Financial Regulation international

Worldwide regulatory developments and their implications for the financial services industry

Basel II compliance: all the right moves?

Choosing the right architectural solution for Basel II compliance is not only about meeting reporting requirements, but also advancing risk management. Christian Terp from IBM explains that this is why they have included data warehousing in their approach. He discusses how IBM has approached Basel II compliance and argues that this approach is the right way to proceed. He also goes on to explain the importance of the Component Business Model in their model to provide the operational flexibility to allow banks to maximise the benefits of Basel II by combining seamless integration with best of breed business components.

Getting on the right track

Depending on its business and risk profiles, each bank will devise a data warehouse model to suit its own needs. A well-defined master plan and timely start with preliminary activities are essential for piecing this together and making sure the plan is implemented efficiently and on schedule.

First, banks need to consider interdependencies and parallel programmes, for example IAS, Sarbanes-Oxley and various local and international anti-money-laundering laws. Reporting requirements for these and the bank's business units also need to be identified. Using gap analysis on a data and systems level, the bank then considers what holes it must fill, taking account of those stemming from potentially new components needed for the model required. Such components might include risk engines, portal solutions or client platforms.

Integrated quality assessment is the next step. This is not only important for checking the content of the master plan documents, but also for monitoring the components of the architecture structure, their costs and implementation implications. Benchmarking against peer groups can be useful for this as well. IBM recommends an approach which includes regular reviews and check-ups for monitoring costly regulatory changes and other operational risk surprises that could affect the project. Basel II, accounting and risk-reporting requirements should be aligned; because organisationally it would be wise to choose representatives from each area to work with IT in managing the project. Regular meetings with line managers should be arranged to

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ensure the proper day-to-day use and function of the new data systems. Apart from this new integrated team, a higher risk-reporting committee made up of individuals ranging from marketing to treasury should also be created as a result of the data warehouse project.

Component or integrated, the bank's approach needs to be scalable enough to cover the advancement of risk management that comes with creating this data warehouse-based architecture. One benefit of an integrated approach is that a bank can use existing data stores for Basel II if it already has an Enterprise Resource Planning (ERP) system in place. This means fewer problems associated with customising a new system and educating employees on how to use it. The bank already would have established a relationship with its product vendor, which is another plus, since building contact with a new software vendor can prove costly and time-consuming.

Many large internationally active banks are likely to find the component-based approach more beneficial, since they would be able to combine components as needed for their tailor-made risk and trading applications (see section entitled *Introduction to the component business model*). These types of applications typically require special needs, so this would save such banks from many integration snags. The second benefit is that they can always buy best-of-breed software and add it on as they wish in future without any reassembling. This also allows them to improvise their methodology issues more effectively.

Banks can optimise new or existing analytics with IBM's Banking Data Warehouse (BDW) model. It is also worth noting that IBM is able to design and manage the infrastructure behind a data warehouse from start to finish. In addition, it has solid relationships with other IT companies, so compatibility with third-party risk, trading and ERP vendors is not an issue. It is currently working closely with ERP vendors on the business concept surrounding Basel II data management.

The building blocks

IBM sees data warehouses as a structured means for storing and managing data. Meta data management involves data acquisition for transferring and communicating the data consistently, a very important aspect of data warehousing no matter what line of business or geographic range a bank is covering. Indeed, consistency plays a significant role in IBM's Basel II architecture, not least since it allows the bank to advance its risk management programme – for example, by giving it a unique yet clear understanding of its data from the group level. IBM considers this a golden opportunity for a bank to force its subsidiaries and business units into following a common understanding of all the data fields. In this sense, the data warehouse not only becomes part of the bank's plan for complying with Basel II, but also a useful tool for it to manage risk better enterprise-wide.

As illustrated, the data warehouse consists of five to six layers, depending on the bank's reporting requirements. It is crucial to have different layers that work independently on allocating responsibilities, identifying needed skills and negotiating dedicated service agreements. Otherwise, the data becomes disorganised and less manageable. The first layer is for the extraction, transformation and loading of data to the data store.

The data store is there to keep the data secure and consistent. However, banks must remember that this is not the base for data reporting. A number of specialised data marts are used instead. These data marts help organise and streamline data for faster, more efficient reporting. They can also be used for special purposes – for example, simulations, probability of default and other risk calculations. The beauty of the data store is that other applications – for instance, those from specialised risk software vendors – can easily be integrated into it. This is why IBM refers to it as the centre for unifying reporting and other risk management functions. Because it is compatible with other systems, IBM's data warehouse model also helps banks cope with data availability and integrity issues associated with Basel II.

Data risk management

Banks that have started planning already know that data warehouse management is an ongoing task, since the meaning (and indeed volume) of data changes constantly. This is another reason why IBM recommends that IT and business operations work together.

IBM employs specialised tools to help safeguard the quality of data going in and out of the warehouse. The idea is to protect against double entries of addresses and faulty interchanges (from external systems), for example. An algorithm is installed (and permanently updated) behind the store to detect poor data and extinguish its sources before it is too late. A systematic process is also created to prevent it from infecting the bank's programmes or sneaking in through other channels. If the bank has problems with trader and customer data entries in its front-office system, for example, then it needs to designate someone to identify the 'bad apples' with an algorithm or other third-party tool.

The bank needs to devise a process for checking and improving bad quality data across the group using tools such as online plausibility checks and alarm systems – that is, databases that systematically address bad data and its sources. These types of components can be tailored to meet any bank's requirements. This basic operational risk measure can save banks a considerable amount of pain, as even the slightest bad entry can cause unimaginable losses. IBM's BDW model allows the bank to apply this across every unit and operation in the bank. This is one of many ways the BDW helps banks to advance their approach to risk management enterprise-wide. IBM believes that this is a good enough reason for banks to use any extra time added to the 2007 deadline to get ahead.

Introduction to the component business model

Most banks largely operate with a vertically integrated business structure where distribution occurs by product silo and operations are biased toward internally manufactured products. Within this structure, making material reductions in the cost base is difficult and customers generally see very little or no differentiation amongst banks. Given their financial challenges, banks cannot afford to have capabilities duplicated across product silos, with each product operating its own processes, systems and product-specific channels. Although they offer increased efficiency, vertically integrated supply chains limit customer choice – leaving firms with an undifferentiated value proposition and lower overall customer wallet share.

As a result of the economic challenges of the last few years, banks are moving away from the confines of their historical business structures. However, with value continuously shifting to different parts of the value chain, many banks are struggling, unsure which areas of their business matter most and how they should structure their businesses to deliver their corporate strategies.

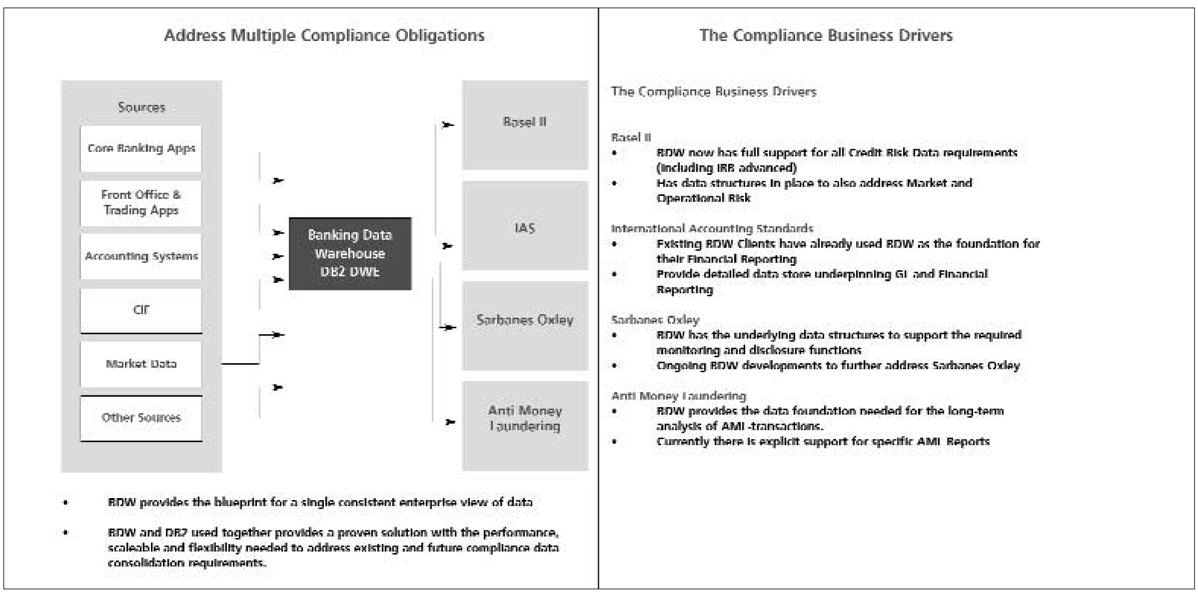
Two primary paths seem clear – one involves the industry as a whole and the other is travelled by individual firms. As an industry, banking is moving away from a set of independent, vertically integrated institutions towards a network of affiliated financial institutions. At the same time, individual enterprises are reconstructing – breaking product silos into small, encapsulated business components that can be shared across the enterprise.

The industry becomes more networked

Although product and service silos still have a stronghold within most financial services institutions, the monolithic view of the enterprise is fading, as is vertical integration. Whether of their own volition or spurred on by new players arriving on the scene with significantly improved value propositions for particular parts of the value chain, companies are beginning to specialise. They are selecting a more specific industry role that suits their strengths – manufacturing, distribution, risk management or processing – and are turning more frequently to external parties to supplement weak capabilities.

As technology continues to progress, connectivity improves and standards emerge, the industry will have the capabilities to become more and more networked. Distributors will own the customer interface, while specialists with deep product expertise will develop new

Figure 1: IBM's BDW addresses the compliance challenge for financial institutions



products based on segment-specific customer insights that the distributors will provide. Companies will take advantage of scale efficiencies offered by selected processors - perhaps even tapping into low-cost labour pools overseas. Most critical of all, the customer will also benefit. With access to best-of-breed products through a variety of distributors and improved customer service, customers will no longer be forced to choose between seamless service and a superior product.

As additional businesses start to deconstruct and revenues shift, banks will need to leverage their biggest asset: their customer base. To do this, banks will have to revisit their current business structures, looking to capitalise on hidden efficiencies and leverage customer relationships across their enterprises.

The enterprise reconstructs

Unlike their limited influence over the structure of the industry itself, financial institutions have direct control over the evolution of their own organisations. To improve efficiency, banks are already beginning to break out of their product silos by identifying and sharing common enterprise processes, such as procurement, human resource management and accounting. They are also beginning to appoint executives responsible for nurturing horizontal competencies such as distribution, manufacturing, risk and processing.

Banks are piecing together an integrated view of the customer; however, channels are still predominately product-centric and management control remains within business units. With interdependent processes across competencies and business units, banks are struggling with overwhelming operational complexity. Connections among different areas of the enterprise tend to be static, inflexible and sometimes manual. Without adequate integration, the cost associated with the resulting organisational complexity can sometimes rise to the point where it offsets any benefits gained from shared processes.

Moving into the future, banks will get relief. Advances in technology will ease the friction of enterprise reconfiguration, and financial institutions will become more comfortable operating across product lines. As collaborative capabilities expand, companies will be able to push the concept of shared processes past their initial competency-based structures to a much more granular business composition - one based on components.

Banks will adopt component-based structures where the business is divided into autonomous yet interdependent parts that can be optimised individually to produce greater value for the whole (see Figure 1). The granularity of the structure enables enterprises to respond rapidly to change, reconfiguring as required. With this business design, competencies - composed of interlinked components – provide the general operational framework, not products. Distribution is tuned to targeted customer segments, offering a variety of products through customer-centric channels. These are all focused on increasing customer loyalty and share of wallet. Reuse of manufacturing capabilities increases and processing operations achieve enterprise-wide scale economies.

As the industry moves to a networked model, banks will not purely focus on distribution, processing or product manufacturing. They will use a combination of distribution, processing and product manufacturing strategies to address different customer segments, products and geographies.

What is a component?

A component is a group of cohesive business activities supported by the appropriate information systems, processes, organisational structures and performance measures. Each component serves a unique purpose and collaborates with other enterprise components, using common messaging standards, information systems and service agreements. The average bank comprises 60-90 components. One such component would be a bank's central risk management operation, supported naturally by a data warehouse.

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Global

Governance: From compliance to strategic advantage

Financial institutions all over the globe are placing a greater emphasis on governance as they comply with tighter regulations. However, while they agree that governance is important, organisations are focusing too much on compliance with the regulatory minimum. To realise the business advantages that good governance can bring, companies need to raise the bar even higher.

Much of the debate about governance has been framed by the question of trust. There is widespread consensus that the rash of corporate scandals in the US and elsewhere in the world in recent years have damaged public trust in financial institutions and other companies. The burst of new regulations placing fresh demands on quoted companies aimed to restore that trust by improving transparency and increasing accountability. Good governance was mandated as a means of shoring up confidence in the integrity of institutions.

That trust and confidence is critical, of course, and not just for the financial system as a whole: in rebuilding it, individual institutions can also reap specific benefits. In a recent study of more than 200 senior executives in the financial services industry, conducted by PricewaterhouseCoopers and the Economist Intelligence Unit, 97% of respondents agreed that a reputation for integrity is a source of competitive advantage.

But good governance is about addressing sins of omission – poor information flows, bad communications and an inadequate understanding of risk – as well as sins of commission – fraud and deliberate wrongdoing. It is about improving the quality of management at all levels of a company, about making the best use of a company's assets and intellectual capital, and about understanding and managing risk. Institutions, in other words, can have their cake and eat it: by improving their governance, their businesses will be better run; and by improving the way they run their business, they can take steps to rebuild some of the trust that they have lost.

The evidence of the survey suggests that governance is equated in many cases with meeting the demands placed on institutions by regulators and legislators and staying out of trouble, not with taking proactive steps to determine what it is that customers want beyond the minimum regulatory standards or improving the overall quality of management — two steps that would secure a company's strategic advantage.

So what will an organisation have to do to meet this governance challenge? For one, a company will have to drive an awareness of governance deep into its DNA. Although much of the debate has focused on the boardroom, good governance depends on all members of the organisation understanding their roles in managing risk, in providing high-quality information on the business to their managers and in being alert to reputational risk. It also means dealing fairly with each other and with customers. That message has not got through to everyone — only 58% of survey respondents assess all job candidates for integrity; even fewer continue to assess employees on this criterion once they are actually in employment.

Secondly, rather than waiting for the next crisis to break, independent directors should take the trouble to understand what management is doing and why survey respondents identified executive compensation as the next 'hot-button' issue to come under the public's microscope. Those companies that implement good corporate governance now are less likely to end up in trouble, as are those firms whose governance processes enable them to anticipate emerging risks, spot underperformance and engage with their key stakeholders.

Moreover, managers should help their board members do a better job by giving them access to outside expertise that will provide the information and advice they need; by setting clear guidelines on the time and level of commitment they are expected to make; and by mandating directors to think beyond the requirements of certification, compliance and internal controls and instead to focus on issues of strategy, risk appetite and performance.

Lastly, institutions will have to communicate with the stakeholders who really affect the way their company performs, not just the ones with the biggest sticks. Good governance is about anticipating the needs of critical stakeholders, managing their expectations and communicating actively with them. Regulators are important partners, of course, but a well-governed institution will be communicating effectively with customers, employees and shareholders too. Some 50% of the institutions surveyed admitted that the quality of their dialogue with customers had not improved over the past two years.

Despite the recent wave of governance-related activity, the level of public confidence in financial institutions remains sadly lacking. Although some 52% of survey respondents think that the public's trust in financial institutions is returning, a mere 6% believe that it is fully restored.

The intervention of regulators is a necessary step in improving trust within the industry but it can only go so far — it is clearly not the same as improving the quality of internal management. The survey findings suggest that this change in mindset remains some way off for many in the financial services industry.

The bulk of financial institutions have made changes to comply with new rules. But too many have viewed governance through a narrow regulatory prism when instead the true objective of good governance should be to ensure better management and create strategic advantage. Confidence stems from competence, not compliance.

Clare Thompson, partner and UK insurance leader, PricewaterhouseCoopers
To obtain a copy of Governance: From compliance to strategic advantage, please visit www.pwc.com/financialservices

EU

Life on the edge: the regulation of derivatives

This briefing looks at the likely effect that the Markets in Financial Instruments Directive will have on the regulation of derivatives, and also considers some of the wider regulatory issues in relation to derivatives.

Derivatives can be a complex area in which regulation often struggles to keep up with the latest market developments. The regulation of derivatives in EU member states is about to be changed by the proposed Markets in Financial Instruments Directive (MIFI, formerly known as the second Investment Services Directive).

What is a derivative?

A derivative is a financial instrument, traded on or off an exchange, the price of which is directly dependent upon the value of one or more underlying securities, equity indices, debt instruments, commodities, other derivative instruments, or an agreed pricing index or arrangement.

Derivatives are generally regarded as being high-risk investments, and so are often seen as unsuitable for private investors. However, they are frequently used to manage and reduce business risks, as well as being treated as investments in their own right.

The current regulatory position

The UK

The UK currently treats certain options, futures and contracts for differences as "contractually-based investments", dealing in which is a regulated activity. As a rule of thumb, dealing in an underlying commodity or other property generally is not regulated, but dealing in a related derivative generally is.

The details are set out in articles 83-85 of the Regulated Activities Order (RAO), which, in summary, provide that dealing in derivatives including any of the following is a regulated activity:

- options to acquire or dispose of currency, precious metals or another FSMA-regulated investment;
- futures, other than contracts made for commercial and not investment purposes;
- contracts for differences, or other contracts the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in the value or price of property of any description, or an index or other factor; and
- contracts for differences are excluded if the profit is to be secured or the loss avoided by one or more of the parties taking delivery of property to which the contract relates. Also excluded are deposit products where interest is calculated by reference to fluctuations in an index or other factor, for example, a stock index.

There are a number of general exclusions in the RAO, the effect of which is to enable certain activities which would otherwise amount to dealing in derivatives to be carried on without the need for authorisation. The main exclusions in this context are the so-called "with and through" exclusion, and the hedging exclusion.

The "with or through" exclusion

Article 16 of the RAO permits unauthorised firms to deal in derivatives if they do so with or through an authorised firm, or in some cases with or through an overseas person whose ordinary business includes activities which would potentially be regulated in the UK.

However, the use of this exclusion has been cut back significantly by the current Investment Services Directive (ISD). Broadly, where a person holds himself out as making a market in investments which fall within the current ISD or as a broker dealer in relation to such investments, the exclusion will no longer be available to that person.

The hedging exclusion

A body corporate can take advantage of the hedging exclusion contained in article 19 of the RAO, if it enters into a contract with another body corporate, and the main purpose of that contract is to limit exposure to an identifiable risk. The exclusion is not available if the business concerned consists of carrying on regulated activities (or would, but for an exclusion), or if the risk arises as a result of carrying on a relevant activity.

European regulation

At a European level, the current ISD requires firms which carry on those financial services covered by the directive to be authorised by their home member state. It also establishes a passporting regime, whereby the authorised firm is then permitted to operate in other EEA member states, either on a cross-border basis or through a local branch, in reliance on its home state authorisation.

Under MIFI, this regime will be extended to include the commodities markets, bringing market participants in some member states within the scope of regulation for the first time, and imposing a stricter regime in some other member states. The benefit, however, will be that they will have the ability to take advantage of the passporting regime to operate across the EEA if they so wish.

MIFI, like the ISD, sets out two categories of activities: investment services and activities (known as core activities under the ISD), and ancillary services. The passport will only be available to open a branch in or provide services into a member state in relation to ancillary services where it is used for at least one investment service as well.

Consequences of regulation

A number of important consequences flow from the fact that dealing in a particular financial instrument is regulated. Firms that wish to deal in or provide other investment services in relation to that instrument will either have to obtain a licence from the regulator in their home member state, or structure their business so as to ensure that they fall within a relevant exclusion.

However, under MIFI, which is not a maximum harmonisation directive, member states will generally retain the power to regulate types of financial instrument in addition to those listed in MIFI, or not to adopt all of the exclusions available under MIFI. This means that certain financial instruments not regulated under MIFI may still be regulated in a number of member states.

Licensed firms will have to comply with relevant capital requirements and conduct of business rules, as well as incurring ongoing compliance costs.

MIFI

Status

MIFI is expected to be adopted in the second quarter of 2004, after the European Parliament voted in favour of it on 30 March. Member states will then have two years in which to implement it into local law.

What is covered by MIFI?

Assuming that MIFI is adopted in its current form, it will apply in relation to the following derivatives:

- derivatives relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash;
- commodity derivatives that must be settled in cash, or may be settled in cash at the option of one of the parties (otherwise than by reason of default);
- commodity derivatives that can be physically settled, provided that they are traded on a regulated market and/or a multilateral trading facility (MTF)[1];
- other commodity derivatives that can be physically settled, which are not for commercial purposes and which have the characteristics of other derivatives;
- credit derivatives;
- financial contracts for differences;
- derivatives relating to climatic variables, freight rates, emissions allowances, or inflation rates or other official economic statistics, that must be settled in cash, or may be settled in cash at the option of one of the parties (otherwise than by reason of default); or
- other derivatives relating to assets, rights, obligations, indices and measures, which have the characteristics of other derivatives.

In determining whether derivative contracts have the characteristics of other derivatives, MIFI provides that regard should be had as to whether, among other things, they are cleared and settled through recognised clearing houses or are subject to regular margin calls. CESR might also consider and provide guidance on their characteristics. This should address the issue that certain over-the-counter physical markets are just as financial in nature as some commodity derivatives traded on exchanges and MTFs.

MIFI activities and exemptions

There are two changes of particular interest for derivatives purposes: the new investment activity of operating an MTF, and the ancillary service of investment services and activities relating to the underlying of the derivatives covered by MIFI, where these are connected to the provision of investment or ancillary services. This will allow a passported firm to be able to provide such services as an ancillary service.

The MIFI exemptions most obviously of interest in the derivatives context relate to:

1 *A multilateral trading facility is defined as "a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments - in the system and in accordance with non-discretionary rules - in a way that results in a contract".*

- intra-group only services;
- hedging;
- own account dealing;
- ancillary business; and
- specialised commodity traders.

Broadly, the own account dealing exemption would be available to own account dealers who neither make a market nor provide a facility to others outside a regulated market or MTF on an organised, frequent and systematic basis.

The idea of the ancillary business exemption is to exclude firms within non-financial groups which deal for their own account in instruments or provide investment services in commodity derivatives where those investment services are ancillary to the main business of the firm's group. "Ancillary" and "main" businesses are not defined and there is no level two power to do so.

In relation to commodity derivatives, as well as the ancillary business exemption, there is a special exemption for persons whose main business consists of dealing for their own account in commodities and/or commodity derivatives. However, this exemption does not apply where the commodity dealer is part of a group whose main business is investment or banking business.

What will MIFI mean for the UK regime?

The biggest change that MIFI will mean for many member states will be the requirement to regulate commodity derivatives. However, certain member states, including the UK, already do so and, while there is a fine line between what is and what is not regulated in certain areas, most of the MIFI instruments are already regulated in the UK. In fact, the boundary set by MIFI appears to reflect the investment versus commercial purposes test for futures set out in article 84 of the RAO in several respects.

The factor which is conclusive of an investment purpose (the fact that the derivative is traded on an exchange) is also determinative in MIFI (although MIFI extends it to MTFs) and the indicative investment factors relating to clearing and margin are also characteristics of which account must be taken in MIFI. While intention of delivery is reflected by the inclusion of all potentially cash settled derivatives, there is no reference in MIFI to one or both of the parties being a producer or user of the commodity.

The main change for the UK will be that a wider range of options will need to be regulated, including options on non-precious metals and soft commodities. These changes will affect a number of important, currently unregulated markets, as well as some instruments on recognised investment exchanges such as the London Metal Exchange.

Apart from this, little change should need to be made to the list of specified investments. The two categories of non-commodity derivatives (both those relating to emissions and those relating to assets and obligations) should already be covered as either futures or contracts for differences, on the basis that they cannot be settled by delivery and must therefore be entered into for investment rather than commercial purposes. Equally, credit derivatives are already covered.

However, it should be remembered that the UK may choose not to translate all of the MIFI exemptions into corresponding exclusions in the RAO.

In terms of exclusions, while MIFI would appear to allow the UK the option of maintaining some form of hedging and holding out exclusions, the future of the with or through exclusion is not so certain. It will be diminished even further than under the current ISD, as it will not apply to the extent that the person trying to rely on it is an "investment firm", for example, a person providing instrument services to third parties on a professional basis.

Conduct of business issues

How does COB apply to derivatives business?

The FSA's conduct of business sourcebook (COB) has a special application to the promotion and selling of derivatives, reflecting the perceived risky nature of this type of investment.

First, direct offer financial promotions (for example, those which allow the recipient to subscribe by completing and returning an application form) in relation to derivatives are prohibited unless the firm has adequate evidence to suggest that the investment may be suitable for the recipient, or an exemption to the rules applies.

Secondly, a firm must not arrange or execute an investment in a derivative for a private customer unless it has taken reasonable care to ensure that the customer understands the nature of the risks involved. These must include providing the customer with the warrants and derivatives risk warning which is set out in the annex to chapter five of COB, and ensuring that the customer understands and accepts the risks and confirms in writing that this is the case. The risk warning must also be given to a private customer in relation to retail securitised derivatives and for options and contracts for differences listed under other EEA exchanges, together with further disclosure about the investments in question and the potential risks of dealing in them.

Conduct of business rules under MIFI

MIFI contains a number of provisions designed to ensure market transparency and integrity. More detailed rules are likely to be developed by CESR at level two, which will result in standardised European conduct of business rules. These in turn are also likely to result in changes to COB.

A three-tier client classification system, broadly similar to that currently operating in the UK, is proposed under MIFI, offering different levels of protection depending on the nature of the client. There will be a light touch regime for the intermediate professional category, and an exclusion for dealing with eligible counterparties (a similar, but narrower, definition to the current UK market counterparty category).

MIFI contains an exclusion from the conduct of business rules for dealings on an agency or principal basis with eligible counterparties. This will potentially cover large end-user corporates as well as authorised firms. Strangely, though, whether a large corporate may be treated as an eligible counterparty will be determined by the corporate's home state rather than the state of origin of the service provider.

Best execution

MIFI lays down substantive best and timely execution duties, with no explicit carve out for intermediate customers. It requires firms to take all reasonable steps to obtain the best possible result for their clients, moving away from a focus exclusively on best price. The firm will be under a duty to look at the most appropriate execution venue and there will be no automatic safe harbour for trading on a regulated market on which the relevant securities are admitted for trading.

Order execution policy

Under MIFI, firms will have to provide investors with an order execution policy, which must cover at least the execution venues which allow the firm to obtain, on a consistent basis, "best results" for the client. Investors must give prior consent to the policy and, in particular, they must give their express prior consent to execution of trades outside a regulated market or MTF. This consent may be given generally or in relation to a specific transaction.

Other obligations

A number of the other conduct of business provisions of MIFI, such as those relating to pre- and post-trade disclosure and quote disclosure, are limited to shares. However, the Commission will report on the possible extension of the scope of the pre and post-trade transparency obligations to transactions in other classes of financial instrument within two years, and within three years in relation to quote disclosure, so this position may change.

Emissions trading

The inclusion in MIFI of derivatives relating to emissions ties in with the start of the European Emissions Trading Scheme (ETS) on 1 January 2005.

Under the EU directive establishing a scheme for greenhouse gas emission trading within the Community[2], businesses in the sectors to which the directive applies will require a permit to emit carbon dioxide into the atmosphere, and will be capped as to the amount of emissions they are permitted to release over the initial three year period of the scheme.

The scheme is currently limited to large emitters of carbon dioxide in the energy production, ferrous metals, mineral, pulp and paper industries, but there are provisions to extend the scheme at a later date. Those businesses which cannot operate within their caps will either be obliged to purchase emissions allowances or face a penalty, and will therefore be doubly incentivised to reduce their emissions.

In addition to trading by those businesses subject to the caps, it is hoped that financial services providers will help to develop a market in emissions derivatives to allow businesses to hedge the risks associated with the scheme. Both put and call options might be attractive to companies which cannot predict how many allowances they will need during the initial three year period, and would also allow a company to lock in a price. Swaps might be used in relation to emissions-related obligations in different currencies.

Emission allowances themselves are not specified investments under the UK regime, nor are they options on emissions allowances. However, it is arguable that emissions futures are regulated under the existing UK regime, on the basis that, even if emissions allowances cannot be correctly described as commodities, they must be "property of any other description". Companies intending to trade emissions futures under the

2 *Directive 2003/87/EC*

European ETS (and those already trading under the UK ETS) should consider whether they are structured in a way which allows them to trade without requiring authorisation.

The introduction of the European ETS will surely also bring the establishment of some MTFs or exchanges either for the emissions themselves or for emissions derivatives. Even if the implementation of MIFI does not result in the creation of a new regulated activity of operating an MTF, the introduction of CESR's common standards for the regulation of Alternative Trading Systems means that the FSA can now impose certain requirements on the permissions of firms which operate MTFs, allowing the FSA to treat MTFs in a manner more akin to regulated markets.

In particular, limited requirements relating to post trade transparency apply to all investments traded on a regulated investment exchange, a regulated market or a commodities market in the EEA and the requirements are extended to "look-alike" contracts, for example, off-exchange contracts which are substantially similar to on-exchange contracts.

Also related to emissions trading is the growing use of weather derivatives to manage risk by businesses whose earnings can be adversely affected by unpredictable environmental factors. When electricity is in high demand as a result of a hotter summer or colder winter than expected, more fossil fuel will be burnt and more greenhouse gases emitted. The price of emissions allowances is likely to rise to rise as a result, and derivatives offer a means of guarding against that risk.

Basel II: credit risk mitigation

The new proposals for the recognition of credit risk mitigation represent a significant development of the existing rules. Credit risk mitigation will have a wider application under Basel II, due in particular to the recognition that broader types of collateral and credit derivatives can be used to mitigate credit risk.

Basel II allows the use of credit derivatives to mitigate credit risk. However, it lays down reasonably stringent requirements that must be met. Credit derivatives must represent direct claims on the protection provider, which must be explicitly referenced to specific exposures.

These requirements exist so that the extent of the cover is clearly defined. In addition, the credit derivative must be unconditional and there should be no clause in the protection contract which is outside the direct control of the bank that could prevent the protection provider from being obliged to pay out in the allotted time.

The credit events specified by contracting parties in any credit derivative must also at least cover bankruptcy, insolvency and liability to pay debts as they fall due, and also the restructuring of the underlying obligation involving forgiveness or postponement of principal, interest or fees that results in a credit loss event. Basel II also lays down specific requirements where conditions are included in relation to mismatches, settlement and the timing of the termination of cover.

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Germany

German regulator sets rules on outsourcing and credit business for the treatment of "credit factories"

The German regulator has published a note on legal requirements for the outsourcing by credit institutions of the administration of their credit business to so-called "credit factories". The note is intended to clarify and substantiate the existing general supervisory framework in regard of outsourcing and credit business.

Due to declining margins, rising costs and increasing supervisory requirements German banks are being forced to reorganise their credit business. The shifting away of the banks' risks from bad credits can be achieved by either selling them to so-called "bad banks" or by assigning them to a factoring company for collection. More and more, the banks also mandate so-called "credit factories" with the loan processing and sometimes even leave it to them to take credit decisions. By doing so they intend to streamline and downsize their credit business operations.

In the first of the above scenarios, a true sale of the credits to a bad bank would go beyond a mere outsourcing because the full ownership of the receivables is completely transferred to another party, which then deals with the receivables as their own ones. In the second scenario, only an element of the collection activities is outsourced, which as such is permissible. However, when outsourcing an essential part of the credit business to a credit factory as in the third scenario, both the banks and the credit factories have to comply with supervisory requirements such as section 25a (2) of the German Banking Act (*Kreditwesengesetz* or KWG), together with a circular of the Federal Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* or the BaFin) on outsourcing published in December 2001 (the Outsourcing Circular), and the Minimum Requirements for the Credit Business of Credit Institutions of December 2002 (*Mindestanforderungen für das Kreditgeschäft* or MaK).

In order to clarify the relevant supervisory framework for an outsourcing to credit factories the BaFin on 12 December 2003 published a note (*Vermerk* or the Note).

Limits to the outsourcing of credit business to credit factories

Section 25a (2) of the KWG, as well as the Outsourcing Circular, set forth the rules on the outsourcing of "material" areas of a bank's business to another company. "Material" within the meaning of section 25a (2) of the KWG are all services directly related to the processing of the banking business and constituting relevant risks (especially market, credit, default, settlement, liquidity and reputation risks as well as operational and legal risks). As both loan processing and credit decisions form part of the material business of banks, the following requirements set forth in section 25a (2) of the KWG and the Outsourcing Circular have to be met:

- the outsourcing must neither impair the orderliness of the banking business nor the managers' ability to manage and monitor them and the outsourcing bank has to maintain the ultimate responsibility for the business;
- the outsourcing bank has to contractually ensure its instruction rights vis-à-vis the company to which the business is being outsourced;
- the outsourcing agreement has to contain provisions relating to the liability of the credit factory for possible processing errors; by taking suitable measures the credit factory shall ensure that a compensation of possible damages suffered by the outsourcing institutions arising from the defective processing of matters is ensured without endangering the continued existence of the company; and
- the transfer of decision-making powers to another company which might give rise to further risks is only admissible if the outsourcing bank imposes on the other company exactly predetermined and verifiable criteria for their decision-making. The company to which the activity is outsourced must not have any scope of discretion.

In addition to section 25a (2) of the KWG and the Outsourcing Circular, the MaK which regulates the credit business operations of banks have to be observed when outsourcing credit business to credit factories. The MaK provides detailed standards for the business organisation (such as the separation of functions into the market segment and the credit administration segment), the lending process, the establishment of risk qualification procedures and the identification, monitoring and controlling of credit-business related risks. Pursuant to the MaK, central management functions as well as the definition of the credit risk strategy, the establishment of risk classification procedures, the establishment of processes for the early recognition of risks in the credit business, the risk management and risk controlling, the stipulation of organisational guidelines and other risk related areas cannot be outsourced.

The risk control has to remain with the outsourcing bank which has to retain the necessary instruments and information relating to the issued loans in order to be able to control the loan portfolio properly.

Furthermore, the remuneration and incentive systems of the credit factory must not contradict the quality requirements which are to be demanded from a responsible and proper processing of loans and the adequate qualification of the staff of the credit factory has to be ensured.

From these limitations the permissible scope of activities of the credit factory can be determined as outlined below. The following areas can be outsourced to credit factories (this list not being exhaustive):

- the transfer of the credit documentation to a credit factory acting as back office, provided that the requirements of section 25a (1) and (2) of the KWG are observed;
- the outsourcing of the loan processing (for example, checking of completeness and correctness of documents, gathering information, analysis of balance sheets); and
- the preparation of votes or drafts of loan resolutions on the basis of the assessment criteria stipulated by the outsourcing bank.

The credit factory must, however, not take any credit decisions if it has any scope of discretion. Within the credit business there are two possibilities to include credit factories in the taking of credit decisions. The outsourcing bank provides the credit factory with exactly predetermined and verifiable criteria in order to exclude the credit factory's scope of discretion. This is easily achieved in regard of standard bulk business such as residential real estate financing or consumer credits, as these areas are highly standardised and do not leave any scope of discretion to the credit factory when taking credit decisions. In these cases, the credit factories can "take" credit decisions. But these will be only the blind execution of already predetermined general decisions made by the outsourcing bank in its guidelines.

However, the large-volume risk-exposed private and corporate lending business is not yet fully standardised due to its special complexity and structural diversity. The outsourcing bank can only provide a certain framework for the aspects to be considered within a credit decision. Therefore, the credit factory would have a scope of discretion to assess and to decide a specific case. Due to the scope of discretion of the credit factory the outsourcing bank could not influence the individual granting of loans and a precise control of the loan portfolio would no longer be possible. Such a situation must be avoided, as highlighted in the Note. This can be achieved if the outsourcing bank adopts the prepared credit decision of the credit factory in each individual case as its own. The outsourcing bank would then have to control whether the credit factory preparing the credit voting followed the predetermined criteria and did not exceed its scope of discretion. If this was the case, the outsourcing bank could rely on the decisions made by the credit factory and would not have to take a completely new credit decision on its own.

Outlook

The Note by the BaFin sets forth the current supervisory framework for the outsourcing of credit business to credit factories. Furthermore, it deals with questions of such outsourcing that had not yet been resolved by previous supervisory practice such as the general outsourcing rules and the general rules on credit business. Insofar, the Note gives helpful guidance.

However, it needs to be taken into account that also other legal issues beyond the scope of the Note are crucial to a successful outsourcing. For example, the value added taxation of the services of credit factories is typically a major issue. Banks usually cannot or can only to a very limited extent deduct input VAT on the services of credit factories because the granting of loans is exempt from VAT. Insofar, cost reductions achieved by an outsourcing to credit factories might partly be reduced by irrecoverable input VAT. However, there are strategies to treat the services of credit factories as VAT exempt and thus save the cost reductions.

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UK

Financial Services Practitioner Panel Annual Report Gives Voice to Industry Concerns

At the end of March, the Financial Services Practitioner panel produced its annual report which, although it did not receive the same level of publicity as some of the FSA's recent announcements, provides some worthwhile insight into how much of the FSA's recent work and direction are viewed from the perspective of the regulated financial services industry itself. Although practitioner and industry views and perspectives are put to the FSA as part of responses to consultation on individual initiatives, and indeed are summarised in the various feedback policy statements made by the FSA once considered, these are highly issue-specific. The Panel's recent report provides a broader view and indicates where industry's priority concerns lie.

The Panel's status and role

As part of the corporate governance structure set up for the FSA by Sections 8 and 11 of the Financial Services and Markets Act 2000 to impose a duty on the FSA to consult with and consider representations made by the practitioner panel as to "*the extent to which [the FSA's] general policies and practices are consistent with its general duties [under the Act]*." Section 9 provides for the establishment of the Practitioner Panel itself with the FSA appointing, subject to HM Treasury approval, its chairman (Jonathan Bloomer assumed the role in November 2003) and a membership to be appointed by the FSA as it considers appropriate from a range of individual authorised persons, representatives of other authorised persons, recognised investment exchanges and of recognised clearing houses. The Panel itself has agreed non-statutory objectives against which to measure its own performance. These are:

- to monitor the overall effect of the FSA's activities on the industry;
- to assess the FSA's effectiveness, as seen by practitioners, against its objectives;
- to actively communicate industry concerns to the FSA;
- to actively promote broad industry views and interests;
- to provide practitioner views to the FSA on specific regulation; and
- to promote international competitiveness of the UK markets.

Its view of the main issues of 2003

Several issues highlighted where industry concern arose last year, some of concern to retail and wholesale sectors, others of more concern to one or the other. Those of more interest to international and non-retail firms included the following:

International Competitiveness

The various and ever increasing numbers of European legislative moves adopted as part of the EU's Financial Services Plan (to which member states signed up in 1999 in order to speed up the creation of a single European financial services market) are beginning to pass into law and move to implementation at member state level. The Panel has taken this opportunity to point out the threat to the international competitiveness to the UK's financial markets of a growing regulatory burden from Europe as well as being imposed nationally. It also warns of the dangers to UK markets to competitiveness within Europe itself, should they face a greater burden than their EU neighbours through the premature or "gold-plated" (unnecessarily onerous) implementation into UK law of obligations set at EU level. It reminds the FSA of its statutory obligation to take account of international competitiveness in its entire regulatory policy making.

Cost of Regulation

As would be expected, the Panel voiced industry's concern at the incremental rises in compliance costs under the FSMA regime; a concern that has grown rather than abated over the past year. It urges the FSA to explore whether there are any potential cost-reducing interfaces between EU, UK and US regulatory regimes which might help to create a cheaper common financial services market. It supports any initiative to conduct an in-depth study to achieve more understanding of the sources and causes of regulatory compliance cost and effects on international competitiveness, a notoriously difficult task. It exhorts the FSA to adopt and pay some measure of cost reducing "regulatory dividend" to reward and incentivise good compliance/risk management behaviours within firms. On this note, it welcomes both the Project ARROW initiative (the risk-related operating framework of the FSA) and HM Treasury's inclusion of regulatory cost issues in the Two Year review of the FSMA.

Quality and Use of Cost/Benefit Analysis by the FSA

The FSA is under a statutory obligation to subject new initiatives to cost/benefit analyses but the Panel points out that these are of variable quality and are often employed far too late in the rule/policy formation process to capture all relevant costs and benefits, for example, to justify proposals already adopted. It would prefer a more 'ex ante' approach, such as a professional economist would use, which would pay greater regard to marginal cost effects on industry of rule changes and also factor in, and recognise as a cost, the consumer disadvantage of a reduction in choice and the possibility of unintended consequences from a rule change.

The FSA's risk-based operating framework

Again, as would be expected, the Panel is enthusiastic about the FSA's adoption of a risk-related operating framework in its supervision of firms. This framework has become known as the ARROW process and is very much in its early stages. Informal monitoring by the Panel of firms subjected to it has revealed concerns that the FSA's conclusions on that firm's "ARROW performance" be relayed to firms quicker and with greater clarity as to how to achieve a lower risk rating. To some extent the FSA could counter this by pointing out that it should not be for it to perform a creative "intra-firm" compliance role for firms, but obviously the demand for specific and detailed feedback after any assessment must always be there.

Prohibition on Insurance against Regulatory Fines

In the February edition of *FRI* this writer highlighted the (then) recent changes to the General Provisions in the FSA's Handbook. These prohibit an authorised person from insuring against any regulatory fine which may be imposed by the FSA on an individual officer, employee or contractor for that authorised person who has approved person status and is thus subject to regulatory discipline which, of course, includes financial penalties. The effect of this will be to ensure that one source of financial 'lifeboat' from his or her employer for such an individual is no longer allowed. The Panel is unhappy with this change and sees this as an example of 'overkill' by the FSA, pointing out that a market-led solution of adverse publicity or reputational damage caused an individual approved person who deliberately misbehaved, would be a better and fairer means of sanction than preventing insurance arrangements. The effect of this change will surely be demand for risk premia in individual salary packages.

..and for 2004

Finally, areas for the Panel's focus in the current year include the HM Treasury's two-year review, a biennial survey of regulated firms which should provide a useful snapshot of how firms perceive the FSA's performance and view which topics are of most concern to them. Also, what effect the forthcoming extension in the scope of the FSA's areas of responsibility (into more areas of the UK retail financial sector) will have on its operational efficiency, and monitoring of the continued implementation of EU directives with an eye to the concerns already expressed that the UK should not take an over-enthusiastic approach and add to the baseline of obligations and burdens contained in such EU Directives.

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UK

CP176 and the delicate issue of unbundling

In 2001, Paul Myners responded to a Treasury mandate to report on the cost and payments structures embedded in fund management - notably with regards to funds ultimately owned by retail investors with interests in pensions, savings plans and life policies, amongst other collective investment vehicles – by lifting the lid on traditions, procedures and practicalities which had developed over many years of financial market practice and change.

This very investigation challenges, in a way, the precepts of efficient markets: practitioners will insist, not unreasonably, that markets are live, efficient, developing entities which are formed and perpetuated by majority opinion and requirement and by the inexorable forces of supply and demand. They will claim that to impose control overnight on systems which effectively regulate and cleanse themselves is unnatural and as futile as channelling rivers or herding cats.

Myners' stance, however, was vindicated by certain factors militating in support of investigation with a view to imposing regulation. First, markets can operate efficiently at the same time as allowing traders, growers and stallholders to put in place and protect margins and systems which line selective pockets, ultimately and inevitably at the expense of the punter with the shopping-bag. Second, in every market square there are a few operators who knowingly take advantage of the shopper by touting faulty goods, mis-adjusting their weighing-scales, re-packaging their products with later sell-by dates and by claiming that those pineapples are English-grown. Third, Treasuries are government-driven bodies with political ideology, secondary motives and hidden agendas which take a hand in shaping the objectives and procedures which they introduce.

Ours is no exception: its fiscal stance and its ideals mean that it cannot be doing with the burdens of being the rescuer of last recourse when pensions are whittled away or fail, and retail funds collapse or erode savings. It does not like 'fat-cat' brokers and fund-managers emphasising the fault-lines of inequality and pocketing bonuses which, as irregular in timing as unpredictable and occasionally extreme in value, jolt indices, jostle inflation and prompt unpredictability in consumer trends and fiscal revenues – anathema to methodical governors.

Myners' findings are well documented and familiar - little point in rehearsing them here. They threw up question marks, raised eyebrows, wagging fingers and expressions of hope that buyers and sellers, not least the less punctilious ones amongst them, would look to their ethics and activities rather than suffer the indignity of having a 'nanny' regulate them into the required behavioural norms and patterns.

Myners' report and recommendations formed the perfect platform for follow-up action in the form of the publication of a stern CP176 - the FSA's Consultation Paper on Bundled Commissions, Soft Commissions and Transparency. This ran to millions of words, referred extensively to a report from an external consulting firm (Oxera) and struck terror in to the hearts and wallets of many. At its core was a commandment in the making: "Thou (O Fund Manager, O Broker) shalt not use the citizens' savings to generate turnover and commissions exceeding what is necessary, nor purchase for thy business that which thou shouldst be buying with thine own funds; nor yet shall thou structure and report on such costs as are paid from the citizens' own moneybags without their consent and in such a way that they cannot make out on what their gold is being spent, nor why, nor in what measure."

There is doubtless a core of good sense and best intentions: market professionals all know the quips about the fund-manager who softs his golf and skiing outings in the form of unnecessary churning of portfolio holdings through the expensive machinery of one and the same broker who happens, by coincidence, to be his old schoolmate. That had to go, and pensioners needed to have protection, albeit sanctimonious, for the fund which had been mis-sold to them in the government's altruistic flurry of enthusiasm to get pensions responsibilities off its back and on to that of the private sector. The hitches came because the commandments appeared potentially to drag innocent and even benevolent market practices and practitioners in its wake, and threatened to unleash a multitude of breaches of the proverbial law of unintended consequences. These range from crippling honest, small asset managers via the disruption of orderly capital flows, to driving our financial services industry in to foreign hands.

One of the many strengths of the FSA's position and its procedures is that it means what it says when it whispers: "consultation". Plenty of time was given - too much, some operators would say, bruised by the inertia bred by uncertainty in the business arena - for anyone who felt so inclined to represent their interests, their predicaments, their ideas and their rebuttals. This even-handedness has the additional advantage of bleeding away resentment and indignation from the industry at the same time as giving the FSA a reliable feel for the way the winds are blowing, and strengthening their position ahead of the definitive policy statement as a result.

The industry saw sense and organised itself into correspondence, discussion, seminars and a touch of introspection. Existing industry associations, including the IMA, NAPF and AIMR, 'girded their loins' and responded forcefully and largely fairly. New industry associations were set up, including the Association of Independent Research Providers (AIRP).

There emerged certain highest common factors in terms of acceptance of inevitable change ahead. Soft Commission was recognised as being open to abuse and favouring brokers, but as a potentially valuable 'product' once reformed, tightened, re-defined and transparently handled. It was broadly agreed that it is 'cheeky; for a fund manager to make his clients pay for the basic tools of his trade, without which he could not have drawn them to him in the first place. Most saw sense in saying that if you spend clients' money, it is right to know: how much you are spending on what; that you are getting good value for money; and that what you buy should work as far as possible towards that end-investor's direct best interests.

It followed naturally that one should seek the clients' permission in advance for the ways in which their money should be spent. Also that the acceptable core of such expenditure should consist only of competitive, high-quality trading execution and of the research services which help form the decision as to what trades should be committed. Most considered it right that prices paid to brokers should be properly and clearly negotiated, explained and allocated. In a nutshell, people woke up, compared ideas, saw the light and began to face in one and the same direction.

And now we are close to the end-game. On Friday, John Tiner, CEO of the FSA, 'broke cover' at a CBI Financial Services' Council Meeting to lead us towards the final stages of the CP176 saga. Essentially, he had a conjuring trick to perform: to stage a qualified retreat from the FSA's earlier position to a more moderate stance, reflecting acceptance of the common core, at least, of representations submitted in response to the CP. He had to indicate a more reasonable and industry-friendly search for the solution, without appearing to have back-pedalled, underestimated the peripheral fall-out from the sanctions originally implied, or to have fallen short of best practice in terms of reconnaissance.

He needed to make clear that this concession does not come at the expense of addressing the underlying objectives of achieving an acceptable level of clarity, reason and accountability in spending investors' money. He does 'lip-service' and more to the recognition of the dangers of excessive severity driving capital and therefore business offshore - the 'regulatory arbitrage effect' that could theoretically see global, integrated fund managers simply moving the domicile of their vehicles offshore - and promises us view of the Deloitte & Touche research which effectively pacifies the 'hawks' in that respect.

The following points are key:

- the FSA will publish a Policy Statement at the end of April which, we expect, will formalise the contents of his statement to the CBI, namely that;
- it will "give the industry space to develop and trial a solution based on improved disclosure";
- that the FSA will assess progress in December, and take a view at that stage whether enough of the right medicine has been prescribed and swallowed;
- that, notwithstanding, they "see some regulatory change as appropriate to set the right framework."

This begs the question as to what changes those might be. We surmise that tightening and re-definition of traditional soft commission may feature, as may recognition of systems and agents operating with authorisation to act as introducing and funding brokers; norms to ensure that client mandates, articles of incorporation, trust instruments and the like address the need to inform - if not exacting authorisation from - clients as to application of their money. Perhaps the requirement of brokers that they set up and display clear menus with dishes, recipes, ingredients, origins and prices as a basic component of Terms and Conditions of providing service will emerge.

The FSA clearly intends that "fund managers' use of clients' commissions should be limited to the purchase of trade execution and of investment research":

- whilst they emphasise the need for "Disclosure….to separate out the payments for execution from those for research" and for "the emergence of an explicit market price for research";
- if, in December, the industry's steps to implement enhanced disclosure are deemed insufficient or ineffective, then "we (the FSA) will need to look again at regulatory intervention";
- the body will seek regular progress reports during this time; and
- separately, they will continue to busy themselves with the need "to review the governance of retail funds."

They clearly continue to dislike the perceived 'cosiness' amongst fund managers and the boards of many of the vehicles they manage, implying a degree of (self-) protectiveness and of 'back-scratching'. Perhaps this contributed to the split-level trust scandal, to bouts of mis-selling and to intentional or incidental opacity which ends up confusing and bewildering the public. John Tiner ended his oratory with the sternest of nursery admonishments: "The ball is now very much in the industry's court. If it seems to them that we are breathing down their neck on this issue, then that is because we are."

The present leads inexorably to the future. What will follow? The industry has no option but to 'unbundle'. The trick, after commending the slickness, fairness and good sense of it all, is to predict which 'stings' lie in which 'tails', whom they will 'poison' and how severely. Consider some possible 'scorpion toxins':

- Scenario 1: margins in broking and fund management that are already under severe pressure from various effects and impacts, will be further eroded – directly and indirectly - by this 'cleaning-up operation' and the costs entailed to bring about and maintain the 'squeaky-clean' *status quo* in the future;
- Scenario 2: some failures;
- Scenario 3: there will be even more consolidation in both segments, leading to lower levels of competition, higher levels of monopoly and to US, Japanese and other 'super-banks' taking control of our home-grown brokers and asset managers;
- Scenario 4: homogenisation, economies of scale, needs for consistency and pressurised margins lead to the further commoditisation of an industry which has been steadily forfeiting many of its levels and qualities of personal service, of performance, of style, of leadership and of evolution for years already. This cannot possibly be good for the UK's foremost position in the industry globally;
- Scenario 5: notwithstanding recognition of the likely benign end-effects of CP176, some operators will 'stamp their feet', sulk and reach for the option of regulatory arbitrage;
- Scenario 6: some brokerages will be obliged by commercial factors to compensate for revenues foregone as a result of 'unbundling'. There are precious few ready remedies available to them. One is the insidious move towards widening spreads in prices of stock traded net by market makers. This scenario is compounded by the danger that the recourse could not exist in a few isolated instances; it is more likely to be adopted as a common measure, countering perceived market efficiency and raising considerably the hidden trading costs borne by funds.

With any luck there will be some 'healing' once the 'scorpions' have been dispatched to the 'herpetarium'. The benefits that will come include:

- Benefit 1: an Aegean cleansing of the stables of middling research and analysis. The tale, dead dreary by now, is that too many traditional, sell-side analysts: exist; were subsidised by primary business flows, are now in the balance of the books and will weigh on margins if they are left intact in the future; generate same-ish, turgid stuff which is closer to post-mortems than ideas; cheat; are made to tell lies by their 'overlords'; are 'neutered' by house style, house stance, book positions, corporate-client-focus and the 'filtration-plant' in the office of the Head of Research; and lead to distortion of salary scales, too often leading indirectly into exerting a monopoly over the employment tribunal chambers at Woburn Place. When it becomes necessary to rationalise them, reprice them and price their product reasonably, then investors will regain some confidence and even an advantage.

- Benefit 2: the natural recourse to in-house, buy-side analysts will resume its growth, jolted by the late bear market and constrained by the market distortions created by traditional, proprietary research. Such buy-side R&A teams are geared to their own clients, their own funds and their own fortune and misfortune in a far more palatable, straightforward and profitable mix.
- Benefit 3: independent research entities, bearing virtuous watchwords as their mottos and excellent work fashioned through competition, price-sensitivity and the drive to succeed as small businesses, will have a more encouraging climate in which to work.
- Benefit 4: hedge funds will find ways to make the changes work for them, not against. They make money, they set high standards, they proliferate, they employ and they 'wither' and 'die' if they are not competitive or successful. The nature of their structures, status and style is such that post-CP176 will by and large prove a benign climate for these funds.

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UK

CP185 – Moving the funds industry forward

The publication of CP185, *The CIS sourcebook – A new approach*, heralded the first real review of rules surrounding collective investment schemes in the United Kingdom since the 1980s. Piecemeal changes had been made throughout the intervening period but the process of change was such that the regulations were always to be a long way behind the trends in the industry and had the effect of stifling innovation and/or sending product manufacture offshore.

The CIS sourcebook – A new approach reflects the FSA's consideration of whether the existing sourcebook could be trimmed down, and thereby moves more towards the principles-based legislative framework preferred by the FSA. While the requirements of the UCITS regime demand a higher level of prescription than that contained within other areas of the Handbook, nevertheless, the FSA have sought to minimise as far as possible the degree of prescription that had crept into the sourcebook over the years.

The publication of CP185 was greeted with widespread support from the industry, and although there were inevitably a number of areas of detail where the industry requested additional clarification, overall the reception has been positive. At one of PricewaterhouseCoopers regular investment management forums in early December, the FSA presented an initial summary of the findings arising from the consultation process and outlined the next steps. In essence the next steps for the FSA involved some additional liaison with the industry and consumers in order to clarify certain issues of policy that have arisen but with the aim of implementing the revised rules in March 2004.

Assuming that the final text differs only marginally from that which has been proposed, the industry will then be able to develop products which are specifically tailored to the requirements of particular client groups, without the necessity of so doing in an offshore jurisdiction. The FSA has also sought to implement the requirements contained within the UCITS amending directives, the so called UCITS III, to permit the maximum degree of flexibility.

The UCITS III requirements, taken together with the proposals in CP185, will make the United Kingdom a very attractive place both to launch products and conduct their management. Inevitably the existence of discriminatory tax regimes will still preclude the ability of managers properly to undertake cross-border distribution but nevertheless the United Kingdom is now in a position to attract a significant amount of the growth potential in the funds market.

Of course, all of the above necessitates the Inland Revenue adopting a sensible approach to the tax structures surrounding the products. Given the effort that has been put into CP185 to make the United Kingdom a very competitive jurisdiction it would seem reasonable to assume that the Inland Revenue will make the necessary changes to the tax regime.

Providing the Inland Revenue does play its part, then the opportunities afforded by CP185 will encourage managers to undertake a 'root and branch' review of their fund ranges, developing tailored products for specific client groups and probably providing a further impetus to rationalise the existing range of funds. The United Kingdom may therefore see a reduction in the 'me too' fund range but the development of a wider range of specialist fund types that can only be of benefit to all in the industry.

Roger Turner, partner, investment management regulatory practice, PricewaterhouseCoopers

Malaysia

Amendments to the Securities Laws

The demutualization of the Kuala Lumpur Stock Exchange (KLSE) required amendments to the securities laws to accommodate the new structure of the exchange. The amendments include new definitions, provisions to cater for the new exchange structure and public policy framework in relation to composition of the board of the exchange company.

In conjunction with the amendments to facilitate the new structure of the exchange, the legislature has taken the opportunity to make further amendments to the securities laws. This is generally for the purpose of enhancing the securities regulatory framework and the powers of the Malaysian Securities Commission, especially in the area of investor protection. To this end, the amendments seek to:

- streamline and strengthen the framework on investment advice;
- enhance civil and administrative powers;
- introduce whistle blowing provisions; and
- facilitate the regulation and development of the securities laws and to ensure the integrity of the capital markets.

These amendments came into force on 5 January 2004 in the form of Securities Industry (Amendment) Act 2003 (SIA), the Securities Commission (Amendment) Act 2003 (SCA), the Futures Industry (Amendment) Act 2003 (FIA) and Securities Industry (Central Depositories) (Amendment) Act 2003 (SICDA).

Strengthening Framework on Investment Advice

Any person who carries out investment advisory activities is required to be licensed under the SIA. The recent amendments streamline the requirement for an investment advisory license to more accurately reflect the current range of activities in the capital market. Investment advisory activities now include a person "*who carries on a business of analysing the financial circumstances of another person and provides a plan to meet that other person's financial needs and objectives, including any investment plan in securities, whether or not a fee is charged.*" As such, financial planners are now required to be licensed under the SIA.

Furthermore, the amendments seek to rationalise the investment management industry. The legislature has revoked the Security Industry (Exempt Fund Manager) Order 1997 and consequently all fund managers are now regulated under the SIA and are required to be licensed.

All license holders are now required to participate in Continuing Professional Education (CPE) and must earn 20 CPE points each year in order to have their licenses renewed.

Investors are given further protection whereby the Commission may take action against the licensed persons in breach of their license conditions or any other applicable obligations. New powers granted to the Commission licensee include:

- to direct the person in breach to comply with, observe, enforce, or give effect to any requirements or provision under any securities law or conditions of restrictions on a license;
- to impose a penalty in proportion to the severity or gravity of the breach but which shall not exceed one million ringgit;
- to reprimand the person in breach; and
- to require the person in breach to take such steps as the Commission may direct to remedy the breach or mitigate the effect of such breach, including making restitution to any person aggrieved by such a breach.

The amendments also enhance the protection of assets of clients of fund managers. For example, the Commission has been given further powers to protect investors' assets when the Commission is of the view that the interests of the investors of the fund are likely to be jeopardised or are jeopardised. For example, the Commission may direct the fund manager to not deal with the monies or property subject to such terms and conditions as the Commission may impose, and/or direct the fund manager to transfer the monies or property to a trust company or any other person as may be specified by the Commission.

Enhancing Enforcement Capabilities

The amendments have clarified and expanded the scope of the powers of the Commission to take civil and administrative actions. In addition to the general provision that the Commission may take actions against any person who fails to comply, observe, enforce or give effect to the rules of the exchange, clearing house, central depository or provisions in any of the securities laws, the amendments list specific persons who are subject to the Commission's powers. These include, among others, the directors, officers, and advisers of listed corporations. Further, the amendments enhance the ability of the Commission to require the person in

The amendments have also expanded the range of situations where the Commission may apply to the High Court for certain orders

breach to take any such steps as the Commission may direct to remedy the breach or mitigate the effect of such a breach, including making restitution to the person aggrieved by the breach.

The amendments have also expanded the range of situations where the Commission may apply to the High Court for certain orders. Instead of specifically listing the circumstances pursuant to which the orders could be sought, as was previously the case, the Court's jurisdiction may now be invoked if the Court considers there is or will be a contravention of a 'relevant requirement'. This includes any securities law under the purview of the Commission, any conditions of a license issued under the securities law, and any rules of an exchange holding company. Further, the 'relevant requirement' may also include any written notice, circulars, conditions or guidelines issued by the Commission.

The range of orders that may be made by a Court has also been expanded to include:

- an order restraining the person from acquiring, disposing of, or otherwise dealing with, assets which the High Court is satisfied such person is readily likely to dispose of or otherwise deal with; and
- an order requiring that person, or any other person who appears to have been knowingly involved in the contravention, to take such steps as the High Court may direct to remedy it or mitigate its effect, including making restitution to any person aggrieved by such a contravention.

The ability of an aggrieved person to directly seek redress from courts for breaches of securities laws has also been expanded. The jurisdiction of the Court may be invoked by the aggrieved person if the Court considers there is or will be a contravention of a 'relevant requirement', rather than breach of specific provisions in the securities laws as previously required. Given the expanded scope, the amendments provide litigants with a broad range of causes of action with which to pursue transgressors of securities laws. The same civil actions are afforded to the exchange, clearing house, and central depository in the event of rule breaches. However, the expanded powers to require restitution are subject to inbuilt check and balance mechanisms. Account must be taken of: the profits that have accrued to the person in breach; or whether or not any person has suffered loss as a result of the breach.

Therefore the Commission, exchange, clearing house, and the central depository may only take civil action when profits have been accrued to the person in breach and investors need to prove loss as a result of the breach in order to succeed in a civil action.

The amendments have also enhanced the Commission's ability to take administrative actions by broadening the scope of the existing powers and expanding the administrative remedies available to the Commission.

Whistle Blowing Provisions

The whistle blowing provisions were intended to complement enforcement efforts and assist in curbing corporate abuses and promoting better corporate governance. In general, the amendments provide for the reporting of breaches of the law to the relevant authorities and incorporate legal protection to informants for bringing transgressions to light.

In respect of auditors of public listed corporations, the provisions impose a mandatory obligation to immediately report to the relevant authority, breaches of any securities law, rules of a stock exchange, or any matter which may adversely affect to a material extent, the financial position of the listed corporation. The Commission may also require the auditor to submit any additional material in relation to the audit as the Commission may specify, enlarge, or extend the scope of the audit, and/or carry out any specific examination or establish any procedure in any particular case. The auditor shall be remunerated for carrying out any orders required by the Commission and shall be protected against any legal action in respect of such disclosure.

Chief executives or officers of a corporation responsible for preparing or approving financial statements or financial information, and internal auditors or secretaries to a listed corporation, may also report to the relevant authority, any breaches of any securities law, a breach of any rules of a stock exchange, or any matter which may adversely affect to a material extent, the financial position of the listed corporation. However, there is no mandatory obligation to report such a breach. The provision is intended to encourage disclosure for the sake of better corporate governance and for the proper discharge of their duties. Where the disclosure is made in good faith, the officers are given statutory protection against retaliation in the form of dismissal, harassment, or discrimination at work, or any action in court.

Other Amendments

The following amendments were introduced to facilitate regulation and development of the securities laws and to ensure the integrity of the capital market.

Strengthening Clearing and Settlement Arrangements

The amendments also seek to strengthen the systemic integrity of the stock exchange and clearing and settlement houses. A new Part in the SIA discontinues the applicability of specific provisions in the Bankruptcy Act and other insolvency laws so as to ensure that settlement of trades executed on the exchange are not compromised in the event of the insolvency of any market participant who is a party to the trade. Some of the measures to this effect include:

- provisions for certain rules, proceedings, charges and contracts not to be regarded as being invalid at law on the ground of inconsistency with the provisions relating to the distribution of the assets of a person under the law of insolvency or the appointment of a relevant office-holder over any assets of a person;
- legal clarification that where securities are delivered by a participant in settlement of a market contract or provided as market collateral or under a market charge, the recognised clearing house shall be permitted to deal with such securities free of any claims; and
- provisions that state that a failure by a recognised clearing house to comply with its default rules shall not affect the validity of its actions so long as the failure does not affect the rights of any person entitled to require compliance with those rules.

Expanded Compounding Powers

The power of the Commission to compound monies for offences has been expanded to include other technical offences. Compoundable offences now include rules and directives of the stock exchange and clearing house, matters in the conduct of securities business, compliance with enforcement and investigative actions, and matters relating to insolvency and operations of the clearing house.

Conclusion

The amendments are founded on the anvil of enhancing investor protection. Such enhanced protection comes on the heels of significant changes in securities laws in other jurisdictions in the wake of recent corporate scandals in the US and Europe. They represent yet another step in the convergence of the standards of Malaysian securities laws with those of other countries with more established securities markets. It is clear however, that they merely represent another step in the evolution of securities regulation in Malaysia. More changes and clarification to the laws will doubtlessly follow in due course.

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