

Current laws and regulations

Legal reform is certainly a good starting point in the process of reforming China's bankruptcy sector, as China does not yet have a unified bankruptcy law that applies throughout the country and to all types of debtor entities.

Today, China's bankruptcy law is a patchwork of outdated legislation, held together by 'quick fix' regulations promulgated by the Supreme People's Court (SPC), together with local rules and regulations in certain localities. The legislation applicable to a particular bankruptcy or reorganisation depends on the nature and, to some extent, the provincial location of the debtor and whether it is an SOE or an enterprise which is not state-owned (non-SOEs). Non-SOEs include collective, private and foreign-invested enterprises.

Non-SOEs now play a major role in the Chinese economy today and are not covered by any specialised bankruptcy law. This gap has been temporarily filled by some very basic and brief rules for the bankruptcy of non-SOEs, as set out in The PRC Civil Procedure law (CPL), coupled by an interpretation from the SPC providing that the PRC Enterprise Bankruptcy Law, which applies only to SOEs, shall apply by reference to non-SOE bankruptcies in matters on which the CPL is silent.

During July 2002, further regulations were issued by the SPC to provide much-needed supplemental rules and procedural guidance to assist courts dealing with the bankruptcy of SOEs and non-SOEs alike. They are viewed by many as a 'stop-gap' measure pending the promulgation of comprehensive bankruptcy legislation.

The draft new law

Currently, there are several 'hot' policy issues surrounding the DBL:

- Whether it will create a truly unified bankruptcy regime applying also to SOEs and not only to non-SOEs. The current draft applies to all enterprise legal persons, but also provides that the State Council may separately enact regulations specifying the time limit and scope within which the new bankruptcy law will apply to SOEs. It has been reported that the new law may be applied to certain types of SOE in a 'phased manner'.
- Whether it will apply to financial institutions, particularly those poorly-managed state-owned banks which might otherwise require bailing out by the Chinese government (the current draft states that there will be separate implementing rules for commercial banks, insurance companies and other financial institutions).
- The extent to which social security expenses and employees' claims are to be given priority under any bankruptcy or reorganisation process.

Press reports quoting various Chinese officials, academics and central bankers suggest that the DBL's passage through the legislature will be no rubber-stamping exercise. The DBL may therefore undergo a number of further changes before it is enacted.

Nevertheless, the current draft of the DBL appears to be very much a comprehensive piece of legislation, containing many concepts familiar to the bankruptcy regimes of many developed countries, such as:

- application to court for initiation of bankruptcy proceedings by debtor or creditor – no need for prior governmental approval;
- advertisement of bankruptcy proceedings and stay of all other legal proceedings;
- defined bankruptcy criteria including 'cash flow' test;
- the administration to be handled by court-appointed insolvency administrators, who must possess specified professional qualifications, such as certified public accountants and lawyers;
- supervising powers vested in creditors' meetings and a creditors' committee;
- investigation by the court of management's conduct and corporate affairs;
- repudiation or assumption of pre-existing contracts by administrator;
- priority of security interests and certain types of 'preferential' claim;
- creditor classes and voting;

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- rights for disgruntled creditors to appeal to court;
- filing of claims, including joint claims, claims under guarantee and unliquidated claims;
- conversion of foreign currency claims into RMB;
- provisions regulating insolvency set-off;
- set aside of fraudulent preferences, transfers at undervalue and other improper transactions;
- overall supervision of process by court;
- comprehensive reorganisation and rescue mechanisms; and
- powers enabling Chinese courts to recognise foreign insolvency proceedings.

Subject to the above comments regarding SOEs and financial institutions, the DBL would apply to all kinds of commercial enterprise and lawfully established economic entities, including partnerships and their partners and sole proprietorships. However, individual (consumer) bankruptcy would not be covered.

A comparison of the most recent draft of the DBL against the draft of two years ago indicates a trend towards preferring to increase the involvement of creditors, as the major stakeholders in any bankruptcy process, and reducing the involvement of the courts. These changes appear sensible, given that an independent judiciary, experienced in bankruptcy matters, will need time to be established and likely concerns that, at least initially following enactment of the DBL, courts in China's provinces may tend to favour the borrower, its employees and other local interests.

How would the new bankruptcy law affect international investment into China?

The enactment of the new legislation will not of itself solve the current lacuna that is China's bankruptcy system. Nevertheless, a very important first step in the reform process will have occurred and international investors will see tangible evidence of a major commitment on the part of the Chinese's authorities to a process of gradual development towards an efficient bankruptcy system.

It will likely take several more years for the courts and their judges to develop experience and expertise in this area, for 'test cases' to be run and interpretations delivered, for regulations and procedural rules to be made, for a reputable (and regulated) private sector body of professional 'administrators' to emerge, for an 'administrator of last resort' function to be set up (for cases where they are insufficient assets to pay the fees of a private sector practitioner), for treaties on cross-border recognition of insolvency proceedings to be concluded with other countries, and for the process and its rules to gain familiarity and understanding in the minds of all involved.

Even though bankruptcy law reform in China will be welcomed by international investors, in the short term they are unlikely to change significantly the various methods which they use to mitigate their exposures to counter-parties in China, through the usage of 'off-shore' structures or otherwise.

However, and over a period of years, not months, one would expect more confidence amongst international investors, and perhaps:

- greater reliance on contracts;
- greater confidence in minority shareholder and joint venture structures;
- increased foreign lending, both on an unsecured and secured basis;
- increased shareholder value for those foreign companies which hold investments in Chinese companies;
- positive revaluation of non-performing loans by both sellers and buyers;
- improvement to the financial condition of state-owned banks, through improved recovery rates in respect of non-performing loans and reduced lending risk, in turn leading to faster opening up of the financial sector to foreign competition in line with WTO;
- greater participation by foreign investors in auctions and other disposals of non-performing loans by state-owned banks or asset management companies;
- possibly, opportunities for foreign professional firms to sell their services in China's bankruptcy sector;
- better recoveries by foreign investors in respect of their lending to Chinese counter-parties, or in respect of non-performing loans which they have purchased;
- investors seeking to exit joint venture agreements may have more negotiating leverage; and
- more prospect of cross-border recognition of insolvency proceedings initiated outside China.

Implications for Hong Kong SAR

Hong Kong is fortunate to have its own well-developed bankruptcy system already. However, increasingly the effectiveness of Hong Kong's system is being undermined by the need for reform in China's bankruptcy sector.

In recent years, particularly following the handover of sovereignty over Hong Kong, there has been a notable shift towards closer integration between the economies of Hong Kong and other Chinese cities in

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the Pearl River Delta area, such as Donguan, Guangzhou and Shenzhen, some of which are also special economic regions of China. While Hong Kong companies continue to expand their businesses into China, particularly into these cities or their provinces, through the establishment of manufacturing facilities, joint venture arrangements or otherwise, Chinese companies are expanding their businesses into Hong Kong. It is seen as the financial capital for the region, through public share listing, trade or investment.

Nowadays, and as a result of the integration described above, nearly every medium or large corporate insolvency in Hong Kong involves some assets, business or related entities in China. The absence of a developed system in China to enable the Chinese aspects of the case to be handled, and satisfactory cross-border recognition of proceedings, necessarily lessens the efficiency and effectiveness of Hong Kong's bankruptcy system, which in turn impacts confidence and international investment into or through Hong Kong. It is therefore of significant importance for Hong Kong, and for Hong Kong's government and business community, to promote and encourage the early development of an efficient bankruptcy regime in China, appropriate cross-border recognition between Hong Kong and China, and an overall result that is truly one country, two systems.

Fortunately, an opportunity for Hong Kong to have its say may be available. After all, where else is China likely to look for the some of the necessary bankruptcy expertise and experience which it will certainly need to reform its bankruptcy sector, whether through promulgating new legislation, reforming its judicial system or ensuring experienced and reputable professionals are available to handle bankruptcy cases? In the drafting process of the DBL, China has already sought input from some of Hong Kong's most reputable insolvency professionals and academics. At a time when Hong Kong has 'insolvency resource' available following its recent recession, China requires large quantities of expertise and recent experience. Could reform in China's bankruptcy sector become a Hong Kong affair? Will the Chinese authorities offer this opportunity and will Hong Kong's insolvency industry grasp it?

Conclusion

The investment climate in China is changing and the new bankruptcy law will be a significant landmark. As with any change, there are opportunities for those who see them. Tracking the progress of China's bankruptcy reform will be important for investors, as will careful risk management and planning of investments. For the business community and international investors in the Pearl River Delta, there will be an increasing need to understand the bankruptcy systems of both Hong Kong and China, and their interrelationships.

***Michael Barker**, partner of Freshfields Bruckhaus Deringer and head of Asia restructuring and insolvency and: **Rupert Purser**, partner of Baker Tilly Hong Kong and insolvency practitioner*

Editor: Virginie O'Shea • tel +44 (0)20 7017 4128 • fax +44 (0)20 7017 4135 • virginie.o'shea@informa.com
Associate Editors: **Joanna Gray**, Solicitor and Senior Lecturer in Law, University of Dundee
Karel Lannoo, Senior Research Fellow, Centre for European Policy Studies
Dr. George A. Walker, Solicitor and Senior Lecturer in Law, Centre for Commerical Law Studies
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