



**International  
Regulatory Outlook  
December 2006**



**Promoting efficient, orderly and fair markets**

**Helping retail consumers achieve a fair deal**







**Improving our business capability and effectiveness**



**Financial Services Authority  
International  
Regulatory Outlook  
December 2006**

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25 The North Colonnade Canary Wharf London E14 5HS  
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099  
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## Preface

Last year, we received positive feedback following the publication of the second edition of the International Regulatory Outlook (IRO). We have therefore kept the same broad format as in the 2005 edition while taking the opportunity to develop our presentation. In our main Highlights section we have now made a clearer distinction between current implementation priorities ('Here and Now') and initiatives where stakeholders have wider scope to influence the content of policy ('On the Horizon').

This report covers a wide range of policy developments in the international sphere. From these we have extracted three key messages:

- **Do not underestimate the continuing challenge of implementing EU measures.** Two of the highest profile measures, the Markets in Financial Instruments (MiFID) and the Capital Requirements (CRD) Directives, are in the process of being implemented. Firms should be confident that they have the systems in place to meet the new or revised prudential, organisational and conduct of business requirements.
- **To influence policy, stakeholders need to be involved at an early stage in the development of**

**policy thinking and to engage fully in consultations.** This is particularly relevant in a European context, where we have made a commitment to apply, wherever possible, a copy-out approach to implementing EU legislation. This will reduce the extent to which firms operating on a cross-border basis may find that our provisions covering a particular activity diverge from those applied by regulators in other Member States – and so achieve greater consistency and help to contain costs. To maximise the benefits of such an approach, stakeholders will need to engage actively in relevant consultations to help identify whether regulatory intervention is appropriate in the first place and, if so, what intervention might be proportionate and effective.

- **As well as looking at individual measures, we would also encourage stakeholders more generally to support the adoption of 'better regulation' processes – aimed at achieving outcome-focused solutions that are risk based and take account of market reality.** Sensible regulatory outcomes are likely to emerge only where policy makers undertake regulatory impact

assessments – embedding market failure analysis and cost-benefit studies – from an early stage. This needs to be combined with an open-minded approach in which decisions not to intervene or to recognise industry solutions (e.g. codes and standards devised by practitioners) can represent preferred outcomes. We are keen to promote this thinking across all the international regulatory forums with which we work.

For our own part, we will be seeking through 2007 to marry our obligations to implement key EU measures with our domestic commitment to move towards more principles-based regulation. Implementation of the MiFID conduct of business provisions, for example, is being undertaken within the framework of a wider reform and simplification of our conduct of business regime<sup>1</sup>. We intend the new Conduct of Business Sourcebook – NEWCOB – to be easier for firms to understand, use and comply with.

John Tiner

1 As set out in CPs 06/19 and 06/20, published in October 2006



# Executive Summary

*The international regulatory agenda for the coming year continues to be dominated by the implementation of significant banking and securities legislation agreed at the European level and by the continuing development of Solvency 2. The FSA remains fully engaged in policy development in the*

*EU. This and our work on the wider international policy agenda are underpinned by our commitment to better regulation disciplines and our intention to rebalance the UK regulatory regime to reduce reliance on detailed rules in favour of greater use of principles.*

## Key Points

### Better regulation

- Our policy-making agenda continues to be dominated by our commitment – both domestically and in the international sphere – to better regulation disciplines. We strongly support the growing emphasis placed on better regulation in the EU. Looking more broadly, the FSA has been in the vanguard of promoting a more rigorous prioritisation of the agendas of institutions such as IOSCO and the Financial Stability Forum. We have also announced our intention to shift the balance of UK regulation towards the greater use of principles and away from detailed rules. Given the significant proportion of UK regulation that originates in the EU, this clearly has implications for the way we will approach European policy-making. In a recent speech setting out our thinking John Tiner, the FSA's Chief Executive, stated our view that: 'Adoption of more rigorous disciplines around policy-making in Europe will improve the quality of regulation, ensuring that it is more evidence based, proportionate and attuned to market failure. Where we believe that principles would be the appropriate outcome we will press for these.<sup>2</sup>' Though more remains to be done in this area there is already much evidence of progress. We were, for example, encouraged by the decision of the European Commission not to introduce regulation in the area of clearing and settlement but, rather, to press the industry itself to devise a solution to the market failures that exist in that area.

### Delivering consistent implementation and common standards within the Lamfalussy process

- With most elements of the Financial Services Action Plan (FSAP) and a number of key post-FSAP measures now adopted, a large part of our focus in the coming year will centre on improving regulatory cooperation. This is necessary if the new measures are to be implemented effectively. The Lamfalussy committees (CEBS, CEIOPS and CESR), together with the newly formed Interim Working Committee on Financial Conglomerates, have a key role to play, both in specifying formally what cooperation should look like and also promoting regulatory convergence on a day-to-day basis. We look forward also to the preliminary suggestions, to be included in the second interim report, of the Inter-Institutional Monitoring Group on improving the Lamfalussy process. The report is scheduled for early 2007.

### A key theme is cross-border supervision

- Financial markets routinely operate across national borders. Regulators on the other hand operate according to domestically-defined objectives. So, for financial markets to function cohesively, supervisors must collaborate. We will continue our efforts to drive forward effective collaboration in the supervision of cross-border business.

### Big-ticket directives moving from negotiation and consultation to implementation

- A number of directives (including CRD, MiFID, the Transparency Directive and the Third Money Laundering Directive) are to be implemented in 2007. Firms' senior management should have a clear understanding of the new requirements as detailed in our consultation proposals and revised Handbook provisions and have the systems in place to facilitate necessary change.

2 See [http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1013\\_jt.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1013_jt.shtml)

## Key Points cont...

### Senior management need to take notice of the following forward-looking initiatives

- A number of highly-significant regulatory reforms are at varying stages of consultation. Work continues apace on Solvency 2, which will result in the application of revised risk management and capital adequacy requirements for insurers. The Basel Committee on Banking Supervision (BCBS) as well as the European Commission will be working on a number of issues – such as liquidity risk management, the definition of capital and the large exposures regime – to supplement the new risk-based capital requirements regime for banks and investment firms. We urge all those with an interest in the outcome of these initiatives to engage fully in the relevant consultations. Additionally, the European Commission is at varying stages in the process of investigating the need for action in a number of specific areas and has agreed a statement of policy for modifying the legislative framework for investment funds.

## Outline

The international policy agenda is very broad and raises issues relevant to each of the FSA's statutory objectives – maintaining market confidence, protecting consumers, increasing consumer understanding and reducing financial crime. The IRO updates stakeholders on a range of global and EU measures affecting financial regulation in the UK. It also describes our participation in international policy-making and identifies opportunities for stakeholders to influence discussions in EU and global forums. We address these issues in the five sections of this paper.

### Section A

#### Highlights

This section presents a high-level commentary on the regulatory outlook. The discussion is presented in terms of immediate (Here and Now) implementation issues and decisions taken, medium-term regulatory initiatives (On the Horizon) and a section on our priorities for international supervision.

### Section B

#### Sector messages

As an integrated regulator we prefer – wherever possible – to treat common issues in a consistent way across industry sectors. But within the IRO we also provide sectoral coverage, reflecting the fact that international policy work is often conducted along sectoral lines. In this section, we present a selection of the issues affecting stakeholders in specific sectors: Capital Markets; Banking; Insurance; Asset Management; Retail Intermediaries; Accounting and Auditing; Consumers; Financial Crime; and Financial Stability.

### Section C

#### Better regulation developments

We are committed to developing the quality of regulation and regulatory processes. To be most effective, better regulation disciplines need to be adhered to at all levels of regulatory decision making. In this section we present our views on how the better regulation agenda is being advanced internationally.

## Section D

### EU legislation information bank

This section provides information on the purpose, implementation approach and timetable of the most significant legislative measures developed at the European level, together with our comment on UK-specific aspects of these measures.

## Section E

### Directory of EU and international committees

This section details the composition, work programmes and our priorities in respect of the EU and international committees and forums.

## The UK policy context

While we participate in various EU forums, responsibility for representing the UK in negotiations on EU Directives and other legal measures is a matter for the UK Government. This is also the case for changes to UK legislation, with the Treasury taking the leading role on financial services. In the case of the Basel Committee, the Bank of England participates alongside us. And there are many other instances of cross-public sector involvement in regulatory policy-making. In particular, the Treasury, the Bank and the FSA work closely on a tripartite basis in dealing with EU measures affecting financial services. So while the IRO is an FSA publication, readers should bear in mind that policy-making in this area involves a wider set of relationships.

## Future updates to the IRO

The feedback that we received after the November 2005 IRO was very helpful. If you wish to offer views about this publication please contact us at [IRO@fsa.gov.uk](mailto:IRO@fsa.gov.uk). In outlining issues that may be relevant to stakeholders, we wish to draw attention to certain initiatives that we believe are of general interest. However, we cannot provide a definitive description of all measures that may be important to particular firms or other stakeholders. No statements in the IRO constitute rules or guidance under the Financial Services and Markets Act (FSMA) 2000.



# Highlights

## Overview

This section provides a high-level commentary on the most significant European and wider international developments. It covers immediate implementation concerns, significant measures which are at varying stages of the legislative process and themes relating to cross-border or international supervision.

### (i) New rules, standards and guidance

This discussion differentiates between current implementation issues – ‘Here and Now’ – and longer term regulatory initiatives – ‘On the Horizon’. Details of the timing and main features of each of the measures are presented in Section D.

### (a) Here and now

The Markets in Financial Instruments Directive (MiFID) continues to present a major implementation challenge. Firms that are not well advanced in their plans by now are likely to face significant compliance risks...

MiFID implementation will make a significant imprint on the FSA Handbook and will affect most of

the firms we regulate, and not just those falling directly within the scope of the Directive. Member States will need to have made the necessary changes to laws and rules by 31 January 2007, in time for implementation by 1 November. Our consultation programme is well advanced and the Treasury is close to finalising the necessary changes to UK legislation. We set out the current timetable for consultation and rule-making in our MiFID Implementation Plan Update published on 18 October 2006<sup>3</sup>.

Now that the Level 2<sup>4</sup> technical implementing measures have been adopted, the Committee of European Securities Regulators (CESR) and the European Commission are looking at ways of delivering consistent implementation and application of MiFID at Level 3. CESR published a work plan on October 20, listing key priorities under this heading for 2007<sup>5</sup>. These

focus on operational issues that need to be tackled in the run up to implementation. The first outputs were Consultation Papers on data consolidation and record-keeping published at the end of October. We will assist in the delivery of CESR’s programme and expect that significant progress will be made on relevant issues by the first quarter of 2007. We encourage firms to engage in that process and to provide their input to CESR’s consultations.

Our Consultation Papers have included detailed cost-benefit analysis on all of the substantive rule changes we propose, whether those measures are prescribed by the Directive or discretionary. In addition to this cost-benefit analysis, in November 2006 we published the results of a separate strand of work – over and above our obligations under the Financial Services and Markets Act (FSMA) – to attempt to quantify the overall

3 See [http://www.fsa.gov.uk/pubs/international/mifidplan\\_update.pdf](http://www.fsa.gov.uk/pubs/international/mifidplan_update.pdf)

4 See Section E for a description of the Lamfalussy Committees and their role in developing EU legislation.

5 See [http://www.cesr.eu/index.php?page=home\\_details&cid=169](http://www.cesr.eu/index.php?page=home_details&cid=169)

impact of MiFID for the UK. The paper indicates that, under certain assumptions, MiFID could generate some £200 million per year in quantifiable ongoing benefits, which will be attributable mainly to reductions in compliance and transaction costs. The quantified one-off cost of implementing MiFID could be between £870 million and £1 billion with ongoing costs of around an extra £100 million a year. These are aggregate figures: it is likely that the distribution of costs and benefits will vary among firms depending on exactly how MiFID affects their business<sup>6</sup>.

In order for the Directive to be most effective in achieving its objectives, it is essential that firms actively push ahead with their plans for meeting the November 2007 deadline.

...Meanwhile, the new risk based capital regime introduced by the Capital Requirements Directive is about to go live ...

The new CRD regime comes into effect in the EU from 1 January 2007. We formally finalised our rules in October 2006. However, 2007 is a transitional year – firms may elect to remain on the Basel 1-based rules for some or all of 2007. All firms subject to the CRD must have adopted the new regime by 1 January 2008.

With our domestic rulemaking complete, we are continuing to work closely with our supervisory counterparts in multilateral forums such as the Committee of European Banking Supervisors (CEBS) and the Basel Committee's Accord Implementation Group (AIG), as well as bilaterally with national authorities. We are working together

to develop proportionate and pragmatic solutions to the cross-border application of the new capital framework. We have stepped-up discussions with overseas regulators of internationally-active firms through regular regulatory colleges and bilateral meetings about key issues such as model approval and Pillar 2.

The delay in implementing Basel 2 in the United States has focused attention on how this may affect UK banks and investment firms who have substantial operations there. We do not consider the delay in US implementation as posing a significant barrier to firms in the UK seeking waivers for the use of the advanced approaches from 2008 or for those US firms with subsidiary operations in the UK<sup>7</sup>.

...Responding to industry comment, the Commission has adopted a non-legislative approach to reforming clearing and settlement arrangements. But industry proposals will be scrutinised carefully ...

Improving the effectiveness of clearing and settlement in the EU has been identified as a European Commission priority. In July 2006, Commissioner McCreevy announced that the Commission would not be pursuing legislative action on clearing and settlement, preferring instead to develop an industry-led code of conduct to achieve its objectives.

Commissioner McCreevy has said that the structure of trading, clearing and settlement in the EU will continue to evolve as integration accelerates, and that a regulatory

measure at this stage could slow down or even block the restructuring process that is already underway.

The Commissioner therefore called for industry action to further integration. European trade associations representing stock exchanges, clearing houses and centralised securities depositories worked closely with Commission staff to finalise proposals for a code of conduct, which was signed by a number of EU infrastructure providers on 7 November 2006. In this, they have committed to the following:

- A series of measures to improve price transparency by the end of 2006.
- Agreement on a roadmap and conditions for ensuring effective rights of access on a fair, transparent, non-discriminatory basis by end June 2007.
- Separate accounting and price unbundling of clearing and settlement services by early 2008.

This initiative is welcome in that it demonstrates the Commission's willingness to consider market and non-regulatory solutions. The Commission is to review progress made in the removal of legal and fiscal obstacles in the context of the Giovannini<sup>8</sup> barriers by June 2007. By February 2008, it is to provide a full assessment of the overall situation and possible further policy actions necessary to ensure progress. The Financial Services Committee is to examine, by March 2008, the overall situation and provide guidance on the need for further policy measures in light of the Commission's examinations.

6 See press release <http://www.fsa.gov.uk/pages/Library/Communication/PR/2006/123.shtml>

7 For a more detailed explanation of our approach, please refer to [http://www.fsa.gov.uk/pubs/international/non\\_eea.pdf](http://www.fsa.gov.uk/pubs/international/non_eea.pdf)

8 For mandate and reports of the Giovannini Group see [http://ec.europa.eu/economy\\_finance/giovannini\\_en.htm](http://ec.europa.eu/economy_finance/giovannini_en.htm)

### ...In a separate development, the European Central Bank has announced plans to develop securities settlement infrastructure...

Also in the clearing and settlement arena, the European Central Bank (ECB) has announced plans to develop a new platform for securities settlement in the Euro area (TARGET 2 securities settlement). The objective of this project is to allow the synchronised settlement of securities transactions in Euro against central bank money. The ECB is presently consulting on the proposals via national central banks. We expect a final decision on this project by early 2007. We are working with the Treasury and the Bank of England, as well as engaging with market participants, to assess the implications of these proposals for the UK market.

### ...The deadline for implementing the Transparency Directive is also fast approaching. The consequences for UK firms should in general be manageable...

Having consulted on our proposals for implementing the Transparency Directive in CP06/4<sup>9</sup> we published a Policy Statement with near-final rules in October<sup>10</sup>, three months before the 20 January 2007 implementation deadline.

The Transparency Directive updates existing EU legislation on the admission of securities to official stock exchange listing. For accounting periods starting after the deadline, issuers on regulated markets will need to comply with periodic financial reporting requirements that are comparable to

existing requirements in company law and listing rules but which extend beyond those requirements in terms of content, timing and publication. Investors in shares of issuers listed on regulated or prescribed markets will need to comply with major shareholding disclosure rules which in large part reflect the current company law regime but also contain important differences, for example in terms of notifiable interests.

All regulated information will need to be stored and easily accessible by investors. It is our belief that the current arrangements in the UK for disseminating and storing disclosed information are consistent with the requirements of the Transparency Directive. However, we will need to review this once the European Commission issues more detailed measures on central information storage, having received advice from CESR in July 2006. Looking further ahead, Policy Statement 06/11 set out our intention to conduct further work on contracts for difference (CFD) disclosure, exploring the possible market failures, and costs and benefits of introducing a CFD disclosure regime.

### ...Commission publishes its Investment Funds White Paper announcing its policy and legislative agenda on the future of UCITS...

In November 2006 the European Commission published its White Paper on investment funds (UCITS), marking the end of the UCITS review<sup>11</sup>. The paper represents the Commission's statement of policy and the schedule for modifying the legislative framework. The process leading up to publication has been rigorous and transparent. We have

had substantial dialogue with the Commission since 2004. Among our priorities was that radical restructuring of the UCITS Directive should be avoided to preserve its established benefits. We are broadly satisfied with the restricted degree of legislative change being proposed at present.

The White Paper contains a number of policy propositions that will entail modifying the current UCITS Directive. The Commission intends to publish a working draft in the first half of 2007 for negotiation between Parliament and Council in autumn 2007. We have been encouraged by the Commission's commitment to perform impact and cost-benefit analysis in its legislative process. The most significant changes proposed relate to a simplified prospectus, a simplified notification procedure, the removal of obstacles to mergers of funds and asset pooling, and measures to bring about the enactment of a fully-functioning management company passport.

### ...Negotiations on the Payment Services Directive continue with a view to creating a new European statutory framework for payment services...

The Treasury is currently leading the UK's input to negotiations on the Payment Services Directive. The Directive aims to enable users to make cross-border payments as quickly and securely as national payments. It introduces an authorisation regime for payment service providers not currently authorised as credit institutions or e-money issuers and imposes conduct of business requirements on all payment service providers.

9 See 'Implementation of the Transparency Directive/Investment Entities Listing Review'

10 See Policy Statement 06/11 Implementation of the Transparency Directive <http://www.fsa.gov.uk/pages/Library/Communication/PR/2006/106.shtml>

11 See [http://ec.europa.eu/internal\\_market/securities/ucits/index\\_en.htm#061116](http://ec.europa.eu/internal_market/securities/ucits/index_en.htm#061116)

Payment services as such are not currently regulated in the UK. The Directive will affect some firms we currently regulate but also other types of business (eg money remitters) who interface with other bodies such as the Office of Fair Trading (OFT) and HM Revenue and Customs. The Finnish Presidency of the European Council is trying to reach agreement on the Directive at first reading following the report from the European Parliament's ECON Committee in September 2006.

...The Third Money Laundering Directive and the regulation on information accompanying wire transfers represent further enhancements to EU arrangements for countering financial crime...

See financial crime sector message on page 29.

## (b) On the Horizon

There are a number of international initiatives currently underway that are at an earlier stage of development and do not, at present, have a fixed implementation schedule. Several of these measures are likely, however, to result in significant changes to the regulatory environment. So it is important that firms and other stakeholders factor such measures into their planning and consider how to contribute to any relevant consultation exercises.

...We continue to devote significant resource to the Solvency 2 project, which aims to introduce an EU-wide and comprehensive risk-based approach to determining solvency requirements of insurance firms...

Solvency 2 is a fundamental and wide-ranging overhaul of the current Solvency 1 suite of directives, affecting life and non-life insurers and reinsurers. The objective of the project is to update requirements from directives which have their roots in the 1970s; in particular to make solvency requirements more risk responsive and to take better account of intervening advances in risk-management, including capital modelling techniques. The framework will be based on an appropriate adaptation of the Basel 2/CRD three-pillar structure (minimum capital requirements, supervisory review, and reporting and disclosures, respectively).

While implementation is not expected before 2010, preparatory discussions are well advanced and decisions on key policy questions are likely to be taken over the forthcoming period in the run-up to the formal framework directive proposal, expected in the Summer of 2007.

We strongly support the Solvency 2 project and have, together with the Treasury, issued two Discussion Papers on key aspects of the new directive: 'Solvency 2: a new framework for prudential regulation of insurance in the EU' (February 2006); and 'Supervising insurance groups under Solvency 2' (October 2006). The latter is intended to promote an open and wide-ranging debate about the optimum

supervisory model for insurance groups with subsidiaries operating in several EU states. We are in close discussions with the industry, including through our Insurance Standing Group. We participate very heavily in the work of the Committee of European Insurance and Occupational Pensions Supervisors' (CEIOPS) work, drawing up technical advice to the Commission on the drafting of the framework directive. CEIOPS currently has a number of consultations under way including substantial papers on the structure of Pillar 1 requirements and on the direction of public disclosure and regulatory reporting requirements under the new regime. CEIOPS has recently completed its second quantitative impact study (QIS2) and a third exercise (QIS 3), which will focus on calibration issues, is planned for April 2007. We encourage a further strong participation from UK firms in this critical exercise.

It has been agreed that occupational pensions should remain outside the scope of the Solvency 2 project. However, there remains the question for the future of whether the Pensions Directive will subsequently be amended to replace references in that Directive to the current Solvency 1 directives with updated references to Solvency 2, thereby requiring occupational pensions to comply with some or all of the requirements in the new framework. The Commission's position on this is currently unclear, though a number of other European regulators that have both insurance and pensions in their remit are pushing for this change to be made. Clearly this would be a very important question for the UK, and we will continue to work together with the Pensions Regulator to try to ensure that the

particular operational model of UK occupational pensions is well understood, and that any future prudential changes are appropriate and subject to rigorous cost-benefit analysis.

...A review of the process for determining the solvency of insurance firms however raises issues about accounting, regulatory and economic measures of capital...

It is important, in the interests of transparency, that there be a good degree of consistency between Solvency 2 valuation standards and International Accounting Standards (IAS). International Accounting Standards Board (IASB) work on accounting for insurance contracts is not concluded (a standard is not expected until 2009) and the IASB has stated its view that current accounting practices for insurance contracts are diverse and often differ from accounting approaches in other sectors. A more harmonised regulatory valuation standard for technical provisions is central to the Solvency 2 project. CEIOPS' Pillar 1 consultation paper therefore includes a proposed regulatory valuation standard, founded on market-consistent principles. Our long-term objective is to promote the convergence of accounting, economic and regulatory measures of capital.

...As well as assessing the quantity of capital required by particular firms, there is also renewed interest in the composition of capital...

Work is now under way on a number of significant prudential policy reforms, building on the implementation of Basel 2.

The Basel Committee on Banking Supervision (BCBS) is expected to start work on its planned **review of the definition of eligible capital** in early 2007. Meanwhile, the review of the definition of capital within the EU is now gathering pace. CEBS, having completed surveys in respect of national rules and regulations and of capital instruments used by banks, is now embarking on a quantitative analysis of the types of capital held by banks, with an emphasis on hybrid capital instruments. This is due to be completed by May 2007. The Commission has yet to activate its request for CEBS advice on the guiding principles to underpin the definition of capital.

The European Commission, with the help of CEBS and the European Banking Committee (EBC), is undertaking a **review of the existing large exposures regime for banks and investment firms**. Following a stocktaking exercise of both national regulatory regimes and industry practices undertaken by CEBS, the EBC is considering what direction the review should now take.

A further strand of work that has recently been initiated in several EU and international committees is on **liquidity risk management**. The Joint Forum, the BCBS and CEBS have all begun to consider whether current rules on liquidity risk are sufficiently risk-sensitive and reflect changes in liquidity risk management practices. The European Central Bank's Banking Supervision Committee is also looking at whether current liquidity management practices have implications for financial stability.

... The debate about balancing the needs of regulators to review mergers on prudential grounds with the rights of firms within the single market to make cross-border acquisitions continues...

Following concerns raised originally by EU Finance Ministers in 2004, the European Commission has published a proposal to reform the regulatory scrutiny process for cross-border mergers. This is to take place through the amendment of EU banking, insurance and securities directives. These proposals will affect all firms authorised to carry out activities covered by the EU prudential directives.

The aim of the Commission is to prevent Member States and supervisory authorities abusing supervisory powers to refuse to approve potential acquirers. The Commission has proposed the introduction of a maximum time limit for collecting information and assessing potential acquirers and specific assessment criteria that will be harmonised across Member States.

We already operate a time-limited process and agree with the Commission that combining this with a set of harmonised assessment criteria should help ensure consistency and transparency across Member States.

We are supporting the Treasury in trying to ensure that the reforms are proportionate and achieve a good balance between the needs of supervisory authorities and the acquiring firm, so improving efficiency and preventing abuse. It is also important that supervisory authorities retain the powers necessary to maintain the reputation and integrity of EU financial

markets. Once the proposals have been agreed, changes to the regime will need to be implemented through FSMA and will require changes to our Handbook and, probably, our change of controller notification forms and supporting documentation.

The Commission's proposals were published in September 2006 and are currently being discussed in the European Parliament and Council, with a view to reaching agreement early in 2007.

... Work on mortgage credit continues but the case for regulatory intervention has yet to be made...

In 2003, the European Commission set up an industry and consumer stakeholder Mortgage Forum Group to identify the obstacles to an integrated EU mortgage market. The group reported in December 2004. The Commission responded to the group's 48 recommended actions in a 2005 Green Paper<sup>12</sup> and is now engaging industry, consumer and government stakeholders in several strands of consultation<sup>13</sup>. This is expected to result in a White Paper in mid-2007. The Commission has also said that stakeholders should not assume from this that legislation is inevitable.

We continue to stress to the Commission (and to the European Parliament, which is also formulating a report) the necessity to identify a market failure and make a clear case for regulatory intervention before seeking to

develop rules. This includes being clear about the issues under consideration, working from a strong evidence base and considering the use of non-legislative means for identified market failures. The measured approach that both the Commission and the Parliament have so far adopted suggests that they have been responsive to industry comment.

In responding to the Commission inquiry<sup>14</sup>, we have suggested focusing efforts on practical barriers to market entry. We see scope for exploring market-led initiatives that might increase access to funding; improve the availability of creditworthiness data and accurate land registry information; and raise lender confidence in valuation standards.

On consumer protection issues, we think the case for intervention has yet to be made. Consumer protection regimes have developed to address the features and risks of national markets. It is far from clear that action to impose a uniform European regime in this area would be cost effective. Moreover, as the evidence suggests consumers will continue to shop for mortgages within national markets, action to standardise mortgage disclosure across markets will add little to integration. The UK experience is also that intervening on consumer protection matters is costly, underlining the importance of ensuring that any regulatory intervention is necessary and will deliver real benefit.

## (ii) International supervision

Markets and firms increasingly operate across national borders. Achieving supervision which is both effective and efficient in such an environment requires that we think carefully about collaborative approaches to regulation and maintain close working relations with supervisors in other significant financial centres.

### European Union

...Within the EU, we are actively engaged in processes that facilitate regulatory cooperation on a cross-European basis...

The Council of Ministers (ECOFIN) adopted in May 2006 a number of Financial Services Committee (FSC) recommendations on the development of tools to foster supervisory convergence and cooperation. These were based on the so-called 'Francq Report'. On the basis of these recommendations, ECOFIN invited each of the three Level 3 Committees (CEBS, CESR and CEIOPS) to report on the development of tools and mechanisms to facilitate further cooperation and convergence. We are actively contributing to the development of appropriate responses to the ECOFIN proposals in each of the Level 3 Committees (chairing, for example the CEBS Convergence Task Force).

12 See UK response to 2005 Green Paper on Mortgage Credit in the EU [http://www.fsa.gov.uk/pubs/international/response\\_mortgagecredit.pdf](http://www.fsa.gov.uk/pubs/international/response_mortgagecredit.pdf)

13 The consultative strands used by the Commission include:

- a Mortgage Funding Expert Group to advise on obstacles to a more open funding market, and how to address these;
- an industry and consumer 'dialogue group' to further discuss and explore consumer protection issues. The dialogue group, and the funding expert group, are due to complete their work before the year end; and
- a standing Governmental Expert Group on Mortgage Credit which has, amongst other things, offered views on the Commission's analysis of responses to the Green Paper.

14 Most recently in the joint FSA/Treasury response to a Commission questionnaire on mortgage credit issues - <http://www.fsa.gov.uk/pubs/international/gegmc.pdf>

The Francq Report proposed to improve cross-European regulator training. There are already a number of initiatives to improve training at the sector-specific level. CEBS, for example, has already run a series of courses on specific aspects of CRD implementation, jointly with the Basel Financial Stability Institute, which were tailored to the needs of EU banking supervisors. We share the view of several other European regulators that such training could usefully be put on a more systematic footing. We strongly support the idea of providing opportunities for supervisors across the EU to get together to discuss aspects of implementing measures. In the longer term we would wish to promote the creation of a cross-sectoral training platform which would enable supervisors from across the sectors to come together to exchange views and experiences. We believe that such training events – which would probably be held in different locations around Europe – would go a long way to creating a common supervisory culture.

We are also actively supporting the work of the Interim Working Committee on Financial Conglomerates (IWCFC). The IWCFC was set up by CEBS and CEIOPS and membership is made up of banking and insurance supervisors (the Commission, CESR and the ECB observe). The Committee is charged specifically with considering conglomerates issues. The priorities of the IWCFC are to:

- complete the review of the Financial Conglomerates Directive (FCD) which is required by 2007;
- provide advice to the Commission, in particular for the preparation of draft

implementing measures in the field of conglomerates activities;

- contribute to the consistent implementation of the FCD and to the convergence of supervisory practices related to the FCD, and
- contribute to the promotion of supervisory cooperation, including through the exchange of information.

We believe it is important that the mandate of the IWCFC remains narrow and focused strictly on conglomerates issues. Within this narrow and time limited framework, however, we believe that there is important work for this Committee to do. Links to the work of the IWCFC can be found on both CEBS' and CEIOPS' websites.

...Regulatory collaboration extends well beyond policy development. Ensuring that adequate business continuity and crisis management preparations are taken is an important element of this work...

Crises in financial markets tend to occur infrequently, but they have the potential to be high-impact events and supervisors need to engage in contingency planning designed to ensure that they are adequately prepared. In April 2006, we participated in a financial crisis management exercise designed to test arrangements set out in a memorandum of understanding agreed in 2005 on financial crisis management between EU finance ministries, central banks and regulators. Following that exercise, a work programme to enhance the effectiveness of EU arrangements for dealing with cross-border crises was put in place, and we expect to play our full part in that follow-up work,

along with the Bank of England and the Treasury. We are also looking proactively to enhance our arrangements on the sharing of information that would be needed in a financial crisis with a number of major EU (and non-EU) regulators.

We have also taken a lead in organising the UK Tripartite authorities' programme of annual market-wide disaster recovery exercises. In each of these exercises, we have liaised closely with a range of overseas regulators in both the planning and delivery. In the period ahead, we will be looking for opportunities to engage in further exercises with counterparts in key regulatory jurisdictions.

## Beyond the EU

...Working with supervisors outside the EU to improve our oversight of firms operating on a cross-border basis and to address market failures that may arise in more than one financial centre are also important elements of our work...

Beyond the EU, we have continued to build on a number of arrangements for information sharing and supervising major international firms. For example, arrangements have for some time been in place with the Swiss banking regulator and the Federal Reserve Bank of New York (FRBNY) to provide for a more coordinated approach to supervising global Swiss banks.

We have also worked closely with US supervisors to deal with sources of operational risk in global financial markets. Earlier this year, for example, we participated in an

initiative with the FRBNY, the Securities and Exchange Commission (SEC) (together with a number of other European regulators) and 14 prominent industry participants, to address a serious backlog that had developed in credit derivative and other OTC instrument settlements. Though there remains more to do, the infrastructure that supports the credit derivatives market is substantially stronger as a result of this cooperative exercise. In a joint Financial Times article<sup>15</sup> with Timothy Geithner (President and Chief Executive, FRBNY) and Annette Nazareth (Commissioner, SEC), Callum McCarthy (our chairman) provided the following insights on the reasons for the success of this exercise.

‘First, regulators and supervisors recognised that they were more likely to achieve their goals if they worked with the private sector in the development of solutions to complex problems. In this case, supervisors laid out broad objectives but let the market design the solution. Working with the market may be necessary to keep pace with changes at the frontier of innovation.

Second, to fix the credit derivatives problem it was necessary to involve a large and diverse pool of financial institutions. No firm or national authority had the capacity to make progress on its own. To correct this collective action problem, firms needed confidence that competitors would be held to similar standards. Having firms set common metrics and insisting on sharing aggregate reporting data with the entire group

ensured that each firm could measure its progress against the group, discouraging individual firms from free-riding or circumventing the group’s effort.

Finally, in a more integrated global market, we will increasingly find ourselves compelled to pursue borderless solutions. In the case of derivatives, a local or national solution would have been insufficient to protect domestic financial markets from the risks posed by market practices’.

Industry, supported by international regulators, has shown a willingness and capacity to address post-trade processing systems more broadly. It is now considering, with continued regulatory support, how to address confirmation backlogs in other OTC derivatives instruments, including equity derivatives<sup>16</sup>.

## FSA-SEC bilaterals

We have also built on our longstanding links with the SEC in the US. In June 2006 Callum McCarthy and John Tiner led a visit to meet SEC Chairman Christopher Cox and senior staff members. The aim was to establish a high-level understanding of respective and joint priorities. The issues discussed at this, and a return London meeting in November, included the emergence of global trading platforms and the resulting impacts and issues arising for us as regulators, and the risks and possibilities for collaborative working in the area of hedge funds. Interactive data and business continuity issues were also discussed.

## Exchange regulation

The recent heightened market interest in possible cross-border mergers of exchanges has prompted regulators to consider their policy stances in respect of such potential developments. A statement made by Callum McCarthy reiterated our neutrality in respect of exchange ownership and considered how we would address the supervisory issues arising from varying degrees of exchanges’ operational integration<sup>17</sup>. We are concerned only with whether a Recognised Investment Exchange continues to meet its UK regulatory obligations. Similarly, as part of the Euronext College of Regulators’ discussions regarding the potential combination between the New York Stock Exchange and Euronext we affirmed, together with other concerned regulators, that joint ownership or affiliation of markets alone would not necessarily lead to regulation from one jurisdiction becoming applicable in the other<sup>18</sup>.

We are also supportive of the draft legislation being considered by Parliament – the Investment Exchanges and Clearing Houses Bill – that would grant us the power to veto disproportionate rule changes proposed by Recognised Bodies<sup>19</sup>. The new provisions will provide confidence to UK markets and stakeholders that foreign ownership will not undermine the essence of the UK regulatory regime. Equally we are keen to underline the points made by Ed Balls (Economic Secretary to the Treasury) in describing the purpose of the proposed legislation when he stated that:

15 Financial Times, 28 October 2006. ‘A safer strategy for the credit products explosion’.

16 See 19 September speech by Thomas Huertas FSA Director, Wholesale Firms Division and Banking Sector Leader, for more detailed discussion of derivatives issues [http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0919\\_th.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0919_th.shtml)

17 See <http://www.fsa.gov.uk/pages/Library/Communication/PR/2006/055.shtml>

18 See <http://www.fsa.gov.uk/pages/Library/Communication/PR/2006/097.shtml>

19 See [http://www.fsa.gov.uk/pages/Library/Communication/Statements/2006/recognised\\_bodies.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Statements/2006/recognised_bodies.shtml)

- ‘it will not apply to the existing regulatory provisions of the exchanges and clearing houses, nor involve the FSA in micromanaging their rulebooks;
- it is not intended to make overseas ownership of UK exchanges any easier or more difficult than it is at present<sup>20</sup>.’

## CFTC hearing

The US Commodity Futures Trading Commission (CFTC) issued a Request for Comment and hosted a June hearing on what constitutes a ‘board of trade, exchange, or market located outside the United States’. The request was prompted by London-based, but US-owned, ICE Futures’ listing of a West Texas Intermediate (WTI) crude oil futures contract in direct competition with NYMEX Inc in the US. More

specifically, the CFTC was considering whether a foreign board of trade should be required to register in the US once its US contracts become ‘significant’. We participated in the hearing and presented our position that the existing system whereby the CFTC may issue ‘no action letters’ for foreign futures exchanges, under reliance on the equivalence of home state regulation, should be retained.

In October the CFTC affirmed the use of the ‘no-action’ letter process to permit foreign boards of trade (FBOTs) to provide direct access to their electronic trading systems to US members or authorised participants. The CFTC also stated that it would be seeking to enhance the existing policy with additional requirements with respect to information sharing between the CFTC and both the exchanges and

the relevant home state regulators. We view this as a positive and proportionate outcome to this issue. We support in particular the CFTC statement that ‘common regulatory objectives can be attained through different regulatory means’. In November 2006 we signed a Memorandum of Understanding (MoU) with the CFTC to further strengthen the exchange of information related to cross-border oversight of US and UK derivatives exchanges. The arrangement will support enhanced consultation, cooperation and exchange of information related to market oversight and builds upon the existing framework for exchanging information between the two institutions, formalising the enhanced information exchange and coordination that had already taken place over the last year.

20 Speech by Economic Secretary to the Treasury, Ed Balls MP, at the City of London Corporation Dinner, 25 October

21 See CFTC 31 October press release for more detail <http://www.cftc.gov/opa/press06/opa5252-06.htm>



# Sector Messages

In this section we present issues of particular relevance to specific sectors (broadly defined). For example, while it is clear (as presented in the Highlights section) that both MiFID and the CRD will impact on most of the regulated community, in this section we draw attention to the sector-specific aspects of these directives. While we present the headline issues for various sectors, firms should refer to the relevant Consultation Papers and Policy Statements for a more comprehensive account of the issues that may affect them.

The main features and implementation schedules of various directives are detailed in Section D.

## (i) Capital Markets Sector

Sector Lead      *Sally Dewar*  
Manager          *Rebecca Jones*

### MiFID

The MiFID pre- and post-trade transparency regime will have important implications for exchanges' and investment firms' operating trading systems or dealing in shares admitted to trading on a European Regulated Market. It will also have an impact on users of equity trading venues. As explained in CP06/14, MiFID will also bring Multilateral Trading Facilities run by investment firms within the scope of the CRD. Firms are encouraged to assess the impact of the new obligations on their business models and providers and users of equity trade data should provide their input to CESR's Level 3 consultation on data consolidation.

MiFID also requires end-of-day transaction reports to the regulator. All transactions in instruments admitted to trading on a Regulated Market will have to be reported. In CP06/14 we proposed, in the light of cost-benefit analysis, to extend reporting obligations to include commodity, interest rate and foreign exchange derivative contracts. All UK-based firms will have to ensure that their transaction reporting arrangements cover all the relevant instruments and are received by the relevant authority. This may involve significant system changes.

### Credit Rating Agencies

In line with advice from the Committee of European Securities Regulators (CESR), the European Commission concluded in January 2006 that no new legislative proposals were needed with respect to Credit Rating Agencies (CRAs). The Commission considered that the existing financial services directives, combined with CRA's compliance with the IOSCO Code, would constitute an efficient and proportionate response to the key risks associated with CRA's role in securities markets. However, the

Commission also announced its intention to monitor developments in this area very carefully and reserved its right to consider introducing new proposals if it became clear that compliance with the IOSCO Code was unsatisfactory or if new circumstances arise. Such new circumstances could include serious problems of market failure or fresh developments in other parts of the world. The Commission asked CESR to monitor compliance with the IOSCO Code and to report on its findings to the Commission on an annual basis.

The first report, to be submitted in December 2006, will identify for each CRA whether there are any provisions of the IOSCO Code with which they are not compliant and the reasons given for this. This will provide indications of the level of day-to-day application of the Code. To this effect, CESR representatives have held a meeting with the CRAs to discuss how the Code has been applied. In addition, CESR has carried out a survey of market participants to assess their experience of the implementation of the Code by CRAs.

Meanwhile, the US Congress passed the Credit Rating Agency Reform Act in September 2006, the object of which is to open up competition and to increase transparency by formalising the conditions according to which a rating agency may obtain Nationally Recognised Statistical Rating Organisation (NRSRO) status.

### Private equity

We are participating in a Task Force on Private Equity (TFPE) that brings together both representatives of European regulators and central banks. The TFPE is gathering information on developments in the private equity market with a view to analysing, from a financial stability perspective, the risks to banks related to their private equity/leveraged buy-out investment, underwriting, distribution and advisory activities. This work was prompted by the recent substantial growth and innovation in the private equity market which may be significantly altering the nature and scale of banks' exposures to leveraged buy-outs.

The TFPE has prepared quantitative and qualitative surveys for use by national regulators. We have already used the quantitative survey to understand better the involvement of UK, US, Swiss and Asian banks active in the UK private equity market. The results of this survey have been fed into our Discussion Paper on private equity<sup>22</sup> and are being fed into the TFPE work, facilitating wider comparison and analysis. The TFPE intends to publish a paper setting out its key conclusions in 2007.

## (ii) Banking Sector

Sector Lead      *Thomas Huertas*  
Manager            *Yannick Cox*

A busy year of implementation is on the horizon, and the banking sector outlook continues to be dominated by European and wider international initiatives.

### CRD Implementation

In October, the FSA Board agreed the rules and guidance necessary to transpose the CRD into the FSA Handbook in time for 1 January 2007 when the CRD must be implemented. 2007 will be a transitional year, with some banks opting to remain on Basel 1 rules. On 1 January 2008, all firms subject to the CRD must have adopted the new regime. We have very much appreciated the active and constructive dialogue with the trade associations and individual banks in developing a pragmatic and proportionate approach to implementation.

With our rules and guidance now finalised, we are intensifying our discussions with overseas regulators. Our attention is now firmly focused on the practical implementation challenges that are facing both the FSA and banks arising out of the cross-border application of the CRD and the Basel 2 framework. More broadly, we are actively engaged in the sharing of practical experiences with fellow regulators in forums such as the Basel Committee's Accord Implementation Group and the Groupe de Contact within CEBS.

Alongside CRD implementation, a number of potentially significant prudential policy initiatives are beginning to gather pace in various EU and international committees.

Reviews of the definition of capital, liquidity risk and large exposures have all been embarked on and banks should engage early in the debate on the future direction of these workstreams (see page 15).

### MiFID

With less than one year to go, firms need to remain focused on their implementation programmes to ensure they meet the 1 November 2007 deadline. MiFID will bring significant changes, notably a new approach to client categorisation, the introduction of an appropriateness test for non-advised sales, and more exacting best execution requirements. But there may also be opportunities: for example, the possibility for investment firms to become systematic internalisers; and to take advantage of the extension of the passport to commodity derivatives business.

As the regulatory landscape continues to evolve, we encourage firms to engage actively with their relationship management team about MiFID, and respond to the consultation papers that CESR is publishing as part of the Level 3 programme for delivering convergent European implementation of MiFID. Some firms have already reassessed their business model and practices to ensure compliance with MiFID and also to exploit the potential benefits MiFID brings; those who do not may be left behind.

### Other directives

Numerous directives which are in the implementation phase or still in the negotiation stages have the potential to impact on the banking sector. Firms should keep up to date with the **Third Money Laundering**

**Directive<sup>23</sup>, the Unfair Commercial Practices Directive** and with the latest developments on the **Payments Services Directive** and the **Consumer Credit Directive**. Firms should also be aware of the next steps following on from the consultation on **recent clearing and settlement developments** (see page 12).

The European Commission issued a CP on the **Deposit Guarantee Scheme Directive** back in 2005, and, although the Commission has recently concluded that the current rules are sufficient for the time being, it has proposed several self-regulatory improvements to the way the schemes work cross-border within the EU<sup>24</sup>. We also continue to work with our European counterparts to ensure the **Mortgages White Paper** results in practical and proportionate proposals (see page 16).

### Derivatives backlogs

A group of international regulators including the FSA has been working with the industry to **reduce credit derivative confirmation** backlogs. (See also pages 17 and 18). Good progress has been made with credit derivative backlogs, and the focus is shifting to embrace equity and interest rate derivatives as well. The group is also working to introduce more rigorous industry-wide standards for the settlement of derivatives trades.

### DG Competition sector inquiry into retail banking

The European Commission's competition services, DG Competition (DG Comp), are continuing with their sector inquiry into retail banking, which was launched in June 2005. The purpose

of the inquiry is to ascertain whether there are features of the sector which may be restricting or distorting competition within the EU; in particular whether high entry barriers and lack of effective consumer choice may be to blame for the lack of cross-border competition. The inquiry is split into two parts: (i) *payment cards*, where DG Comp published its interim report on payment cards on 12 April 2006; and (ii) *core retail banking*, where DG Comp published on 17 July 2006 its interim report on current accounts and related services.

A final report on the retail banking sector inquiry, covering both core retail banking and payment cards, is due to be published in January 2007. It is likely that DG Comp will come forward with recommendations for tackling restrictive practices in the EU retail banking market, although enforcement action to address specific issues has not been ruled out.

### DG Markt expert group on customer mobility in relation to bank accounts

The Commission's internal market directorate, DG Markt, has set up an expert group on customer mobility in relation to bank accounts. The purpose of the group is to identify and propose solutions to legal, administrative or other obstacles that customers encounter when opening, closing or switching bank accounts: both domestic and cross-border. The first meeting of the group was held in September and the group is expected to publish its findings/recommendations before Summer 2007.

## (iii) Insurance Sector

Sector Lead        *Sarah Wilson*  
Manager            *Amy Leonard*

Having designed and implemented a new regulatory regime for UK insurance firms, 2006 has been a year of embedding the new requirements. The changes we have made have focused on both capital adequacy, through new and more robust capital and governance requirements, and improved disclosure to consumers to help ensure that they are treated fairly.

### Individual Capital Adequacy Standards

Much of our supervisory effort over the past year has focused on the new risk-responsive capital requirements – Individual Capital Adequacy Standards (ICAS) – and, in particular, reviewing firms' own assessments of the capital they need to run their businesses. We have now reviewed assessments of 70% of general insurers and 75% of life insurers measured by liabilities. We have also taken the opportunity to propose some additional reserving and capital requirements for life insurers along with some new principles and guidance for ICAS. More specifically, and following on from the implementation of a revised prudential regime for with-profits insurers, CP 06/16 Prudential Changes for Insurers<sup>25</sup> presented our proposals for rationalising the prudential regime of non-profits insurers. We also proposed introducing sub-principles and associated guidance that will provide all insurers with greater certainty about our expectations as they undertake their Individual Capital Assessments (ICAs).

23 See Financial Crime sector message, page 28.

24 See <http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/06/1637&format=HTML&aged=0&language=EN&guiLanguage=en>

25 See [http://www.fsa.gov.uk/Pages/Library/Policy/CP/2006/06\\_16.shtml](http://www.fsa.gov.uk/Pages/Library/Policy/CP/2006/06_16.shtml)

## Solvency 2

This experience of implementing a risk-based capital regime has been invaluable in terms of the wider moves towards a pan-European capital adequacy framework and negotiations on the Solvency 2 Directive continue to be a priority for us (see page 15).

## Competitive position of the UK

While the competitiveness of the UK is an issue for all sectors, attention has focused on insurance in light of a number of wholesale insurers announcing their plans to redomicile to other jurisdictions. Taxation is typically cited as the primary reason for these moves, but we recognise that regulation is also a factor in firms' decisions on location. While firms will consider regulation in its broadest sense, we have asked ourselves some challenging questions as to whether there are things we can improve. We have announced that we will reallocate resources at times of high market activity so that we are able to authorise new insurance entities within four weeks. This will be done without diluting regulatory standards. We also announced our intention to introduce a new regime for insurance special purpose vehicles (ISPVs) by the end of the year. Our approach to supervising ISPVs through the ceding insurer is a proportionate one, and reflects our drive to make it easier for firms to do business in the UK. We believe that opening up the ISPV market will also allow insurers to manage their capital more efficiently.

We aim to promote efficient, orderly and fair markets and our challenge to the industry to deliver a solution to contract certainty by the end of 2006 goes to the heart of this. We believe it should be

possible to work with the market and not impose costly requirements when the market is able to identify its own solution. A decision on whether the market has succeeded in delivering a solution will only be taken at the turn of the year, but progress to date has been encouraging.

## Reinsurance

As we forecast last year, 2006 has seen a number of key changes for European reinsurance companies. Reinsurance companies have been regulated in the UK for some time, but the implementation of the Reinsurance Directive will help establish a sound and level playing field across Europe. We issued CP 06/12 Implementing the Reinsurance Directive<sup>26</sup> in June 2006 and have confirmed that we will implement the Directive requirements in 2007. (See Section D for more information).

Internationally, we welcome the US National Association of Insurance Commissioners' (NAIC) announcement in March 2006 that it will explore, by the end of 2006, alternative solutions to the current approach that requires non-US reinsurers to provide collateralised credit protection. On our part, we will continue to seek opportunities to explain to our counterparts in the US how we regulate reinsurers and will continue to press for mutual recognition of our respective regulatory regimes.

## MiFID

Although insurance companies are exempt from the scope of MiFID, our implementation of this Directive is being combined with substantial rationalisation of our Conduct of Business Sourcebook (COB), on which we are currently consulting.

We are considering on a case-by-case basis, and in the light of cost-benefit analysis, whether the MiFID conduct of business requirements should also apply to the investment business of non-MiFID firms, including insurance companies.

## Competition Inquiry

We continue to keep a close watching brief on the inquiry by DG Comp into business insurance, which was launched in June 2005. The purpose of the inquiry is to ascertain whether there are features of the business insurance sector which may be restricting/distorting competition within the EU. In particular, DG Comp is looking at standard policy wordings, co-insurance arrangements, access to risk data/statistics and commission disclosure. As part of a fact-finding exercise, DG Comp sent detailed questionnaires to insurance trade associations in the latter part of 2005 and to individual insurers and brokers in early 2006.

DG Comp is currently analysing the responses to those questionnaires and is expected to publish its preliminary findings in late 2006 or early 2007, with a final report anticipated in the second quarter of 2007. They are expected to hold a public hearing on their findings in February 2007.

## IAIS

The triannual General Meeting of the International Association of Insurance Supervisors (IAIS) took place in October 2006, alongside the annual conference and the Annual General Meeting. The Technical Committee adopted a third paper on disclosures by insurers – a standard on disclosure concerning technical risks and performance for life insurers. Work will continue now to

merge all three (life, non-life and reinsurance) disclosure standards into a single version. The other standard agreed at the same time was on asset-liability management.

The IAIS continues to provide input to the International Accounting Standards Board on its projects on insurance contracts, financial instruments and revenue recognition. It remains committed to producing global reinsurance data, and a second report on that subject has been prepared. It also continues to encourage practical cooperation between supervisory authorities, and work is well advanced on developing a multilateral memorandum of understanding on information exchange to enable this. A draft was circulated to the membership in November 2006 for comment by 15 January 2007. It is possible that the process will be finalised in time for approval at the February 2007 meeting.

#### (iv) Asset management sector

Sector Lead *Dan Waters*  
Manager *Bruce Robson*

The volume of regulatory change coming from Europe will make this a challenging year for asset managers. Three initiatives will have a significant and potentially conflicting impact on fund management.

##### MiFID

Implementation of MiFID will have important implications for many asset managers. The most significant implications are likely to arise from the MiFID requirements on client categorisation, outsourcing of portfolio management services, best execution and transaction reporting. Our consultation programme covers

our proposed approach to implementation on all of these issues.

Many asset managers will also be subject to both MiFID and CRD. As these directives overlap substantially in the area of systems and controls we issued a CP 06/9 Organisational systems and controls – common platform for firms<sup>27</sup>. This received strong industry support, and the rules were made in November.

##### CRD

CRD may impact asset managers in a variety of ways. The CRD will provide a proportionate capital treatment for the operational risk of so-called ‘limited licence’ and ‘limited activity’ firms. It is expected that ‘pure’ asset managers, those who deal as agent, will fall mostly within the limited licence category. This would result in their being required to hold minimum capital related to a fixed overheads formula or, if higher, the sum of their market risk and credit risk requirements. In May, we published three CPs that touch on specific aspects of CRD implementation, namely systems and controls (CP 06/9), regulatory reporting (CP 06/11) and the structure of the new prudential sourcebooks (CP 06/10).

##### UCITS III

Funds that convert to or are authorised as UCITS III are allowed to use derivatives for investment purposes. This effectively opens the retail market to derivative instruments. As a consequence several issues arise relating to the adequacy of risk management practices and procedures of firms running such funds and to the clarity of disclosures to unit holders. We are working with the industry to tackle these challenges. Separately, the CESR Expert Group

on investment management has looked into several issues relating to the UCITS Directive, such as clarifying key definitions, simplifying and harmonising notification procedures, achieving greater clarity on what assets UCITS may invest in (including closed-end funds), and the treatment of embedded derivatives and structured financial instruments. They plan to make their findings public in early 2007.

##### European Commission White Paper on asset management

As reported in more detail on page 13, in November 2006 the Commission published its White Paper on asset management outlining its policy and legislative agenda, on the future of UCITS funds. We welcomed the open and transparent consultation process and will continue to have substantial dialogue with the Commission and other member states on asset management issues. The changes should make it easier for fund managers to sell products across European borders, merge existing funds, and operate across borders.

##### Hedge Fund Managers

We cooperate with many regulators on the issue of hedge funds. In particular, we will see:

- continued leadership of the valuations project within the IOSCO Standing Committee on Asset Management;
- continuing discussions with the FRBNY and the SEC on expanding our cooperation; and
- work with our European colleagues through the European Commission’s Expert Group on Hedge Funds.

We will seek to enhance our dialogue with other regulators and the industry through discussions within the Financial Stability Forum and bilateral contact in regard to specific supervisory concerns (such as derivative confirmation backlogs, discussed on page 18). We will also engage with industry representatives such as the reconvened Counterparty Risk Management Policy Group (CRMPG II). The CRMPG II is a private sector group of banks and hedge funds that was first constituted in 1999 in the wake of the Long Term Capital Management (LTCM) crisis.

We have also found it useful to share with other regulators the results of the Prime Broker Survey (PBS). The six-monthly PBS looks at the exposures to hedge funds of the London-based banks that provide prime brokerage services. We have run this exercise since 2004 and it now covers roughly one third of global assets under management by hedge funds (\$494 billion in April 2006). The survey gathers data on exposures via prime brokerage activity or the trading of OTC derivatives and helps us to monitor and analyse developments and trends in prime brokerage and the hedge funds industry. For the purposes of UK financial stability, the results of this survey are shared with the Bank of England and the Treasury. We also share the analysis with a number of international regulators.

In conjunction with the capital markets sector team we are working with international regulators on valuation practices through IOSCO and its Standing Committee on Asset Management (SC5). The committee has a mandate (with input from the IOSCO Standing Committee on the Regulation of Market Intermediaries) to complete

a project on hedge fund valuations by April 2007. It is to pay particular attention to issues related to illiquid and complex assets and the process by which sufficient independent oversight of the fund manager's role in pricing the investment portfolio may be structured. We expect the results of this work will be important in informing the industry and regulatory authorities on good practice with respect to valuations.

We also undertook our own valuations project which involved visits to a sample of 12 hedge fund managers. We set out our findings in a letter to the Chair of the IOSCO working group which was published on 29 November 2006.

Side letters are another issue that we will examine in more detail. Side letters are preferential terms given to some investors in the same share class of a hedge fund. Our conclusion is that non-disclosure of side letters that give preferential liquidity or transparency, are a breach of Principle 1 of our Principles for Business – that managers operate with integrity<sup>28</sup>. The concern we have is for non-side letter investors that are potentially disadvantaged by inadequate disclosure. We had several constructive meetings to discuss the issues with the Alternative Asset Management Association (AIMA) over the course of 2006. AIMA has since published industry guidance on how firms should disclose side letters. We will follow this up with thematic work, which we will report on in 2007. Thereafter, it is an area we will consider during supervisory assessments.

## (v) Retail intermediaries sector

Sector Lead *Stephen Bland*  
Manager *Mandy Spink*

The UK retail intermediaries sector is made up of around 5,200 financial adviser firms, 8,700 general insurance intermediaries and 3,350 mortgage advice firms (although some firms carry on more than one of these activities). There are also over 700 accountants and solicitors who offer similar mediation and advice services in addition to their ordinary business.

### CRD

A number of financial adviser firms currently fall within the scope of the Investment Services Directive (ISD) and the prudential requirements of the Capital Adequacy Directive (CAD). These firms should pay attention to the CRD, scheduled for implementation from 1 January 2007. There has also been some rearrangement of the capital requirements for mortgage and insurance intermediaries. For further information please refer to CP06/10 Strengthening Capital Standards – which covers the restructuring of the Handbook as a consequence of CRD implementation.

### MiFID

The implementation of MiFID will have an impact on financial advisers, including those that fall outside the scope of the Directive. Most financial advisers will be exempt from MiFID by virtue of Article 3 of the Directive, which applies to financial advice firms that do not hold client money, and do not wish to use the passport to conduct cross-border advice. However, as explained in CP06/19: Reforming Conduct of Business

Regulation, we are proposing a radical review of our Conduct of Business Sourcebook, which incorporates implementation of the MiFID conduct of business provisions. In that CP, we are consulting on the extent to which the MiFID requirements should also apply to non-MiFID firms, in the interests of consistency for consumers and fair and effective competition. Financial advice firms can consult our small firms website for more information.

We continue to support the UK effort to ensure that the European Commission completes a robust review of the requirements for Professional Indemnity Insurance under the IMD and the MiFID, as provided for under Article 65(6) of MiFID. A draft report was published by the Commission on 3 August 2006 for public consultation. In the draft report the Commission stated that a proper evaluation cannot be made without more practical experience and data from Member States, and indicated that it will continue to monitor the situation and provide an adequate evaluation of the regime as more evidence becomes available. We remain unconvinced that the current requirements are justified on a risk basis and have recommended that the Commission should set out a clear timetable for revisiting the issue to ensure that a subsequent thorough review is completed on a timely basis.

### European Commission work on mortgage credit

In July 2005 the European Commission published a Green Paper on mortgage credit in the EU. The responses to this are currently under consideration and we expect a White Paper in mid-2007. Firms conducting mortgage mediation

should continue to monitor developments during 2007. This issue is further discussed on page 16.

### Other EU Directives

Other pieces of EU legislation that are relevant to investment, insurance and mortgage intermediaries are the Third Money Laundering Directive and the Unfair Commercial Practices Directive (See Section D for more detail on these Directives).

### (vi) Accounting and auditing sector

Sector Lead	<i>Kari Hale until 1 January 2007. Sally Dewar thereafter.</i>
Manager	<i>Karin Walda</i>

### Context

Although we are not the UK regulator of accounting and audit matters (this role is undertaken by the Financial Reporting Council (FRC)), developments in the field of accounting and audit have a direct effect on the firms that we regulate. So we aim to work collaboratively with the FRC. This is illustrated through intelligence sharing on:

- developing accounting standards for financial instruments;
- the implementation of international standards for auditing in the UK; and
- work relating to standards for auditors and reporting accountants in the UK.

Our work in the accounting and auditing sector is driven by our statutory objectives, particularly that of market confidence, and because of our role as the UK Listing Authority (UKLA) where high-quality, internationally

comparable financial information is particularly important for investors and other stakeholders.

### How we influence the agenda

Given the increasingly international nature of accounting and auditing, we seek to influence the international agenda through participation in the working groups of international and European committees<sup>29</sup> that comment on the International Accounting Standards Board (IASB) proposals affecting the regulated community. In particular, we participate in technical discussions on accounting and auditing issues at the International Organization of Securities Commissions (IOSCO), for example on auditor concentration. In turn, IOSCO contributes to IASB advisory groups, the International Financial Reporting Interpretations Committee (IFRIC) and the International Auditing and Assurance Standards Board (IAASB) consultative advisory group.

### The regulatory environment

International Financial Reporting Standards (IFRS) or equivalent standards are now required for listed groups in the EU. The Prospectus and Transparency Directives require third country issuers to use IFRS or equivalent standards, though the European Commission has deferred assessment of what constitutes equivalent standards until 2009. CESR will work closely with the EU Commission on the equivalence mechanism to take effect when this period expires. Having equivalent standards will help companies in one marketplace access investors in other markets without incurring the costly exercise of performing reconciliations from the local GAAP.

29 The Basel Committee on Banking Supervision (BCBS), International Association of Insurance Supervisors (IAIS), the Committee of European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

## Priority issues

A crucial part of this assessment will be the work that the IASB and the US Financial Accounting Standards Board (FASB) are doing to converge their standards and the SEC's Road Map to remove the requirement for EU companies with a US listing to reconcile to US GAAP. There is a declared intention to have made some progress towards convergence of US GAAP and IFRS by 2008. On the Roadmap, the SEC has announced that it intends to remove the requirement to reconcile from IFRS to US GAAP by 2009 as long as there is progress on convergence and there is consistent enforcement of IFRS in the EU. CESRFin (an operational group within CESR focusing on accounting issues) and the SEC have published a joint workplan on this work<sup>30</sup>, and developed formal protocols to underpin it. They will be sharing information on the application and enforcement of IFRS.

## Further developments

The EU 8th Company Law Directive, which takes effect from mid-2008, seeks to clarify the duty of statutory auditors and sets out certain principles to ensure their objectivity so that investors and other interested parties can rely on the accuracy of audited accounts. It covers auditor independence, auditing standards, public oversight arrangements for auditors, the role of audit committees and the registration and oversight of third country auditors. One of the areas of harmonisation under this Directive is the implementation of international auditing standards (ISAs) across the EU. The Commission will commence its assessment of ISAs, and whether they are appropriate for implementation across the EU, during 2007/8. The UK has already implemented ISAs.

The Commission has announced that, by the end of 2006, it will be publishing a report on auditors' liability that will outline the policy options and will be open for consultation. It will be difficult to derive a single system for limiting auditor liability within the EU when legal constructs differ widely. In the UK, in the forthcoming Companies Act, proportionate liability is being introduced for auditors.

## (vii) Consumer sector

Sector Lead *Vernon Everitt*

Consumer issues are at the heart of our work. This is apparent from our statutory objectives: two refer explicitly to consumers (protecting consumers and promoting public understanding of the financial system); the other two significantly affect consumers' interests (market confidence and reducing financial crime).

Given the extent to which regulation is influenced by international developments, we are constantly mindful of the need to promote the interests of UK consumers in international policy discussions.

This is not only a feature of our work in the measures relating to retail financial services, such as the Commission's retail market competition inquiry (see page 23) and work on mortgage regulation (see page 16), but also the more technical areas of regulation where such measures have an indirect impact. For example, the CRD and MiFID protect consumers collectively by maintaining the financial soundness of banks and investment firms and by broadly underpinning existing UK protection.

Other European initiatives which impact on UK consumers are discussed elsewhere in this IRO. For example, implementation of the Third Money Laundering Directive and new requirements on wire transfers regulation (discussed in the Financial Crime sector message) benefit society by assisting in the fight against money laundering and terrorist financing.

Another area where we have played a major role in the UK and which is becoming a higher priority at European level is in financial education and financial capability. The European Commission is taking a keener interest in this area and has already acknowledged the significant work being done in the UK. We have led the UK's national strategy for financial capability for three years and will continue to share our knowledge and experience with our international counterparts.

Looking ahead, we will continue to engage at an early stage of policy development those organisations that represent the interests of UK consumers – including, of course, the FSA Consumer Panel. We will also reinforce our strong representation of UK consumers in international discussions.

## (viii) Financial stability sector

Sector Lead *David Strachan*  
Manager *John Milne and Jonathan Elven*

Two of the main objectives of the Financial Stability Sector Team are to ensure that we;

- efficiently and effectively bring about a reduction in the highest significance financial risks; and

- increase the resilience of the financial system to any major shock, whether it arises from financial events or physical disruptions such as a terrorist attack or a flu pandemic.

The work towards achieving these aims will continue to involve cooperation with the other Tripartite authorities (the Bank of England and the Treasury), as well as with the relevant authorities in other jurisdictions and with international financial bodies.

### Crisis preparations

Over the course of the past year we have initiated or taken part in a number of activities aimed at strengthening cross-border communications and undertaking exercises intended to enhance coordinated crisis preparations in relation to both financial and physical risks. (See also page 17).

### Joint Forum Working Group on High Level Business Continuity Principles

The Joint Forum Working Group, established in early 2005 and chaired by the FSA, was tasked to draft some high-level business continuity principles which might establish a broad international framework for taking forward business continuity planning in the financial sector. The Principles, which have now been published in final form<sup>31</sup>, are not intended to replace current arrangements nor are they prescriptive. However, they do provide a framework of sound practice for international standard-setting agencies. The Principles aim to promote a common base-level of resilience across national boundaries by establishing a consistent context for the development of business continuity arrangements. Feedback

has been very positive from both industry practitioners and other regulators.

### International Monetary Fund (IMF) regional seminars on flu pandemics

In the Spring and Summer of 2006 the IMF ran a series of regional seminars. The seminars were designed to raise awareness amongst the financial authorities of the risks to their financial systems that might arise from the onset of a flu pandemic and to advise on preparations they might make. Representatives from the FSA and the Bank of England took part in several of these seminars presenting material on the Tripartite authorities' preparations for a flu pandemic.

### The Tripartite market-wide disaster recovery exercises

In 2004 the Tripartite authorities announced that they intended to conduct an annual programme of market-wide disaster recovery exercises designed to strengthen the resilience of the UK financial sector to major operational disruption. Three exercises have since been held, the most recent being the 2006 flu pandemic exercise which took place over a six-week period in October and November<sup>32</sup>. In all of the exercises the Tripartite authorities have involved representatives from other key regulatory jurisdictions in the planning and delivery and have taken a proactive approach to sharing the lessons learned from each.

### Financial Stability Forum (FSF)/Tripartite Planning and Communication Workshop

In relation to the FSF work streams on financial resilience and business continuity planning (see page 48), in November 2006 the Tripartite

authorities hosted a joint workshop with the FSF on planning for financial crises and business continuity incidents. The aim of the workshop was to identify and address issues and gaps in cross-border communication and in crisis management more generally. The workshop was attended by representatives from the authorities in several jurisdictions and from a number of international bodies. A series of follow-up work streams have been agreed as a result of that workshop.

### (viii) Financial crime sector

Sector Lead	<i>Philip Robinson</i>
Manager	<i>Edna Young</i>

International efforts to reduce financial crime will continue to have implications for the UK financial services sector. We remain active in both European and international forums in influencing new initiatives and legislation and particularly in seeking to embed a risk-based approach in the international response to financial crime. We are also actively involved in the UK implementation of these measures, seeking to strengthen the UK's anti-financial crime regime in an effective and proportionate manner.

### EU Regulation on information accompanying wire transfers

The EU Regulation on information accompanying wire transfers will come into force at the start of 2007, introducing new information requirements for payers of funds. We anticipate that the regulation will affect existing FSA-regulated firms, in particular deposit-takers. Within the UK, both a monitoring regime and an enforcement and

31 See UK Financial Sector Continuity Annual Report 2006, page 16. <http://www.fsc.gov.uk/home.asp?catid=7>

32 See Callum McCarthy September 2006 Mansion House speech for greater discussion of the issues [http://www.cesr.eu/index.php?page=document\\_details&from\\_title=Documents&id=3890](http://www.cesr.eu/index.php?page=document_details&from_title=Documents&id=3890)

penalties regime for this regulation will be established during the course of 2007. We are currently working with the Treasury to determine how we will implement this in practice.

### Third Money Laundering Directive

New UK Money Laundering Regulations implementing the EU Third Money Laundering Directive have to be in place by the end of 2007. The Directive translates into EU law the 2003 revision of the Financial Action Task Force's (FATF) Recommendations on money laundering and terrorist financing. Through implementing the Directive, the Member States of the EU will harmonise their anti-money laundering and counter-terrorist financing laws and practices, and create an increasingly level playing field for the prevention of and fight against these types of financial crime.

Implementing the Directive will explicitly incorporate a risk-based approach to anti-money laundering into UK law for the first time. However, in practice this approach already exists in the UK, and has recently been reinforced by the latest revision of the Joint Money Laundering Steering Group (JMLSG) Guidance and the replacement in August 2006 of our Money Laundering Handbook with high-level provisions on senior management systems and controls.

The Directive introduces greater detail for Customer Due Diligence (CDD) provisions. In particular, it establishes a distinction between 'normal' CDD, and simplified and enhanced CDD. It allows a risk-based approach to CDD, but identifies certain high-risk customers and transactions, such as Politically Exposed Persons, where enhanced CDD is required.

The Directive allows a widened scope for reliance on third parties for ID and certain aspects of 'know your customer'. It will also extend the range of firms that have to comply with Money Laundering Regulations, meaning that a number of unregulated firms and some regulated firms engaged in activities currently outside the scope of AML supervision will have to comply with the new regime.

While the JMLSG Guidance already anticipates many of these changes, it will need to be reviewed to ensure full compatibility with the new UK Money Laundering Regulations by the time they come into force.

A new task force has been set up to assist CEBS, CESR and CEIOPS, in their work on anti-money laundering controls by providing a forum for EU supervisors for the exchange of information and good practices relating to the implementation of the Third Money Laundering Directive. The Task Force met for the first time in November 2006, and is chaired by a representative from CEBS.

### Global activities

Financial crime often has to be tackled at a global level. We therefore continue to play an active role in the FATF, an inter-governmental anti-money laundering and counter terrorist financing body which brings together representatives from finance ministries, regulators and central banks.

In 2000 and 2001 FATF listed 23 jurisdictions that were considered Non-Cooperative Countries and Territories (NCCTs). All of those 23 jurisdictions are now considered by FATF to have made significant progress and in October 2006 the last one was removed from the NCCT list. During 2006 FATF has agreed a mechanism whereby

members can raise issues and present cases for discussion when international cooperation is or has been difficult.

One way that FATF seeks to raise standards is to conduct mutual evaluations of the Anti-Money Laundering and Counter Terrorist Financing regimes of its member states. The UK regime is currently being evaluated in this way and the evaluation report will be published in Summer 2007.

FATF has three working groups: on money laundering and terrorist financing; implementation and evaluations; and typologies. On behalf of the UK, FSA representatives chair the working group on Implementation and Evaluation and co-chair the Electronic Advisory Group (EAG) on the risk-based approach. The EAG has a mandate to produce an international best practices paper on the implementation of the risk-based approach, for discussion at the June 2007 plenary. In addition the UK is chairing typology projects on terrorist financing and on Missing Trader Intra-Community Fraud.

FATF has an annually rotating presidency and the UK will take on the presidency from Canada in June 2007.





# Better Regulation Developments

We have long committed to achieving better regulation<sup>33</sup>. What this means in practice is that we seek to intervene only in response to identified material market failures that relate to our statutory objectives, and only when intervention is justified by cost-benefit analysis (CBA)<sup>34</sup>. Our June 2006 Better Regulation Action Plan Progress Report<sup>35</sup> documented what we have done, and what we plan to deliver, on our commitment to better regulation. All regulation, whether of domestic or international origin, imposes costs and has the potential to distort markets. We believe therefore that, beyond our own regulatory policy-making, it is right that we should press for better regulation disciplines to be applied to policy-making at the EU level and beyond. In pressing for this we recognise that the context and circumstances of policy formulation at an EU or international level differ in a

number of respects from those in the UK. However, we firmly believe that better regulation disciplines remain applicable.

## European context

Where we are responsible for implementing the provisions of EU legislative measures through our Handbook, we have to do this regardless of whether such measures would pass our own market failure and cost-benefit tests. It is important that EU policy proposals should be subject to effective process disciplines, thereby increasing the transparency of the process, making evaluation of proposed options more straightforward and, ultimately, reducing the likelihood that such measures would fail to meet our domestic CBA requirements. We see better regulation in Europe as comprising four elements. These are:

- consultation with stakeholders – consumers, industry and regulators;
- consideration wherever possible of the use of non-legislative tools, e.g. competition, codes of conduct<sup>36</sup>;
- rigorous impact assessments of proposed policy options, including legislative ones; and
- subsequent review of measures to assess their actual impact.

Beyond these process disciplines, we believe that the links between better regulation and the development of a European Single Market need to be debated further. As stated by John Tiner, our Chief Executive<sup>37</sup>:

‘it is not clear to me that the Commission’s focus on ‘maximum harmonisation’ is the only way to deliver coherence in the Single Market. A high-level, principles-based, directive should achieve sufficient convergence, whilst

33 See for example, and implications, Callum McCarthy speech [http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1031\\_cm.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1031_cm.shtml)

34 We recently published an updated version of our guide to Market Failure Analysis and High Level Cost-Benefit Analysis. The guide stresses the importance to policy makers of being able to make the case for intervention, recognising that in many cases the optimal solution may be to leave the market to find its own solution. Crucially, the application of high-level CBA alongside the identification of a market failure ensures that the case for intervention is made on economic grounds and is not simply assumed. See [http://www.fsa.gov.uk/pubs/other/mfa\\_guide.pdf](http://www.fsa.gov.uk/pubs/other/mfa_guide.pdf)

35 See [http://www.fsa.gov.uk/pubs/other/2660\\_Action\\_plan.pdf](http://www.fsa.gov.uk/pubs/other/2660_Action_plan.pdf)

36 Domestically we recently issued a discussion paper on the place of industry guidance. See [http://www.fsa.gov.uk/pages/library/policy/dp/2006/06\\_05.shtml](http://www.fsa.gov.uk/pages/library/policy/dp/2006/06_05.shtml)

37 See [http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1011\\_jt.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1011_jt.shtml)

allowing room for manoeuvre in implementation to address country-specific risks. I have not yet won that debate, but will continue to make my case with the Commission and other member states.’

We also believe that in both the UK and EU-wide contexts, there is a strong case for shifting the balance of regulation away from rules and further in the direction of principles. We will also actively promote a better regulation agenda in the European Union. John Tiner recently commented on our commitment<sup>38</sup>.

‘I believe that a shift of emphasis towards more principles-based regulation is not only desirable but inevitable. Attitudes towards regulation in Europe have moved a long way in the past two years – a fact for which we in the FSA take some credit. Notwithstanding that and some examples of a higher level approach in some recent measures, it will take time for a consensus on a substantially more principles-based approach to emerge. We will continue to take a lead in improving standards of regulation in Europe more broadly and to argue for what we think is necessary to get the regulatory job done in the most cost-efficient way for firms, including a more principles-based approach.’

### Progress

We are encouraged by the European Commission’s clear commitment to better regulation, and by some aspects of practical progress to date in this. In particular, industry and regulators are generally consulted at the appropriate time on the text of proposals. The Commission is also taking active steps to consult consumers (though there are many practical problems in doing this at a European level), and we have seen welcome evidence of a willingness

to apply non-legislative tools, for example in the area of clearing and settlement.

However, we would like to see further evidence of a willingness to act on better regulation disciplines at all levels in the European Commission. Such disciplines need to be embedded in policy making structures if they are to be effective. We are also looking for a greater level of rigour and clarity in impact assessments than has been apparent to date. There has been a tendency for some recent impact assessments to make statements of the kind that improving market X will raise EU-wide GDP by Y basis points over a five year period. Whether or not these estimates are correct, they do not provide a sufficiently detailed foundation for informed decisions about specific provisions in a policy proposal.

### Lamfalussy Committees

The Lamfalussy Committees have a key role to play in improving the quality and effectiveness of EU regulation. One central aspect of this is the committees’ work in providing advice on ‘Level 2’ implementing measures. This has not previously been subject to the kinds of disciplines that we have encouraged the Commission to adopt. We are therefore encouraged by and support the decision of CESR to establish CESR-ECONET, its financial economists group. This will increase the ability of CESR to meet the growing number of reporting commitments that require the input of financial market economists. Specifically, the objectives of CESR-ECONET are to:

- enhance CESR’s capability to undertake economic analysis of key risks in the securities market that are, or may become, of

particular significance for Members; and

- evaluate and, as appropriate, develop and maintain CESR’s approach to using impact analysis.

Currently, the group is working to develop and pilot an impact assessment methodology for use within CESR. CEBS and CEIOPS, who have observer status within the group, have been collaborating closely with the CESR group on this initiative. In the case of CEBS, this is taking place through the work of its Convergence Task Force, which was set up primarily to implement the recommendations of the Francq report. (See page 16). We are encouraged, therefore, to see the three committees working closely together on an initiative that we believe will enhance the quality and credibility of their output.

In terms of improving the operational effectiveness of the Lamfalussy process, we look forward also to the preliminary suggestions of the second interim report of the Inter-Institutional Monitoring Group. The report is scheduled for early 2007.

### International

A large part of our international policy work is directly linked to rulemaking and regulatory cooperation in an EU context. This is necessarily the case given how much financial services legislation originates in an EU context, the ability of many EU-incorporated firms to passport throughout the EU and the need for supervisors facing similar issues to work together to achieve a shared understanding and identify solutions to common problems. At the same time, the various global committees on which we participate

play an important role in developing the regulatory environment in which we operate.

The objectives and more key recent activities of the main global committees are summarised in Section E. In general, the codes and standards that are developed by such committees do not have a direct legislative effect. Their activities are nevertheless of considerable importance to our stakeholders. There are two reasons for this.

First, the work of global committees can be a major – indeed prime – input to domestic and EU rule-making. A particularly prominent case is the work of the BCBS to achieve a new capital framework for international banks which prompted the EU to revise its solvency rules for banks and investment firms and led to the CRD. Similarly, several recommendations of the FATF in the area of money laundering and anti-terrorist finance have been included in EU legislation. Moreover, IOSCO's work on credit rating agencies was an important factor in the European Commission's decision not to develop a legislative framework for such firms but to look to a form of self-regulation instead.

Second, the main global committees include various major financial centres outside the EU. The BCBS includes as members regulators from the United States, Canada, Japan and Switzerland in addition to various EU supervisory agencies. IOSCO and the International Association of Insurance Supervisors include representatives from these jurisdictions and also Australia, Hong Kong and Singapore as well as many others. This means that achieving solutions through the global committees is key when we wish to address a regulatory issue that has a wider international dimension (e.g. where there is a potential market failure both in and

outside the EU or where level-playing field considerations arise on a wider international stage).

On many occasions we can, therefore, think in terms of a continuum in regulatory policy development running from international to EU and then to domestic issues (but with issues capable of arising at any level). The appropriate level or levels at which to consider specific regulatory risks or changes in supervisory technique depends on the circumstances of each case. Our interest is to ensure that regulatory issues are identified in a timely way – and in the forum – that assists us in delivering our statutory objectives. To this end, we are supportive of efforts by the various international regulatory forums to develop a more risk-based or disciplined approach to addressing instances of market failure and/or to develop their dialogues with market practitioners. Several global committees have made advances in this area in the last year or so. For example:

- The FATF has established a working group of official and private sector representatives, under the FSA chairmanship, to consider how to develop a more risk-based approach to the implementation and regulation of anti-money laundering measures (AML).
- We led an initiative within IOSCO to improve internal processes for prioritisation by the main decision-making body, the Technical Committee. In brief, this involves a comprehensive process for the compilation of a list of issues which potentially warrant the Technical Committee's attention, followed by a transparent process for deciding which issues on the list have the highest priority. The procedure is extremely flexible and pragmatic and is intended to channel, but

certainly not proscribe, debate. It is hoped however that this procedure, which was adopted by the membership in June, will allow a better focus for IOSCO's work as well as providing a model for other global committees going forward.

- On the topic of regulator-practitioner dialogue, IOSCO's Technical Committee held its third annual conference in November 2006. The conference was centred on the theme of 'A window on IOSCO: a dialogue with industry on the global agenda for financial markets'. The discussions between IOSCO and practitioners were structured around five panels based on the core agenda of five standing committees (investment management, exchanges, intermediaries, enforcement and accounting and auditing). This should present a solid foundation for further dialogue.
- The IAIS expects to finalise a paper in early 2007 on a common structure for the assessment of insurer solvency. The paper will describe the overall IAIS risk-based approach to the assessment of insurer solvency. It will also present a coherent risk-based methodology for the setting of financial regulatory requirements which should properly reflect the risk exposure of the insurer.
- The Financial Stability Forum (FSF) stated in the press release following its meeting in Paris on 6 September 2006 – 'Noting existing examples of effective interaction, the FSF encouraged the IIF and other private market participants to raise issues of market weakness and other important regulatory issues that warrant attention, and regulatory bodies to continue their dialogue with the IIF and other market participants on specific issues.'



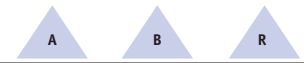
# EU Legislation Information Bank

**Key**

This section indicates time leading up to the implementation of the transposition provisions

This section indicates time from when firms will need to comply with the transposition provisions

## Capital Requirements Directive (CRD)



CRD	2006				2007				2008			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4

**Purpose** The CRD introduces a risk-sensitive prudential framework for credit institutions and investment firms across the EU. It applies to all investment firms, banks and building societies. It is closely linked to the Revised Basel Framework, agreed in June 2004, which applies to internationally-active banks. Like the Basel Framework, the CRD is based on three ‘pillars’:

- quantification of the market, credit and operational risks arising from an institution’s activities (Pillar 1);
- a stronger constructive dialogue between regulators and firms on the risks run by the latter and the level of capital which should be held to support them (Pillar 2); and
- a series of robust public disclosure requirements on firms to encourage a stronger role for market discipline in ensuring firms hold a level of capital appropriate to their business (Pillar 3).

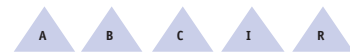
**Implementation approach** We aim to follow a ‘copy-out’ approach to implementation. We have proposed rules which have the aim of achieving regulatory capital standards which are proportionate, risk based and that provide incentives to good risk management. Equally we intend to apply the Pillar 3 disclosure requirements in a way that is relevant and reasonable relative to the aim of encouraging market discipline.

MiFID and CRD contain certain provisions which overlap for significant sets of firms. In our SYSC CP we proposed a common platform of rules which would implement both directives coherently. The common platform will be compulsory for CRD firms and MiFID firms from 1 November 2007, though they may adopt it earlier in 2007 if they wish. From 1 January until they switch, CRD firms must comply with the CRD provisions and our existing Handbook provisions.

**Timetable** The CRD is to be implemented on 1 January 2007.

**FSA Comment** We are fully participating in Basel and European work streams aimed at resolving cross-border implementation issues and further refining the standards underpinning the application of the provisions.

## Markets in Financial Instruments Directive (MiFID)



MiFID	2005				2006				2007				2008				
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4

**Purpose** MiFID is a wide-ranging Directive, constituting a major element in the EU's Financial Services Action Plan. The Directive substantially revises the current Investment Services Directive and is intended to promote a single market for wholesale and retail transactions in financial instruments. MiFID widens both the scope of investment services requiring authorisation by Member States and the range of investments falling within the range of regulation. In relation to these and other investment services and activities, MiFID significantly improves the 'passport' for investment firms. This enables them to conduct cross-border activities across Europe on the basis of their Home State authorisation. Firms will be able to establish branches in other Member States and offer cross-border services in a wider range of cases.

**Implementation approach** Our general approach to implementation by way of intelligent copy-out of the Directive's requirements is unchanged. This is to avoid placing unintended additional obligations on firms. As we said in our Business Plan, we are not seeking to 'gold plate' the provisions in MiFID by introducing new rules which are 'super equivalent'. However, there will be exceptions to this in one or two cases, where we can justify this on grounds of market failure and cost-benefit analysis. Further, there are parts of the Directive which are clearly not easily understandable by practitioners or where it is less obvious what standards of compliance will be required. In these circumstances, and in line with our principles-based approach, we are proposing limited additional guidance where industry would find this helpful. We are also mindful that industry codes of practice can sometimes be a more proportionate response to market failure. We look forward to cooperating with trade associations to explore the scope for industry guidance, either to complement or replace our requirements.

**Timetable** All national authorities need to have made the laws and rules by 31 January 2007. The Directive (Level 1) and technical implementing measures (Level 2) come into force, and the ISD will be repealed, on 1 November 2007. Our implementation programme has been outlined in our Implementation Plan Update published in October 2006.

**FSA Comment** We are committed, together with the Treasury, to meet the 31 January 2007 transposition deadline in order to give the industry nine months to put the measures in place and comply with the rules we set out by 1 November 2007. Our consultation programme has been designed to meet these dates. Both we and the Treasury have pledged our commitment to consult widely and publicly on all key aspects of MiFID.

We intend to be fully involved in the delivery of CESR's Level 3 work programme to ensure that significant progress is made on operational issues that need to be resolved in the run-up to implementation.

## Reinsurance Directive



Rein	2006				2007				2008				
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	

**Purpose** The Reinsurance Directive (RID) aims to introduce harmonised supervision of reinsurance across the EU. It is intended to create a single market in reinsurance (similar to that which already exists for direct insurance) and to remove remaining barriers to trade within the EU. It will establish the supervision of reinsurers by competent authorities in their 'home' country, on the basis of which they will be able to operate throughout the EU.

More specifically it aims to:

- bring EU regulation of pure reinsurers more into line with the existing insurance directives;
- develop a set of harmonised reinsurance supervision rules, facilitating a more efficient and secure cross-border market in reinsurance;

- end the collateralisation requirements currently imposed by other EU Member States; and
- ensure an appropriate level of policyholder protection across the EU.

The Directive is intended to be an interim measure, generally applying the requirements of the current Solvency 1 Directives for direct insurers to reinsurers. We expect a full re-examination of reinsurers' solvency requirements as part of Solvency 2.

**Implementation approach** Our objective has been to establish a sound and prudent regime that does not impose additional requirements on pure reinsurers that cannot be justified on prudential grounds.

We consulted on UK implementation in June 2006 through a Consultation Paper that also considered the treatment of Insurance Special Purpose Vehicles (ISPVs). Under the RID we will introduce authorisation requirements that are proportionate to the lower risks resulting from the structure of ISPVs. These will remove unnecessary information requirements and place greater focus on self-certification than for a traditional insurer or reinsurer.

**Timetable** The EU Reinsurance Directive (RID) came into force in December 2005 and must be implemented across the EU by December 2007. Final rules implementing the prudential changes for UK authorised firms were put in place in October 2006 together with a fit-for-purpose authorisation process for ISPV. Following discussions with the industry, it was decided that our rules should come into effect on 31 December 2006. This enables firms to benefit from our proposed rule changes as at 31 December 2006 for year-end reporting purposes. The Treasury will be consulting on the remaining changes needed to implement the RID early in the 2007.

**FSA Comment** While a full re-examination of reinsurers' solvency requirements is expected as part of Solvency 2, we are supportive of this Directive.

### Third Money Laundering Directive



M L	2006				2007				2008			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4

**Purpose** The main purpose of the Directive is to provide a common EU basis for implementing the revised Financial Action Task Force (FATF) recommendations (issued in June 2003). It will replace the First and Second Money Laundering Directives.

**Implementation approach** We will continue to support the Treasury in implementing the Directive into UK law in a proportionate and risk-based way.

**Timetable** Level 2 implementing measures were adopted in August 2006. The Directive is to be implemented by December 2007.

**FSA Comment** For those firms already following the JMLSG Guidance, the main changes are likely to flow from a translation into law of current good industry practice, though the Directive contains more detail on customer due diligence requirements. For others, small firms and firms not yet regulated for anti-money laundering (AML) purposes in particular, the impact and cost associated with the implementation of the new regime will be potentially greater.

### Transparency Directive



Trans	2006				2007				2008			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4

**Purpose** The Transparency Directive (TD) establishes periodic reporting requirements on an ongoing basis for issuers who have securities admitted to trading on a regulated market situated or operated within the EU. Investors in shares of issuers listed on regulated or prescribed markets will need to comply with major shareholding disclosure rules.

**Implementation approach** We adopted a copy-out approach to implementing the TD. We proposed additional rules only where supported by cost-benefit analysis (CBA), or, if that analysis was less clear, where additional requirements were strongly supported by the market.

Most respondents agreed with our proposed implementation approach. However, where we offered the option of removing certain existing periodic reporting and shareholder disclosure rules that would be super-equivalent to the TD, a very clear majority of respondents (including both investors and issuers) wanted to keep them. Given this, we plan to retain those rules. In addition, there are a small number of areas where we intend to make minor modifications to our CP proposals.

We believe that the current arrangements in the UK for disseminating and storing disclosed information are consistent with the requirements of the TD. However, we will need to review this once the European Commission issues more detailed measures on central information storage, having received advice from CESR in July 2006.

**Timetable** We consulted on our proposals for implementing the TD in CP 06/4. We published our Policy Statement and near final rules in October 2006. The Directive is to be implemented in January 2007.

**FSA Comment** There has been no consensus on whether introducing rules requiring disclosure of contracts for difference would bring benefits, so we will undertake further analysis before we reach any final decision.

### *Unfair Commercial Practices Directive (UCPD)*



UCPD	2006				2007				2008			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4

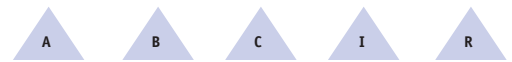
**Purpose** The Unfair Commercial Practices Directive (UCPD) seeks to protect consumer interests from unfair business-to-consumer commercial practices. In particular, commercial practices will be unfair if they are misleading (this includes both acts and omissions) or aggressive. The Directive contains a list of 31 practices which will always be considered unfair. The Directive is a minimum harmonising measure for financial services.

**Implementation approach** We consider that our Handbook and our regulatory approach already address any unfair commercial practices in the area of financial services. We therefore propose not to make any explicit changes to the Handbook to reflect the implementation of UCPD.

**Timetable** UCPD must be transposed into UK law by 12 June 2007. Those laws are then required to enter into effect by 12 December 2007.

**FSA Comment** Implementation for financial services is expected to be delivered mainly through the DTT's umbrella legislation implementing UCPD for all sectors. The DTI published a high-level consultation document on the general implementation of the Directive in December 2005. It is anticipated that they will consult (jointly with the Office of Fair Trading) on draft implementing regulations and guidance in early 2007. The October Reforming Conduct of Business Regulation CP (CP06/19) discussed our approach to implementing UCPD in the area of financial services.

### *Regulation on information accompanying wire transfers*



Wire	2006				2007				2008			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4

**Purpose** The Regulation seeks to adopt into EU legislation FATF Special Recommendation VII on information accompanying wire transfers. The requirement is for transfers of funds to be accompanied by accurate and meaningful originator information (including verified identity information about the originator or, for transfers within the EU, for verified information to be available within three days). Financial institutions will be required to monitor incoming transfers and to detect those without full originator information.

**Implementation approach** To support the Treasury in seeking to ensure that implementation of the Regulation is consistent with the Third Money Laundering Directive.

**Timetable** The Regulation is due to be in force by 1 January 2007. However, competent authorities will not assume enforcement powers until 15 December 2007.

**FSA Comment** This measure is separate from the requirements of the Third Money Laundering Directive. It specifically relates to the need for information about transfers of funds to be immediately available to the authorities engaged in anti-money laundering and terrorist financing.

## Solvency 2

I

*Timeline not yet confirmed*

**Purpose** Solvency 2 is a fundamental and wide-ranging review of the current EU Life and Non-Life, Reinsurance and Insurance Groups Directives (Solvency 1) in the light of developments in insurance, risk management and finance techniques.

**Regulatory aim** The key aim of Solvency 2 is to achieve an EU-wide proportionate, risk-sensitive prudential framework based on an adaptation of the Basel three-pillar framework for insurers. In particular this includes convergence of standards for the valuation of technical provisions for liabilities and more risk-sensitive capital requirements, including a better recognition of risk-mitigation techniques. It also covers permitting the use of firms' internal models for the calculation of capital requirements, introduction of the internal risk and capital assessment, and the ability of supervisors to require additional capital under Pillar 2 following a supervisory review process.

**Timetable** While we do not expect implementation until at least 2010, preparatory discussions are well advanced. Key policy decisions are likely to be taken over the forthcoming period in the run-up to the formal Framework Directive proposal, expected in the Summer of 2007. The Directive will then be subject to formal negotiations and agreement between the Council of Ministers (Member States) and the European Parliament.

**FSA Comment** We are supportive of Solvency 2 (see page 14 for further detail).

## Credit for Consumers Directive

B

R

*Timeline not yet confirmed*

**Purpose** To promote the development of a Single Market for consumer credit. The Credit for Consumers Directive (CCD) will apply to all providers of unsecured credit to consumers (such as banks and building societies), and all unsecured credit intermediaries. A limited set of requirements apply for overdrafts and credit unions.

**Implementation approach** A revised proposal was published by the European Commission in October 2005. This is significantly more limited in scope than the original proposal, and several provisions have been removed. Consequently, this brings us nearer to the regulatory aim outlined in our January 2005 IRO of preventing a 'one size fits all approach' to credit that could give rise to unnecessary regulatory burden or the loss of consumer protections. However, we are still concerned about the lack of evidence to support the aims of the proposal and the use of maximum harmonisation. Similarly, debate continues over the appropriate level of harmonisation and the approach to disclosure and advice.

**Timetable** Negotiations are still taking place in the Council. The European Parliament Internal Market and Consumer Protection Committee have commissioned an economic analysis of the proposal which should be available in March/April 2007. The Commission is likely to review progress in light of that analysis.

**FSA Comment** The original proposal for the Directive could have significantly altered how lending business was undertaken and would have entailed changes to the mortgage conduct of business regime. The exclusion of all secured lending removes this risk, although similar issues may arise in the follow-up to the recent EU Green Paper on mortgage credit.

## Payment Services Directive

B

*Timeline not yet confirmed*

**Purpose** The aim is for users to be able to make cross-border payments as quickly, efficiently and securely as they can within national borders. The proposed Directive introduces conduct of business regulation for all payment service providers (e.g. maximum execution timescales) and an authorisation regime for providers that are neither currently authorised as credit institutions nor e-money issuers – creating a new class of 'payment institutions' (e.g. money remitters).

**Implementation approach** Providing a payment service is not a regulated activity under the Financial Services and Markets Act and we do not regulate payment services. The Treasury has not yet made a decision on the allocation of Competent Authority responsibilities.

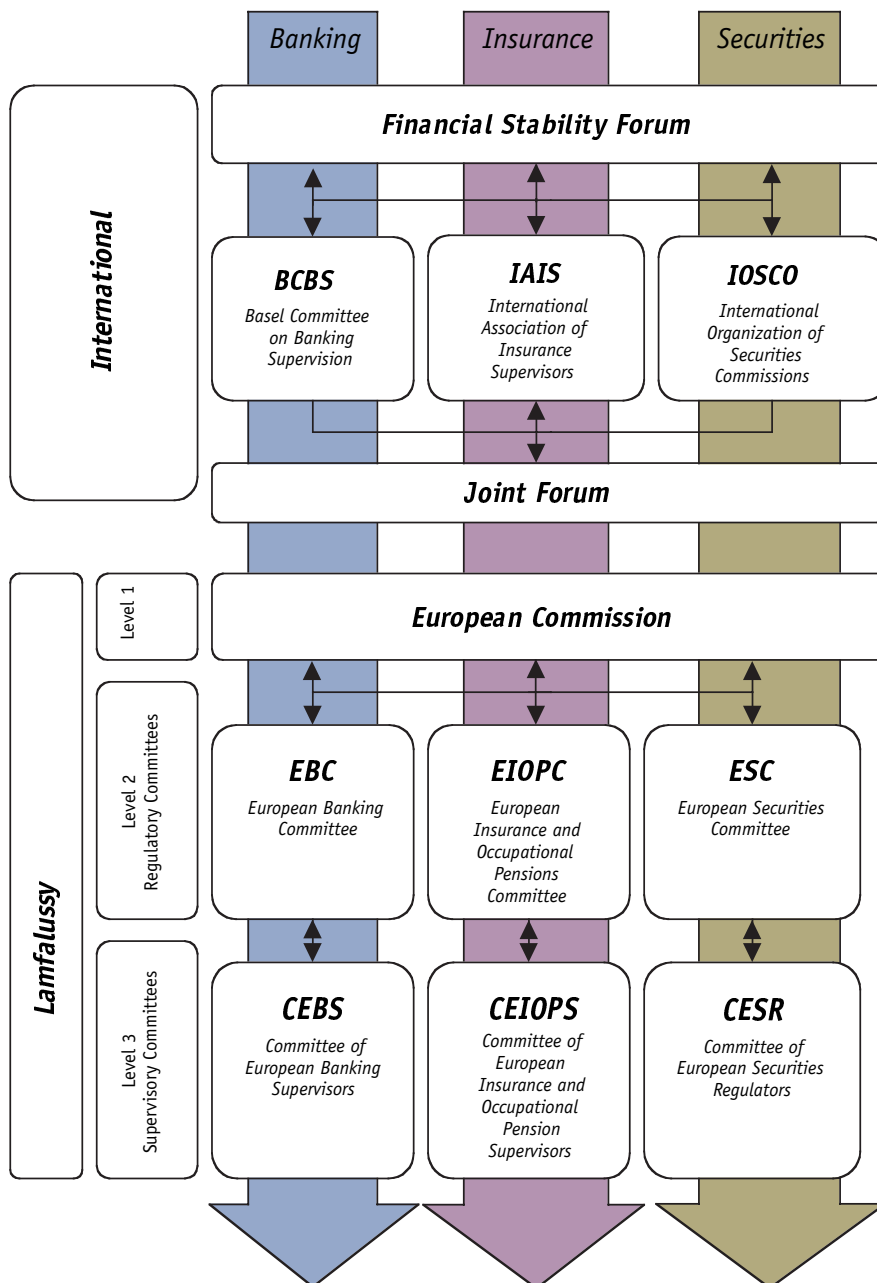
**Timetable** Negotiations are still taking place in the Council, with a view to reaching a first reading agreement with the European Parliament.

**FSA Comment** We will continue to provide support to the Treasury in its negotiations. The UK position is to achieve a Directive that is risk based and proportionate to the underlying market failures.



# Directory of EU and International Committees

This chart gives a simplified representation of the international regulatory architecture for financial services. There are cross-cutting and sectoral (banking, insurance and securities) arrangements at both the international level and the EU level.



## Lamfalussy Committees

The current EU structure for regulatory coordination and cooperation (or the Lamfalussy approach) has its origins in a report prepared by ‘The Committee of Wise Men’ on the Regulation of European Securities Markets – chaired by Alexandre Lamfalussy – and published in February 2001. This report gave rise to CESR, established under the terms of a European Commission Decision of June 2001. The report established the principle of EU supervisory activity being divided into four levels (see below). It also provided a benchmark for the development of comparable structures for the banking and the insurance markets.

### Level 1

Legislative acts are proposed by the Commission for consideration by the Council of Ministers and European Parliament. These are intended to set out the framework principles of the legislation as well as the implementation process.

### Level 2

At Level 2, the Commission, after consulting the relevant Level 2 Committee (composed of representatives of national finance ministries), requests advice from the Level 3 Committee (CESR/CEBS/CEIOPS) on technical implementing measures. The Level 3 Committee provides advice having consulted market participants, consumers and other relevant parties. Under the current procedure (known as the regulatory procedure), the Commission will then make proposals to the Level 2 Committee regarding implementation. If there is a favourable vote in the Level 2 Committee, the Commission will adopt the implementing measure. If the measures are not so approved, they will be referred to the Council where they will be adopted unless there is a blocking majority.

However, a new comitology procedure has recently been adopted by the Council. This is called the ‘regulatory procedure with scrutiny’ and is expected to replace the current regulatory procedure in several existing measures and all future Lamfalussy acts. The new procedure will give the European Parliament (in addition to the Council) a right to block implementing measures on limited grounds.

### Level 3

At Level 3, CESR, CEBS and CEIOPS work on consistent implementation and develop recommended common standards. The three Committees enhance practical cooperation among supervisors and aim to bring about increased convergence in supervisory practice, including via the exchange of information. The Level 3 Committees are outlined in this section.

### Level 4

Level 4 involves the Commission, Member States and financial supervisory authorities working together to ensure the consistent implementation and enforcement of EU law.

## International Regulatory Committees

Beyond the EU, various forums exist for coordinating regulatory activity on a global basis. There are three main sectoral committees that deal with banking, securities and insurance (Basel Committee, IOSCO and IAIS). More recently, the Joint Forum was created to take a cross-sector perspective of regulatory issues given that a number of topics and potential policy initiatives can affect more than one sector. The Financial Stability Forum, established in 1999, also has a wider perspective, focusing on potential threats to international financial stability. We outline the major international committees below.

## The Committee of European Securities Regulators

<i>Chair:</i>	Arthur Docters van Leeuwen (Autoriteit Financiële Markten – Netherlands Authority for the Financial Markets).
<i>FSA representative:</i>	Callum McCarthy
<i>Secretariat:</i>	Paris, <a href="http://www.cesr-eu.org">www.cesr-eu.org</a>
<i>Members:</i>	25 EU Securities supervisors plus Norway and Iceland.



### COMMITTEE OBJECTIVES

The three main roles of CESR are:

- (i) to improve coordination and convergence between securities regulators by developing an effective operational network to enhance supervision and enforcement of the Single Market for financial services;
- (ii) to act as an advisory group to assist the EU Commission particularly with preparing draft implementing measures for EU capital markets directives; and
- (iii) to ensure a more consistent and timely implementation of EU legislation in the Member States.

### FSA PRIORITIES

We fully support CESR's objectives and our priorities include:

- ensuring consistent implementation of legislation and cooperation across all Member States;
- the development of CESR's role within Level 3 of the Lamfalussy structure; and
- taking an active role in CESR's expert groups and permanent operational groups, including chairing of CESR-Tech.

### KEY WORKSTREAMS

CESR provides technical advice on new legislation to the Commission. All advice is subject to a full consultation process. Further details can be found on CESR's website.

#### Advice to the Commission

- *Transparency Directive:* CESR submitted advice to the Commission in July 2006 on the storage and filing of financial information.
- *UCITS:* CESR provided advice in January 2006 regarding clarification of definitions concerning eligible assets for investments of UCITS.

- *Credit Rating Agencies:* CESR will shortly report to the Commission on credit rating agencies' application of the IOSCO Code of Conduct.

#### Consistent implementation and convergence:

- *Market Abuse Directive:* In November 2006 CESR issued draft guidance on the operation of the Market Abuse Directive for public consultation.
- *MiFID:* Level 3 work has commenced on a number of priority issues in order to facilitate smooth and consistent implementation of the Directive.
- *International Financial Reporting Standards:* CESR-Fin continues to monitor implementation of IFRS in the EU and to develop a close working relationship with the US SEC.
- *Peer review:* CESR members have reviewed implementation of (i) CESR's guidelines on the transitional provisions of the amending UCITS Directives; and (ii) CESR's Standard No. 1 on financial information.
- *Mediation:* CESR has finalised its mediation mechanism which is designed to help resolve disputes between regulators.
- *UCITS:* CESR issued guidelines in June 2006 to facilitate the notification procedure for cross-border marketing of UCITS. It published an issues paper, in October 2006, on whether hedge fund indices can fall within the definition of 'financial indices' contained in the UCITS Directive.
- *Prospectuses:* CESR published a 'Q&A' guide in July 2006.
- *Impact assessment:* CESR has begun work to develop an impact assessment methodology.
- *Beyond the EU:* CESR has established a joint work plan with the US SEC. It is also continuing to work with the US CFTC to facilitate transatlantic derivatives business.

## The Committee of European Banking Supervisors

<i>Chair:</i>	Danièle Nouy (Commission Bancaire)
<i>FSA representative:</i>	Thomas Huertas
<i>BOE representative:</i>	Alan Sheppard
<i>Secretariat:</i>	London, <a href="http://www.c-eps.org">www.c-eps.org</a>
<i>Members:</i>	EU banking supervisors and central banks.



### COMMITTEE OBJECTIVES

The three main roles of CEBS are:

- (i) to improve coordination and convergence between banking regulators;
- (ii) to act as an advisory group to assist the EU Commission particularly with preparing of draft implementing measures for banking directives; and
- (iii) to ensure a more consistent and timely implementation of EU legislation in the Member States.

### FSA PRIORITIES

We fully support CEBS objectives and our current priorities include:

- ensuring consistent implementation of legislation and cooperation across all Member States;
- participating in the CEBS consultation process to ensure consistent implementation of the Capital Requirements Directive (CRD); and
- working actively in CEBS' working groups, including chairing its Convergence Task Force.

### KEY WORKSTREAMS

CEBS current priorities are seeking supervisory convergence in the implementation of the CRD, establishing an operational network of supervisors, and providing advice to the Commission on the definition of own funds, large exposures, liquidity, commodities and the equivalence of third country supervision. Full details of these consultations can be found on the CEBS website.

### Advice to the Commission

CEBS is working on providing advice on the definition of large exposures, publishing two reports on supervisory practices (May 2006) and industry practices (August 2006).

Jointly with CEIOPS and the Interim Working Committee on Financial Conglomerates (IWCFC), CEBS submitted initial advice on own funds in June 2006.

CEBS is working on providing advice on commodities business and on liquidity risk management.

CEBS sent a joint letter to the Commission (September 2006), with CESR and CEIOPS, questioning aspects of the proposed Directive changes on mergers and acquisitions in the financial sector.

Jointly with the IWCFC, CEBS is working on the review of the general guidance in relation to equivalence assessments of third country consolidated supervision (US and Switzerland).

### Consistent implementation and convergence:

#### Basel 2 related issues:

CEBS has published guidance, following earlier consultation, on:

- supervisory cooperation and coordination amongst home and host supervisors (Jan 2006);
- the supervisory review process under Pillar 2 (Jan 2006), together with supplementary guidance on concentration risk, stress testing and interest rate risk in the banking book;
- advanced CRD model validation (Apr 2006);
- common reporting framework for banks' capital ratios (Jan 2006, which was recast in Oct 2006); and
- a common approach to the recognition of External Credit Assessment Institutions (ECAIs) (Jan 2006).

CEBS has also published a report on the effects of the CRD on the amount of the regulatory minimum capital in Europe (QIS5).

CEBS continues its work on its supervisory disclosure framework.

#### Other convergence issues:

IAS/IFRS: CEBS continues its work on the impact of IAS/IFRS on banks' regulatory capital and balance sheet.

Outsourcing: CEBS is finalising its guidelines based on responses it received to its second consultation in 2006.

#### Supervisory cooperation:

CEBS has established a Convergence Task Force to develop proposals for i) a mediation mechanism, ii) an impact assessment methodology, iii) common training and staff exchanges, and iv) recommendations arising from the Francq report on supervisory convergence.

CEBS is seeking to identify and address emerging issues relating to cross-border CRD implementation from the supervision of a sample of ten EU cross-border groups.

## The Committee of European Insurance and Occupational Pensions Supervisors

<i>Chair:</i>	Henrik Bjerre-Nielsen (Finanstilsynet, Denmark)
<i>UK representatives:</i>	John Tiner (FSA), Tony Hobman (The Pensions Regulator)
<i>Secretariat:</i>	Frankfurt, <a href="http://www.ceiops.org">www.ceiops.org</a>
<i>Members:</i>	Insurance and occupational pensions supervisors (The Pensions Regulator is represented by Tony Hobman).



### COMMITTEE OBJECTIVES

The three main roles of CEIOPS are:

- (i) to improve coordination and convergence between insurance and occupational pensions regulators;
- (ii) to act as an advisory group to assist the EU Commission particularly with the preparation of draft implementing measures for insurance, reinsurance and occupational pensions directives; and
- (iii) to ensure the consistent and timely implementation of EU legislation.

### FSA PRIORITIES

We fully support CEIOPS' objectives and our priorities include:

- preparing advice for the Commission on Solvency 2, where we hope to share our experience of introducing a risk-based capital regime;
- ensuring that key policy options for financial requirements under Solvency 2 are subject to appropriate cost-benefit analysis (CBA); and
- encouraging further efforts to promote practical cooperation in the supervision of insurers and reinsurers.

### KEY WORKSTREAMS

CEIOPS has formed several working groups to deal with its main priorities. Working groups consist of national experts and the Commission can attend as an observer. The reports produced are subject to consultation and details can be found on the CEIOPS website.

#### Advice to the Commission

CEIOPS is now developing some of its proposals on technical issues relevant to the design of Solvency 2. Its advice to the Commission will be informed by the results of the second Quantitative Impact Study (QIS2) carried out in 2006, a report on which will be published in December. A further such study (QIS3) will commence in April 2007.

CEIOPS is currently consulting on key Pillar 1 issues – including the adequacy of financial resources, technical provisions, the Minimum Capital Requirement (MCR) and Solvency Capital Requirement (SCR) formulas. It is expected to submit its advice to the Commission on

these issues in early 2007. It is also consulting on the principles of supervisory reporting and public disclosure, and on a variety of Pillar 2 issues. A further consultation on the standard SCR formula is likely to be pursued towards the end of 2007.

The development of advice on Solvency 2 is pursued through four expert groups. We chair the group dealing with Pillar 1 issues.

#### Consistent implementation and convergence:

The Solvency 2 – Pillar 3 Expert Group also covers accounting issues, and will continue to consider the implications of the IASB's proposals.

The Occupational Pensions Committee continues to promote a common understanding of the Institutions for Occupational Retirement Provision Directive. The Budapest Protocol, establishing details of supervisory cooperation, was approved in 2006. It is also monitoring the development of cross-border schemes.

#### Supervisory cooperation:

CEIOPS' Compass Task Force is looking at convergence issues, including training and secondment measures. CEIOPS has approved the Luxembourg Protocol, which provides a framework for the cooperation of the supervisory authorities in implementing Directive 2002/92/EC on Insurance Mediation (IMD). The Expert Group on Insurance Intermediaries is currently working on a report on the implementation of the IMD, and examining developing best practice. The need for advice and recommendations to the Commission on the operation of the IMD will be considered.

The Insurance Groups Supervision Committee (IGSC) is seeking to identify lead supervisors for each of the insurance groups operating in the EU, and to develop agreement on the role of lead supervisors in the context of the Insurance Groups Directive. Co-operation with the Swiss insurance regulator (FOPI) has been established following the agreement of a collective MOU with FOPI. It is hoped that cooperation with US supervisors can be developed now a template MOU for use between individual CEIOPS members and US States has been agreed.

The Financial Stability Committee is involved in the monitoring and reporting of cross-sectoral risks with regard to financial conglomerates, in cooperation with CEBS.

## Financial Stability Forum

<i>Chair:</i>	Mario Draghi (Bank of Italy)
<i>FSA representative:</i>	Callum McCarthy (FSA)
<i>Secretariat:</i>	Basel, <a href="http://www.fsforum.org">www.fsforum.org</a>
<i>Members:</i>	Regulators, central banks, finance ministries.

### COMMITTEE OBJECTIVES

The Financial Stability Forum (FSF) was established in 1999, following the Asian and Russian financial crises of the late 1990s. Its role is to identify vulnerabilities and risks in the global financial sector and develop mitigation strategies. In many circumstances the FSF acts in a catalytic fashion to press the international regulatory community or national authorities to address a particular issue. In doing so it aims to promote international financial stability, improving the functioning of markets and reducing the potential for systemic risk. The Forum meets twice a year and brings together national authorities responsible for financial stability in major international financial centres, international financial institutions and representatives of international regulatory committees.

The 16th meeting of the FSF was held in Paris on 6 September 2006 where members considered the current set of potential vulnerabilities and specific threats to the financial system arising from market developments and structural risks and imbalances, together with options for mitigating such risks. The next meeting will be held in Frankfurt in March 2007.

### UK PRIORITIES

- Maximising the benefit derived from the opportunity to discuss issues affecting the UK's regulated markets and sectors on a global basis as the FSF uniquely brings together senior regulators, central banks and financial policy officials with an interest in financial stability issues;
- Ensuring that the FSF coordinates the international forums dealing with global financial issues so that issues are dealt with in a cost effective manner by the correct body and that duplication is avoided; and

- Ensuring that potential gaps in regulation or the implementation of standards and codes are identified and action is taken by the appropriate international body or national authority.

The Treasury and the Bank of England participate in the FSF as well as the FSA at Managing Director/Deputy Governor level

### KEY WORKSTREAMS

Detailed below are some of the more recent issues in which the FSF has taken a close interest and initiated both discussions and research. Further information on these issues and any relevant reports can be found on the FSF website.

- Vulnerabilities, risk identification and financial sector resilience.
- Hedge funds, including holding 'workshops' with hedge fund representatives.
- Large and complex financial institutions.
- Efficient and effective regulation, including mechanisms for enhancing dialogue with the financial services industry.
- International accounting and auditing issues, including the effects of concentration in the market for audit services for large companies.
- Reviewing the process for setting and checking international regulatory standards.
- Offshore centres and improving exchanges of information and cross-border cooperation.
- Business continuity planning and preparedness for a flu pandemic.

## Joint Forum

<i>Chair:</i>	Dirk Witteveen (Netherlands Bank)
<i>FSA representatives:</i>	Paul Wright, Richard Diggory, Paul Sharma
<i>Secretariat:</i>	Basel, <a href="http://www.bis.org/bcbs/jointforum.htm">http://www.bis.org/bcbs/jointforum.htm</a>
<i>Members:</i>	National regulators, Basel, IOSCO and IAIS.

### COMMITTEE OBJECTIVES

The Joint Forum was established in 1996 by the Basel Committee (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) to deal with issues common to the banking, securities and insurance sectors and the regulation of financial conglomerates.

The Joint Forum grew out of a predecessor organisation established to address issues specific to financial conglomerates. The Joint Forum's approach to these issues has included the identification of best practice, cross-sectoral financial risks and their implications, the coherence of sector approaches and coordination with other international forums on issues of material interest.

In addition to receiving mandates from BCBS, IOSCO and IAIS, the Joint Forum has also responded to direct requests from the Financial Stability Forum to examine cross-sector risks the FSF is concerned about (e.g. credit risk transfer and business continuity).

The Joint Forum usually meets three times a year and comprises of senior bank, insurance and securities supervisors from 13 countries along with the representatives of the secretariats of the Basel Committee, IOSCO and IAIS and the European Commission. The most recent meeting took place on 8-9 November 2006 in Edinburgh and the following one is to be held on 22-23 February in Miami.

### FSA PRIORITIES

- Achieving a consistent cross-sectoral approach on key policy issues.
- Using the Joint Forum to identify, prioritise and give consideration to significant issues that cut across all three sectors and have an international dimension.

- Using the Joint Forum to address issues related to financial conglomerates.
- Using the Joint Forum to establish global standards that can ensure a greater degree of consistency as more detailed standards are set for regional or national entities.

### KEY WORKSTREAMS

Detailed below are some of the issues in which the Joint Forum has taken a close interest, initiated discussions and research or issued statements. Further information on these issues can be found on the Joint Forum website.

- Credit risk transfer (the Forum's study of the CRT market was completed in March 2005; this includes a set of questions to help supervisors to determine the risk profile of firms).
- Funding liquidity risk (a paper was issued in May 2006 on the management of liquidity risk by conglomerates based on a study of 40 financial services firms).
- High-level principles on business continuity (the Forum published a paper in August 2006 outlining a number of high-level principles; the paper was revised following the release of a consultative draft in December 2005).
- Review of regulatory and market differences that occur across a range of sectors.

## International Organization of Securities Commissions

<i>Chair Executive Committee:</i>	Jane Diplock (New Zealand Securities Commission)
<i>Chair Technical Committee:</i>	Michel Prada (Autorité des Marchés Financiers, France)
<i>FSA representative:</i>	Hector Sants
<i>Secretariat:</i>	C/Oquendo 12, 28006 Madrid, Spain. <a href="http://www.iosco.org">http://www.iosco.org</a>
<i>Members:</i>	Global Securities Regulators.



### COMMITTEE OBJECTIVES

Created in 1983, IOSCO now covers more than 90% of the world's securities markets. IOSCO's objectives are: (i) the protection of investors; (ii) ensuring that markets are fair, efficient and transparent; and (iii) reducing systemic risk.

### FSA PRIORITIES

- promoting high-quality standards of global securities regulation that are tested through consultation with external stakeholders;
- ensuring that IOSCO remains responsive, transparent and an effective vehicle for information sharing and cooperation;
- encouraging IOSCO to identify emerging issues of concern and mitigate them through appropriate and proportionate responses.
- support IOSCO efforts to identify, through appropriate consultation, opportunities for adopting a more operational approach.

### KEY WORKSTREAMS

Following its 31st Annual Conference in June 2006, IOSCO issued a statement noting that its adoption of a range of operational priorities the previous year had contributed to the effectiveness of the organisation. Some more specific items of work in progress include:

#### *Dialogue with industry*

In November 2006, the IOSCO Technical Committee held its third annual conference in London. The Conference theme was 'A window on IOSCO: a dialogue with the industry on the global agenda for financial markets.' This was a very successful event and we support IOSCO in its continuing efforts to develop its agenda and standards through consultation with market participants and other interested parties.

#### *Information flows*

An important theme to emerge from the latest Technical Committee Conference was the extent to which IOSCO should become more 'operational'. One area where IOSCO

already has a major operational role is in the area of information flows, where its multilateral memorandum of understanding (MMoU) is an important means of promoting more effective cross-border cooperation between regulators. It views the MMoU as the global benchmark for enforcement-related cooperation and exchange of information between securities regulators and requires members to sign the MMoU as a condition of IOSCO membership.

#### *Hedge funds and alternative capital*

Another important IOSCO workstream for us is its work to develop good practice valuation policies and pricing procedures for hedge fund managers. This work has involved direct input from market participants and will cover the role of third parties, as well as the position of hedge fund managers, in producing and verifying prices. In a related exercise, in November IOSCO issued its final report on the regulatory environment for hedge funds. IOSCO will also need to assess the extent to which it needs to undertake work on private equity.

#### *Exchange evolution*

In March 2006, IOSCO issued a consultation paper dealing with regulatory issues arising from changes to the corporate structure of exchanges, following the conversion of several exchanges into for-profit companies. A final report on this topic was released in November.

#### *Auditor services and concentration*

IOSCO is reviewing a range of issues surrounding the quality of audits and auditor independence and looking at the provision of non audit services by accountants. It is also considering the implications of auditor concentration for securities regulators.

#### *Dialogue with certain jurisdictions*

Since October 2004, IOSCO has worked to identify jurisdictions (including offshore financial centres) that appear to be unable or unwilling to cooperate and enter into a dialogue with them in respect of information sharing. This represents an important issue for IOSCO and one on which it has been asked to provide advice to the Financial Stability Forum.

## Basel Committee on Banking Supervision

*Chair:* Nout Wellink (Netherlands Bank)

*UK representatives:* David Strachan (FSA), Nigel Jenkinson (Bank of England)

*Secretariat:* Basel [www.bis.org](http://www.bis.org)

*Members:* Banking regulators and central banks.

### COMMITTEE OBJECTIVES

The Basel Committee on Banking Supervision (BCBS) was established at the end of 1974 and meets four times a year. The Committee's members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. Member countries are represented by their central bank and the authorities with formal responsibility for the prudential supervision of banking business. The European Commission and the European Central Bank have observer status. The Committee is chaired by Nout Wellink from the Netherlands.

The BCBS formulates broad supervisory standards, guidelines and best practice in the expectation that the individual authorities will take steps to implement them through detailed arrangements – statutory or otherwise – which are best suited to their own national systems. In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonisation of member countries' supervisory techniques.

We work together with the Bank of England on the Basel Committee to provide input on behalf of the UK.

### FSA PRIORITIES

Our key focus within the BCBS remains the consistent implementation of the revised capital framework under Basel 2. The Accord Implementation Group allows us to share our experience of Basel 2 implementation with fellow supervisors and develop a shared understanding of best practice and specific problems arising out of the cross-border application of Basel 2.

In addition to Basel 2 implementation, we would also highlight the proposed workstreams on the definition of capital and liquidity that are likely to start in 2007. Through FSA co-chairmanship of the definition of capital subgroup and Bank of England co-chairmanship of the liquidity sub-group, we expect the UK to play a leading role in the development of these two critical areas of prudential regulation.

### KEY WORKSTREAMS

Under the chairmanship of Nout Wellink, the main working committees of the BCBS have recently been restructured so as to meet the changing priorities of the Committee.

There are now four core subgroups:

- Accord Implementation Group (AIG);
- Policy Development Group (formerly the Capital Task Force);
- Accounting Task Force (ATF); and
- International Liaison Group (formerly the Core Principles Liaison Group).

The **Accord Implementation Group** (AIG) was established to share information and thereby promote consistency in the implementation of Basel 2. It is chaired by José María Roldan, Banco d'España. The AIG provides a forum for discussing members' approaches to implementing Basel 2. Within the AIG, there are three subgroups looking at specific implementation issues in relation to IRB model validation (AIGV), AMA and operational risk (AIGOR) and the trading book (AIGTB) respectively.

The **Policy Development Group** replaces the Capital Task Force as the main custodian of the Basel 2 framework and policy development. It has four main sub-groups and a further ad hoc group looking across a broad spectrum of issues ranging from the monitoring of the impact of the revised capital framework to more forward looking work in relation to the definition of capital and liquidity.

The **Accounting Task Force** evaluates and addresses emerging issues related to accounting and auditing, particularly those with potential consequences for the safety and soundness of financial organisations. The ATF currently has six active subgroups, with the most activity occurring in the subgroups related to IAS 39, Loan Accounting, Conceptual Issues and Audit.

The **International Liaison Group's** predecessor, the Core Principles Liaison Group, was originally established to serve as a technical group to discuss and oversee the application of the Basel Core Principles. Originally established in 1997, the Principles have become the international benchmark for banking supervision against which over 100 countries have now been assessed by the IMF/World Bank. Over the past two years, the Principles have been updated and the revised Principles were endorsed by the Basel Committee at its meeting in October 2006. While continuing the work under this original mandate, the CPLG has developed into a high-level forum for the BCBS to liaise regularly with senior non-G10 supervisors, the IMF and World Bank on the main issues on the BCBS agenda. A subgroup of the ILG, the Core Principles Working Group on Capital (CPWG), explores specific issues related to the implementation of Basel 2 in non-G10 countries.

## International Association of Insurance Supervisors

*Chair:* Alessandro Iuppa (Maine, USA)  
*FSA representative:* Sarah Wilson  
*Secretariat:* c/o Bank for International Settlements  
CH-4002 Basel  
Switzerland  
[www.iaisweb.org](http://www.iaisweb.org)  
*Members:* Global insurance supervisors.



### COMMITTEE OBJECTIVES

IAIS was established in 1994 to promote cooperation among insurance supervisors and with regulators in other financial sectors. The Association's membership consists of the supervisory authorities in around 180 jurisdictions. Some 80 trade associations, firms and other bodies have observer status.

The main objectives of IAIS are to contribute to improved supervision of the insurance industry on a domestic as well as an international level, promote the development of well-regulated insurance markets and to contribute to global financial stability.

IAIS develops principles, standards and guidance on insurance supervision and is active in promoting their implementation. The IAIS Insurance Core Principles are utilised by the IMF and World Bank in their country assessments. Decisions on the adoption of IAIS principles, standards and guidance are taken at the General Meeting held during the Association's Annual Conference.

### FSA PRIORITIES

- reinforcing IAIS as a global standards setter;
- ensuring that IAIS work on solvency standards is compatible with UK objectives for Solvency 2;
- furthering the development of a global system of reinsurance supervision and mutual recognition that would permit host-state supervision to take account of supervision in the home state; and
- facilitating the exchange of information and improved collaboration in the supervision of insurers.

### KEY WORKSTREAMS

The General Meeting in October 2006 adopted the third paper on disclosures by insurers – a standard on disclosure concerning technical risks and performance for life insurers. Work will continue now to merge all three disclosure standards into a single version. The other standard agreed at the same time was on asset-liability management. There were also two guidance papers approved on preventing, detecting and remedying fraud in insurance; and on risk transfer, disclosure and analysis of finite reinsurance. The Association also produced issues papers on asset-liability management, on Islamic insurance and on the regulation and supervision of captives.

The work to develop a common structure for the assessment of insurer solvency has slipped slightly, but it is anticipated that a final draft will be ready for approval at the first meeting in 2007, in February.

The IAIS continues to provide input to the International Accounting Standards Board on its projects relating to insurance contracts, financial instruments and revenue recognition. It remains committed to producing global reinsurance data, and a second report on that subject was published in November 2006. It also continues to encourage practical cooperation between supervisory authorities, and work is well advanced on developing a multilateral memorandum of understanding on information exchange to enable this. A draft was circulated to the membership for comment, and it is possible that this could be finalised in time for approval at the February 2007 meeting.



The Financial Services Authority  
25 The North Colonnade Canary Wharf London E14 5HS  
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099  
Website: [www.fsa.gov.uk](http://www.fsa.gov.uk)

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