



**International
Regulatory Outlook
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July update



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Introduction

This document updates the information and messages contained in the second edition of the *International Regulatory Outlook* (IRO) published last November. In this update, we (the Financial Services Authority) aim to highlight some of the more important developments arising from EU measures and discussions in

international regulatory fora which will have implications for our stakeholders. We continue to welcome feedback on the format and frequency of this document (please send comments to internationalregulatoryoutlook@fsa.gov.uk)

KEY POINTS

- The European Commission published its **White Paper on Financial Services 2005-2010** at the end of 2005. This developed a number of themes, including regulatory consolidation following the implementation of the Financial Services Action Plan, promoting a better regulation agenda and enhancing regulatory co-operation. We very much welcome the Commission's commitment to better regulation in particular and will be looking for rigorous justification for any proposed new measures.
- The Commission continues to work on several important work streams – e.g. clearing and settlement, mortgage finance, asset management, payment services as well as **Solvency II**. So, at this stage, it is too early to say how far its legislative programme may reduce as we approach 2010.
- In June, the European Parliament and the European Securities Committee finally agreed the secondary legislation for implementing the **Markets in Financial Instruments Directive** (MiFID). Our implementation proposals, covering retail and wholesale requirements, will be presented in four Consultation Papers and a Discussion Paper issued in 2006.
- Following the adoption of the **Capital Requirements Directive** (CRD) last year, we published a second Consultation Paper in February covering our latest implementation proposals and propose issuing a Feedback Statement in July. Together with the Treasury, we also published a Discussion Paper on Solvency II in February.
- In February, the Commission published a feedback statement on the responses to its July 2005 Green Paper on **UCITS reform**. It hopes to publish a White Paper containing its policy proposals at the end of this year. It is likely that the White Paper will set out measures to make the cross-border market for UCITS more efficient, and the provisions governing fund administration more flexible.
- The Commission published its proposal for a **Payment Services Directive** in December 2005. This outlines the Commission's proposed authorisation regime for payment institutions and conduct of business requirements for all payment service providers.
- The Commission is expected to announce shortly the extent to which it believes that further policy measures are required to improve the operation of **clearing and settlement infrastructure** at an EU level. As part of the Commission's commitment to better regulation, any proposals will need to spell out clearly the Commission's policy objectives, as well as associated costs and benefits to the industry.
- The **Lamfalussy Committee** arrangements supporting EU regulatory co-operation are becoming increasingly well established. Recognising a number of overlapping interests among the regulatory committees, the Committee of European Banking Supervisors (CEBS), the Committee of European Securities Regulators (CESR) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) issued a joint work programme in February. In this report, our Chairman Callum McCarthy outlines his vision for the future development of these structures (p12).
- At the start of June, Callum McCarthy and our Chief Executive John Tiner met Christopher Cox, Chairman of the United States **Securities and Exchange Commission**. During a **two-day bilateral**, senior staff on both sides discussed potential trans-national ownership of exchanges, hedge fund oversight, interactive data and crisis management.

Commentary

This report assesses EU and other global regulatory developments across four headings:

- (1) EU policy and forthcoming legislative developments
- (2) Current EU legislative measures and implementation requirements
- (3) EU supervisory co-operation and the Lamfalussy Committees
- (4) Recent global regulatory issues

EU policy and forthcoming legislative developments

The Commission White Paper outlines future policy on financial services and points to legislative consolidation...

In early December 2005, the European Commission published its White Paper on Financial Services 2005-2010. This sets out the Commission's view on how EU financial services legislation will develop over the medium term, following the main themes identified in its earlier Green Paper (May 2005). The main issues covered by the paper were:

- the need for legislative consolidation;
- the need for better regulation;
- improving regulatory structures; and
- on-going legislative activity.

The White Paper contained little detail on the topic of **legislative consolidation**, although it did state the Commission aimed to 'consolidate dynamically' in the period to 2010. It is hard to assess the consolidation proposals without more detail about what they are likely to mean in practice. There are certainly some areas of European legislation in which it might be possible and useful to address duplication or

inconsistency. However, any attempt to embark on a more ambitious programme of consolidating substantial areas of European legislation could well run into considerable practical and other difficulties. In subsequent remarks, Internal Market Commissioner Charles McCreevy has said that the Commission is not planning to develop a second Financial Services Action Plan (FSAP)¹. This is very welcome and in line with much UK comment on the earlier Green Paper. But while the flow of new legislation is likely to decline, the Commission's financial services programme still has the potential to be significant, at least for some sectors.

Turning to the second issue raised in the White Paper, **better regulation**, we have long been an advocate of evidence-based regulation and, through our work on the economics of financial regulation, a thought-leader in this area. The importance of developing evidence-based regulatory responses to market and regulatory failures is becoming an increasingly important theme in regulation, both at the national and the international level. In recognition of this, the Commission has noted 'Impact assessments will accompany any new Commission proposal', and, wherever possible, these will be shared before publication with relevant stakeholders. It has also said that ex post evaluation (i.e. evaluation following implementation) of FSAP measures and new legislative measures is a priority for the next five years. As part of its better regulation agenda and as a follow-up to the White Paper, the Commission is also enhancing its understanding of securities market issues by creating a European Securities Markets Expert Group.

Given that new EU requirements are estimated to drive around 70% of changes to the FSA Handbook, the Commission's emphasis on better regulation is a welcome development from our perspective. This should support our efforts to promote proportionate regulation as outlined in our *Better Regulation Action Plan* (December 2005) and our *Better Regulation Action Plan (BRAP) Progress Report* (June 2006). It is important that the Commission undertakes

1 Speech by Charles McCreevy 'Europe's capital markets in a global market place', 31 January 2006.

comprehensive, high quality impact assessments which spell out clearly the market or regulatory failure that is being addressed, details of the proposed measures, how they are expected to work and what the main impacts will be on firms, consumers and markets. It is also important that these be made available in good time to enable interested parties to make measured judgements about whether the proposed action is appropriate. Such judgements will require significant engagement by firms and consumer bodies as well as the Commission and national authorities if the process is to work effectively.

On the topic of **regulatory co-operation**, the Commission identified a number of challenges that need to be faced over the coming five years. These included the need to clarify home-host responsibilities and the importance of exploring the delegation of tasks and responsibilities while ensuring that supervisors have adequate information. It also underlined the role of the

Lamfalussy Committees in taking regulatory co-operation forward. These topics raise important issues for us and other European regulatory agencies.

We remain a strong supporter of the Lamfalussy process and continue to devote substantial senior management and other resources to it. We also continue to press for better coordination in the supervision of international firms through collaboration and an appropriate division of labour among supervisors. Callum McCarthy, our chairman, recently commented publicly on some of the more important issues relating to the respective responsibilities of home and host supervisors (see **Box 1**). He underlined the importance of avoiding a ‘one size fits all’ approach and the need to establish a clear set of relationships between home and host supervisors, taking account of the differential ‘regulatory impact’ of different types of firm and market.

Box 1

Callum McCarthy, extract from speech to Institute of International Finance (31/3/2006)

I do not however sympathise with one so-called “solution” to the problem, favoured in particular by some EU banks, namely the idea that any financial institution should be supervised, for prudential purposes at least, pretty much exclusively by the home country (or lead) supervisor – with the ‘host’ regulators in other countries losing the scope to challenge the analysis and decisions of the home regulator or to act independently of them. Let me explain why I do not believe this is a real solution. There are at least four realities which the lead supervisor approach, at least in its simplistic form, does not acknowledge.

First, there is a question of legitimacy: regulators are accountable, and are properly expected to be accountable. It is simply unrealistic to expect a regulator in a country to answer questions about the activities of a bank important to that country by saying that as “host” regulator he or she has nothing to contribute and by referring those questions to a distant “lead regulator”.

Second, there are substantial differences between the legal powers granted to different regulatory organisations in different countries. Even within the EU there is no common basis of legal powers. And beyond the EU the position is even less clear.

Third, there are questions of political will: It is clear that the degree of independence of financial regulators is not uniform across the world, nor is it uniform even within the EU.

Fourth, there are questions of competence. Not all countries are able to devote the resources, or have the experience, to discharge all the responsibilities that might be expected of a lead regulator even with the benefit of some collaboration with host authorities. We should recognise that this is a real problem, which should not be glossed over.

So, for all those reasons, I think we should reject the simple “lead regulator” model. Instead, we need an approach based on three principles:

First, any approach to regulatory convergence has to be based on a recognition of the realities I have just sketched out. “Solutions” which ignore them, however beguiling, simple and neat, are likely to prove a sad waste of time.

Second, we need to recognise that not all financial services are the same, and not all pose the same regulatory problems. The problem for a host supervisor would, for example, be quite different in relation to the following cases:

- a small bank operating simply in wholesale markets. I think this is the easiest case, in which it would be quite plausible to see the home supervisor having an important and significant role involving many of the characteristics of a lead supervisor. We at the FSA where we are the host will want to adopt this approach wherever possible;
- a bank with a significant retail business – CCF (owned by HSBC) in France, Abbey (owned by Bank Santander) in the UK, where there are real interests for the host supervisor which can't be ignored – and in practice are not;
- a bank whose failure would pose a systemic risk in the host country (though not necessarily the home country). Nordea is an example: there could be a Nordea problem – I stress I use Nordea as the example simply to demonstrate the problem, not in any way to suggest any concern about the institution – which was systemic for Estonia and of small impact in Sweden. It is hard to see that being handled exclusively by the Swedish regulator – or exclusively by the Swedish Finance Ministry.

We need to develop a taxonomy regarding the allocation of tasks between home and host authorities which recognises these – and many other – complexities.

Third, we need to develop protocols – for those different circumstances – of the rights and the duties of both home and host regulator: what information should be exchanged? Which decisions should be taken jointly by home and host regulator? What is the process for resolving disputes? The FSA's work on establishing "regulatory colleges" for our largest banks – something that has been conspicuously successful in cooperation with the Swiss authorities in relation to UBS and Credit Suisse, but is not confined to them – is aimed at doing just this.

...However, the forward work programme remains significant ...

The Giovannini reports (2001, 2003) – prepared for the Commission – concluded that existing **cross-border clearing and settlement** arrangements are complex and fragmented, and give rise to inefficiency and higher costs. The Commission therefore continues to examine ways of improving the operation of clearing and settlement infrastructure at the EU level.

The Commission has recently published two documents on post-trade infrastructure, and has invited feedback from the market and Member States on both papers. The first document, published by DG Internal Market, sets out the Commission's work on definitions of post trade functions, and their estimates of the benefits of integrated cross-border clearing and settlement arrangements. The second paper presents the results of DG Competition's fact-finding exercise on competition in EU securities trading and post-trading. The focus of the paper is on problem identification and does not propose specific remedies.

Commissioner McCreevy has challenged the industry to arrive at a market solution to these issues, if they do not want legislative action. He has indicated that the

Commission will make an announcement on what, if any, action is required in July.

The UK authorities have made clear their view that any Commission initiatives in this area must be based on a thorough analysis of the costs and benefits of any policy proposals. Indeed, this dossier presents an opportunity for the Commission to demonstrate its commitment to better regulation principles.

The Commission's consultation on its Green Paper on **mortgage credit** in the EU closed at the end of last year. Recognising the range of issues involved, the Commission subsequently confirmed that it is putting back publication of any White Paper until 2007 to allow for further consideration. As part of this, the Commission has set up an Expert Group to look at mortgage funding, is hosting a series of dialogues between industry and consumer representatives on consumer protection issues and is reconvening a Governmental Expert Group (where the UK is represented by the Treasury and by us). As we said in the November IRO, in the absence of evidence setting out a clear basis for regulation, the case for intervention in the market for mortgage finance has yet to be made².

2 For a discussion of the UK approach to mortgage regulation and lessons for the EU, see 'What lessons can be learned from national regulation on mortgage credit?', address by Dan Waters (Director Retail Policy, FSA) to EU Commission Mortgage Credit Hearing Debate on Mortgage Borrowing, 7 December 2005.

Following publication of its Green Paper on **investment funds** in July 2005, the Commission published (in mid February 2006) a summary of responses received from the asset management industry and other interested parties. The main message was that further work is required by the Commission and CESR to improve the application of the existing **UCITS Directive**³. Among the problems identified was the need to make the product passport and the Simplified Prospectus work more effectively. The Commission is also considering introducing a range of new single market freedoms, including a management company passport and the possibility of pooling or merging funds. Expert Working Groups of market practitioners set up by the Commission reported in July on market efficiency and alternative investment issues. The Commission will be looking to draw on the Groups' recommendations, CESR's technical advice (e.g. concerning eligible assets for investments of UCITS) and other initiatives to advance new proposals in its White Paper on investment funds, which is likely to be published before the end of the year. The European Parliament set out its view on the policy issues raised in the Klinz report (published at the end of April 2006).

Work on **Solvency II**, the EU project to reform the prudential regulation of insurance, is gathering pace. In February 2006, the Treasury and the FSA published *Solvency II: a new framework for prudential regulation of insurance in the EU* outlining the economic and policy context in which this work is taking place. While implementation of Solvency II is not expected until 2010, decisions on key policy issues need to be reached in the next year or so. Now therefore is a key time for interested parties to involve themselves in this work and offer their insights to the Commission as well as the UK authorities.

... *Several major policy areas will be subject to review* ...

Supervisory assessment of major shareholdings: The Commission is reviewing the existing rules covering the grounds on which regulators may prevent the acquisition of minority and majority stakes in authorised firms. This review forms part of a wider study of potential obstacles to cross-border acquisitions within the EU. The review covers Article 16 of the Banking Consolidation Directive⁴, Articles 15 of the

Third Non-Life Insurance Directive and the Recast Life Assurance Directive, Articles 19-23 of the Reinsurance Directive and Article 10 of MiFID. The proposal is to increase the transparency and consistency of approval decisions by fully harmonising the tests which may be applied by regulators to proposed acquisitions, and by introducing joint decision making by regulators. The key here is to establish an appropriate balance between preventing supervisors from blocking acquisitions for reasons that are arbitrary or protectionist, while providing them with scope to address legitimate concerns about potential acquirers. As part of this exercise, the Commission is undertaking a public consultation that will inform the ongoing review of these clauses and, following the consultation, it may propose new legislation during the summer.

Large exposures: In December 2005, CEBS received a call for advice from the Commission on the review of large exposure rules in the EU. This requests CEBS to undertake a survey of market practice in this area. To take this forward, CEBS has published a questionnaire on current industry practices and thinking on the measurement and management of concentration risk. CEBS has also carried out a survey of current supervisory practices in the area of large exposures, and sent a report on this to the Commission in April.

Sector competition enquiries: The Commission launched inquiries into competition in financial services last year. These focus on three areas: payments cards, core retail banking and business insurance. Further to this work, the Commission sent questionnaires to a sample of EU insurers in March 2006 to gather data for the inquiry into business insurance. This follows similar surveys begun last year covering retail banking and payment cards. Reports on all three sectors are due before the end of this year.

Own Funds/Definition of Capital: In June 2005, CEBS was asked to assist the Commission in its review of bank capital (known as 'own funds') by undertaking a review of capital instruments used for regulatory capital. Consequently, CEBS carried out a survey of current supervisory practices on eligible regulatory capital and an analysis of recent market trends in, and the main characteristics of, new capital instruments. This information was included in a report sent to the Commission in June.

3 Undertakings for Collective Investments in Transferable Securities.

4 This is expected to become Article 19 of the recast BCD, which will incorporate the existing BCD and the CRD.

Compensation and ombudsman schemes: The Commission continues to review the operation of guarantee schemes in the banking, securities and insurance sectors. With the Treasury and the Bank of England, we issued a tripartite paper last October setting out our thoughts on designing appropriate guarantee schemes. Subsequently, we and the Financial Ombudsman Service (the ombudsman service) issued a Consultation Paper (CP05/15) reviewing the compensation and eligibility limits attached to the Financial Services Compensation Scheme (FSCS) as well as the compulsory jurisdiction of the FOS. In March 2006, we also issued a Discussion Paper – *FSCS funding review* (DP06/01) – to encourage public discussion of how the cost of paying for the FSCS should be shared out in the future. This was followed in May by a Discussion Paper – *Financial Ombudsman Service compulsory jurisdiction: funding review* (DP06/02) – to stimulate discussion about how the cost of funding the ombudsman service’s compulsory jurisdiction should be shared in the future.

Current EU legislative measures and implementation requirements

The EU directive timelines on p17 indicate the schedule for negotiating and implementing a number of financial services measures relevant to our stakeholders. The key measures under consideration and their implications for firms and consumers are largely the same as those outlined in the IRO published in November, although progress has been made in a number of areas. For many firms, MiFID and the CRD remain the most significant measures in terms of the changes to internal systems and processes that will need to be implemented by the end of 2007.

A major development in recent months has been the Commission’s decision to adopt a largely ‘maximum harmonisation’ approach to the implementation of MiFID. This is to be achieved through the use of a Regulation to implement certain elements, and the inclusion of a provision in the draft implementing Directive (Article 4), which limits the ability of Member States to set obligations at the national level that are additional to those contained in MiFID. It remains to be seen whether such an approach will be adopted for other areas of financial services. But if this were the case, it could have significant implications for the way in which EU requirements are implemented in Member States. We have already made a general commitment that, in implementing measures, we will only go beyond

the provisions of European directives if this can be rigorously justified on the basis of cost-benefit analysis. Such cases are expected to be the exception rather than the rule, but it is important that the detail of regulation can be attuned to the needs of UK markets – particularly in the retail sector – where this is justified.

... Implementing the Markets in Financial Instruments Directive remains a central priority for firms and regulators...

In June, the European Parliament and the European Securities Committee finally agreed the secondary legislation for implementing MiFID. The deadline for transposing MiFID into national rules is 31 January 2007 and the Directive comes fully into force in November that year.

Following an extension to the Level 2 timetable, we have revised our consultation programme. We plan to present our implementation proposals, covering retail and wholesale requirements, in four Consultation Papers (CPs) and a Discussion Paper (DP) issued this year:

- We published the DP on *Implementing MiFID’s best execution requirements* in May; this considered how the overarching obligation in MiFID to take all reasonable steps to obtain the best possible result may mean different things in practice, depending on what investment service the firm is providing and what types of clients and orders it accepts. It examined the challenges for firms of understanding how MiFID’s concepts and terminology will work in practice and, in particular, examined practical issues arising in firms’ execution policies; potential ways of achieving best execution for different clients and markets; and how firms will monitor and review these policies and arrangements. The comments we receive on this will help inform our implementation proposals on best execution for inclusion in the *Reforming COB Regulation* CP.
- The CP *Organisational systems and controls: Common platform for firms (SYSC)* was also published in May; this covered the organisational and systems and controls requirements arising both from MiFID and the CRD, setting out proposals for a unified set of requirements (a ‘common platform’) for all firms subject to either or both of these Directives. The CP included transitional provisions to deal with the different implementation dates for MiFID and the CRD.

- The CP *Implementing MiFID for firms and markets* is planned for July and will cover MiFID provisions on market transparency, transaction reporting, authorisation, permissions and passporting, enforcement and co-operation. It will also cover other requirements that apply to certain types of investment firms, for example the capital and professional indemnity provisions.
- The October CP *Reforming COB Regulation*, will cover the implementation of relevant MiFID conduct of business requirements as well as the implications for businesses that fall outside the scope of MiFID in retail markets. It will also present the results of our work on COB simplification and organisational requirements not included in the SYSC CP, together with consequential changes for other Handbook modules (for example, in relation to the eligible counterparty regime and complaints handling) and implementation of the Unfair Commercial Practices Directive.
- The *Marketing Communications* CP, also planned for October, will cover the MiFID provisions on marketing communications within wider changes flowing from our financial promotions review and will be relevant to all firms.

In developing our proposals ahead of formal consultations, we are continuing to liaise with relevant stakeholders, including firms and industry bodies, consumer representatives, government, and other EU authorities. For a more detailed description of the current position, including FSA and Treasury implementation plans, see our *Joint Implementation Plan for MiFID* issued with the Treasury in May 2006.

...Work on Capital Requirements Directive implementation is now advanced but continued engagement is essential...

At the end of February 2006, we issued our second CRD-implementing CP, *Strengthening Capital Standards 2* (CP06/3). This sets out our refined policy proposals and included a full set of draft rules and guidance for the modules of the FSA Handbook dealing with general prudential issues (GENPRU) and prudential issues covering banking and investment (BIPRU). Consultation closed at the end of April and we intend to produce a Feedback Statement in July 2006. This should allow us to finalise CRD-related Handbook changes by October, before the CRD takes effect from the start of January 2007⁵.

In May 2006, we published our Consultation Paper *Integrated Regulatory Reporting (IRR): Credit institutions and certain investment firms* (CP06/11). Changes to be brought about by the implementation of the CRD require us to revise the reporting necessary to monitor the capital adequacy of firms that undertake the regulated activities of accepting deposits and issuing electronic money, and those investment firms also affected by the CRD. At the same time, we are taking the opportunity to review (among other things) the financial reporting requirements for investment firms, including those subject to MiFID (see above) that carry on investment activities, other than retail investment activities, but are not subject to the CRD.

At the EU level, the Committee of European Banking Supervisors (CEBS) continues to advise the Commission on CRD implementation. It has issued two public consultations on additional technical guidance on the supervisory review process under the CRD, on management of the interest rate risk arising from non-trading activities and of concentration risk in March, and on stress testing in June. The proposals contained in these consultations (CP11 and CP12) complement earlier CEBS guidelines issued in January 2006. In addition, in April CEBS published its guidelines (GL10) on advanced model validation, following two consultations on this topic.

The decision of US federal banking regulators to postpone implementing the revised Basel Capital Adequacy Framework (Basel 2) in the US until January 2009 (a year later than EU roll-out of the advanced CRD options) and the political context in which this decision was made have received significant attention. The formal publication of a notice of proposed rulemaking (NPR) covering Basel 2 implementation in the US is awaited, although the Federal Reserve Board has agreed to the text of a release. As we noted in our November IRO, the US delay will have no impact on the European timetable for implementing of the CRD. In the light of the one year 'gap' between the US and the EU, we are continuing to discuss with the US authorities how we will deal with the practical problems that could arise for UK-based groups with significant operations in the US and US-based groups with significant operations in the UK.

5 For more information about our implementation of the CRD, including practical information for firms and details of industry advisory groups, see the relevant pages of our web site: www.fsa.gov.uk/Pages/About/What/International/basel/index.shtml

... Stakeholders should also note that several other legislative measures have moved forward in recent months...

Other legislative measures affecting the financial services sector are summarised below:

- In December 2005, the Commission published its proposal for a **Payment Services Directive**. The Directive seeks to open domestic payment markets to cross-border competition and enhance competition between payment service providers. The aim is for users to be able to make cross-border payments as easily, safely, efficiently and inexpensively as within national borders. It also seeks to create a level playing field and provide a consistent level of consumer protection and transparency within the market. The key driver behind the Directive is the delivery of the Single Euro Payments Area (SEPA). The Commission consulted in February on whether additional incentives were required to help deliver SEPA or whether self-regulatory initiatives would be sufficient. The Commission has called for the proposed Directive to be implemented by 1 January 2008, although the timetable is still under negotiation. The Treasury has not yet made any decision on the allocation of Competent Authority responsibilities, including any possible role for us.
- In May 2006, the Committee on Money Laundering and Terrorist Financing, a regulatory committee composed of Member States and chaired by the Commission, agreed the text of the Commission's Level 2 measure to implement the **Third Money Laundering Directive**. The text deals with the definition of a politically-exposed person, technical criteria for situations in which customer due diligence procedures may be simplified and criteria allowing Member States to exclude from the scope of the Directive persons and institutions carrying out a financial activity on an occasional or very limited basis.
- The Commission's consultation on implementing measures for the **Transparency Directive** ended in January. It has now published a draft implementing directive which deals, among other things, with procedural arrangements for the choice of the home Member State; minimum content of half-yearly non-consolidated financial statements; major related parties' transactions; maximum length of the usual 'short settlement cycle'; minimum standards for dissemination of regulated information; and criteria for assessing equivalence of various third country regulatory requirements. The draft implementing directive is

currently being discussed by ESC and European Parliament and is expected to be finalised in October.

At the end of March, we published a Consultation Paper on proposed changes to the Listing Rules for investment entities and on proposed changes to the Listing Rules and Disclosure Rules to implement the Transparency Directive. The proposed changes for investment entities replace the existing regime with a more principles-based approach to determining eligibility for listing. This would enable those employing a wider range of investment strategies, including those currently pursued by some hedge funds, to list in the UK for the first time. Appropriate investor protections would be maintained through revised and enhanced disclosure requirements. The implementation of the Transparency Directive will introduce rules on periodic financial reporting and major shareholding notifications and on the dissemination and storage of information. The final rules are scheduled for publication in October, about three months prior to the Transparency Directive's transposition deadline of 20 January 2007.

- We published a CP setting out our proposals for implementing the **Reinsurance Directive (RID)** in June 2006. Until now, there have been no EU directives specifically applicable to reinsurance business, although in the UK we have broadly carried over the requirements of the existing direct insurance directives to reinsurers. We intend to implement the RID in a way that will be mainly deregulatory, introducing the minimum requirements needed to implement the Directive.

Although the RID is primarily concerned with the regulation of pure reinsurers (firms that only carry out reinsurance business), some of the changes we are proposing will also affect direct insurers. In addition, the RID also allows Member States the option to establish an insurance special purpose vehicle (ISPV) market and our CP outlined our plans to introduce a fit-for-purpose regime for authorising and regulating ISPVs. Introducing an ISPV regime will allow insurers to access more diverse sources of capital and manage their capital more efficiently. This will provide an important contribution to our provision of the 'Regulatory Platform of Choice' for insurance.

- **The Regulation on information accompanying wire transfers** is expected to come into force at the start of January 2007. It is not yet clear whether we will need to make some technical changes to Handbook regarding this measure.

- **Unfair Commercial Practices Directive (UCPD):** The Department of Trade and Industry, which leads on this dossier, published its high-level consultation document in December 2005. We will consult on implementing UCPD for financial services in the October 2006 *Reforming COB Regulation* CP and, if possible, we will make any necessary changes to the Handbook (including deleting any rules which overlap with the Directive requirements) at the same time as the introduction of the new COB Sourcebook. We currently expect to propose only minimal changes to our rules.
- **Consumer Credit Directive (CCD):** Negotiations continue on the CCD. The Austrian Presidency held a policy debate at the Competitiveness Council on 29 May. Member States supported full harmonisation in principle, as long as the appropriate level of consumer protection is guaranteed. The Council referred the proposal back to the Council Working Group for further consideration. The DTI carried out a supplementary consultation in March 2006.

EU supervisory co-operation and the Lamfalussy Committees

The three Lamfalussy ‘Level 3 Committees’ – consisting of CESR, CEBS and CEIOPS – have all continued to make considerable progress in achieving regulatory convergence at a sector-specific level. It is equally important, however, that where issues span more than one sector, the committees are also able to collaborate efficiently to produce guidance that is consistent. Partly at our urging, the committees have published a common cross-sector work programme for 2006. This work programme builds further on the Joint Protocol signed by the three Committees in November 2005 and represents a welcome improvement in the approach to cross-sector issues.

CEBS and CEIOPS, with the support of the Commission and the Level 2 committees, have also recently established an informal committee, the Interim Working Committee on Financial Conglomerates (IWCFC), to conduct work on issues relating specifically to conglomerates. The IWCFC met for the first time in May and will now start reviewing the Financial Conglomerates Directive. This work will require the close co-operation of CEBS and CEIOPS.

Box 2

Callum McCarthy offers his views on the evolving role of the Lamfalussy Committees in EU regulation, drawing on his experience as a member of CESR.

It is recognised increasingly that we are entering a critical phase in the development of Europe’s regulatory structure for financial services. Many elements of the Financial Services Action Plan (FSAP) are now firmly in place and attention is now focused on whether a European single market in financial services can become a reality. While there are many factors that will ultimately determine whether Europe succeeds in this objective, the effectiveness of its regulatory structures has an important role to play.

In a European Union of 25 Member States and over 70 national regulators, the task of delivering an effective system of regulation is a challenging one, but we firmly believe that the Lamfalussy structure, if implemented to its full potential, is capable of achieving this. The key objectives of this structure – to streamline the legislative process and achieve regulatory convergence – are clear and have been widely welcomed. Levels 1 and 2 of the process create a common set of legislative requirements which have to be transposed by Member States. Level 3 is designed to achieve supervisory convergence through sharing of experience by regulators and the development of guidelines on interpretation and best practice.

The Lamfalussy structures are still developing (it is easy to forget how young each committee is, and how much time has been taken up by the task of defining Level 2 outcomes for the Financial Services Action Plan). As with any new initiative, there is still much room for improvement. We believe, for example, that there is both scope and – now the pressure of Level 2 work is abating – the opportunity to consider how regulators can collaborate more closely in their supervision of cross-border groups. The aim here should be to explore ways in which home and host supervisors can carry out their tasks more effectively, within existing legal frameworks, and impose less duplication and cost on firms.

We also believe that the Lamfalussy process would be strengthened if the Level 3 committees had the capacity and time to undertake some impact analysis in respect of their proposed advice to the Commission on Level 2 implementing measures. And at the other end of the policy-making process we strongly support a process of peer review to examine how national authorities have, at an operational level, implemented a particular measure in order to identify any gaps or inconsistencies that might need to be addressed.

A number of issues are common to the work programmes of CESR, CEBS and CEIOPS. We constantly need to ensure that there is effective collaboration. As reported in this IRO update, the three committees have recently agreed a common cross-sector work programme and this is supported by closer liaison between the respective Secretariats and regular meetings of the Chairs of the Committees. We welcome this.

Within CESR, we have been giving considerable thought to the development of a medium-term strategy and some refinement to our processes and procedures. The need for such a review was prompted, in part, by the realisation that CESR's role will change quite significantly. For the past four years, CESR's work has been heavily directed towards providing advice to the Commission, most recently in respect of the technical implementing measures under the Markets in Financial Instruments Directive. This has placed a heavy burden on all CESR members, both large and small, but the key elements of the FSAP are now largely in place. The challenge for us now, as a network of regulators, is to apply the new legislation in a consistent and proportionate manner.

As we enter this new phase in CESR's evolution, it is clear that the range of issues with which CESR could concern itself is, in principle, very wide. All the members are agreed that we need to be selective in deciding what to do, both to ensure that we can make progress and keep the demands on members within reasonable bounds. We are also mindful of the fact that we all have different powers, responsibilities and preoccupations and that this calls for a process of prioritisation that is based on principles that are rigorous and commonly accepted.

There is no doubt that we still have much work to do to deliver a truly effective system of European regulation. But I firmly believe that the Lamfalussy structure offers the best prospect for achieving the twin aims of relevant and proportionate regulation and meaningful convergence of regulatory practices. If there is the will and commitment to make this work, I believe the EU will be better placed to create not just a single market in financial services, but one which can remain internationally competitive.

Recent global regulatory issues

Basel Capital Framework and Core Principles

In November 2005, the **Basel Committee on Banking Supervision** (BCBS) published a paper on *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*. This document is an updated version of one initially released in June 2004 and incorporates additional guidance on applying the revised Framework (or Basel 2) to banks' trading activities and on the treatment of double default.

The BCBS is expected to undertake further work on the definition of regulatory capital. This work is necessary because changes in the treatment of expected and unexpected losses and of provisions under the Framework tend to reduce Tier 1 capital requirements relative to overall capital requirements. In addition, the Committee wishes to agree a set of capital instruments that are available to absorb unanticipated losses on a

going-concern basis. The BCBS has said that it will not propose changes prior to the implementation of the revised Basel Framework by member authorities.

In April, the BCBS issued for public comment updated versions of the *Basel Core Principles for Effective Banking Supervision* (1997) and the *Core Principles Methodology* (1999). The Core Principles have been widely used by countries as a benchmark for assessing their supervisory systems and for identifying the need for changes in supervisory practice. They are also used by the IMF and the World Bank when conducting Financial Sector Assessment Programs. A number of changes have occurred in banking regulation in recent years and experience has been gained with implementing the Core Principles in individual countries. The updating of the Core Principles to take account of these changes and experiences should ensure their continued effectiveness. In particular, the BCBS has adopted a new 'umbrella' principle recommending

that banks have integrated risk management systems across different risk types. The criteria for assessing interest rate, liquidity and operational risks have been further developed and those dealing with counter money laundering and terrorist financing, as well as fraud prevention, have been expanded.

Hedge funds

In terms of our policy work in this area, in March 2006 we issued two Feedback Statements: *Hedge funds: A discussion of risk and regulatory engagement* and *Wider-range Retail Investment Products – Consumer protection in a rapidly changing world*. Following the comments received, we plan to consult next year on widening the range of funds that can be marketed to retail investors to include, among other possible funds, funds of hedge funds.

At the same time, the **International Organization of Securities Commissions (IOSCO)** released a consultation report, *The Regulatory Environment for Hedge Funds: A Survey and Comparison*. This draws on the results of a survey of the regulatory approaches applied by 20 IOSCO members, covering, among other things, registration, disclosure, examinations and disciplinary action. The survey found that among respondents:

- none had a formal definition of the term ‘hedge fund’;
- hedge fund advisers are regulated in most jurisdictions;
- few regulators report significant retail exposure to hedge funds (although this might change); and
- the extent to which hedge fund-related fraud was an issue varied between respondents.

Dan Waters, our sector leader for Asset Management, is chairing work by IOSCO Standing Committee 5 on valuation of complex and illiquid assets. SC5 is currently working with industry experts to develop a set of principles representing good practice for valuations by hedge funds and their counterparties. Robust, impartial and transparent valuation policies and processes are the key to delivering equitable treatment amongst generations of investors.

In the United States, the Securities and Exchange Commission began operating a new mandatory registration regime for hedge fund advisers at the start of February. We have held discussions with the SEC on regulatory approaches to hedge funds and explored

ways to ensure that UK-based fund managers with US clients that came within the registration criteria adopted by the SEC were not subject to unnecessary duplicative oversight arrangements. However, as a result of the subsequent decision of the U.S. Court of Appeals in *Phillip Goldstein, et al. v. Securities and Exchange Commission*, in which the court found that the SEC’s rule in respect of hedge fund advisers was arbitrary and in violation of current law, the SEC will be re-evaluating its approach to the oversight of hedge fund managers⁶. We will be following this exercise and will liaise with the SEC and UK-based hedge funds to consider its possible implications.

Insurance issues

The **International Association of Insurance Supervisors (IAIS)** has issued a ‘Road map’ for a common structure and common standards for the assessment of insurer solvency. This sets out a work plan aimed at achieving much greater convergence in solvency systems internationally. The IAIS noted that a necessary first step in this process will be to improve substantially the transparency of existing solvency regimes and the financial condition of individual insurers, with work on convergence coming as a next step. But given the diversity of its membership, the emphasis in the near-term is focused on conceptual issues rather than an internationally-agreed solvency ratio.

Business Continuity

In December 2005, the **Joint Forum** issued: *High-level principles for business continuity*. The paper, which was prepared in response to a request from the **Financial Stability Forum**, provides a common benchmark across countries for developing business continuity requirements. It sets out six principles that are relevant to both firms and financial authorities and a seventh – the incorporation of business continuity management into financial oversight arrangements – that is relevant only to the latter.

Anti Money Laundering

As part of its task of promoting higher anti-money laundering and counter terrorist finance controls, the Financial Action Task Force (FATF) has continued with its programme of publishing mutual evaluation assessments conducted by FATF members⁷. In recent months, reports have been prepared on Ireland and

6 See *Statement of Chairman Cox Concerning the Decision of the U.S. Court of Appeals in Phillip Goldstein, et al. v. Securities and Exchange Commission*, SEC Press Release, 23 June 2006.

7 See http://www.fatf-gafi.org/document/32/0,2340,en_32250379_32236982_35128416_1_1_1_1,00.html

Sweden following those covering Australia, Belgium, Italy, Norway and Switzerland in 2005. An assessment of the United Kingdom will take place this year. To facilitate the mutual evaluation process, the FATF published a handbook for countries and assessors in February designed to help assessment teams and the examined countries that are participating in an AML/CFT mutual evaluation carried out by the FATF or an FATF-style regional group. It provides both procedural information and detailed instructions for performing an assessment.

Accounting

In February this year, the SEC used the occasion of the visit of EU Internal Market Commissioner Charles McCreevy to reaffirm its commitment to the ‘road map’ to eliminate by 2009 the SEC requirement that foreign private issuers reconcile their IFRS-based financial statements to US GAAP.

Regulatory co-operation beyond the EU

As is clear from the above, we participate actively in a range of international bodies – such as IOSCO and FATF – that bring supervisory agencies and national authorities together to discuss regulatory issues⁸. Our objective is to ensure that regulatory issues of global importance are identified and addressed in the most appropriate fora. We are also active in pressing for the adoption of more rational processes for prioritising issues, consulting with the industry and having high standards of governance and accountability among standard setters. At the initiative of the UK Government, the **Financial Stability Forum** has been encouraging sector standard setters to examine and improve the transparency and governance processes associated with standard setting.

International regulatory committees have a key role in identifying issues of common concern and promoting consistent international responses to these. To be effective in this it is important that the committees are able to prioritise effectively among the many issues they confront, to ensure that the most pressing market and regulatory failures are addressed in a timely way. Members of the **IOSCO Technical Committee** decided some time ago on the need to improve the processes by which they prioritise their work. We were delighted to be asked to take the lead in this. An improved framework was discussed and endorsed at IOSCO’s meeting in Hong Kong in June and this will be taken forward by the membership. As with any attempt at

evidence-based prioritisation, this improved approach will involve extensive judgement and certainly does not represent a mechanistic approach to determining IOSCO’s work programme. But it will help to sharpen debate and heighten still further IOSCO’s relevance in the global regulatory sphere.

In addition to our work in global groups, we also maintain extremely close bilateral relationships with major supervisors world wide. To facilitate bilateral communication with overseas regulators, we have concluded over 180 **memoranda of understanding (MoUs)** with international counterparts. These establish a framework for exchanging information between the signatories. In recent months, we have concluded an MoU with Dubai and have revised our MoU with the SEC. This was partly to take account of the SEC’s expanded role (under the new Consolidated Supervised Entity regime) as the global consolidated supervisor for a number of large securities firms.

In early June, our senior management, led by Callum McCarthy and John Tiner, held **two days of meetings with counterparts at the SEC** to discuss – and make substantive progress on – a range of supervisory issues of common concern. These included increasing collaboration to address proposed and potential trans-national ownership of exchanges as well as interactive data reporting, business continuity arrangements and hedge funds. These discussions have resulted in various work streams that will undertake further analysis. On the question of trans-national ownership of exchanges, Callum McCarthy issued a statement on 12 June to encourage discussion of the potential longer-term implications of any change of ownership of a UK Recognised Investment Exchange⁹.

Another area where we are engaging with US regulators on cross-border issues is the Commodity Futures Trading Commission’s current review of the conditions that could lead to foreign boards of trade (that is foreign exchanges) coming under the CFTC’s jurisdiction. At present, foreign exchanges accessing the US do so under ‘no action’ letters. The question under review is whether the scale or nature of the US activity should trigger a requirement to register formally as a CFTC-regulated exchange. As part of this work, Verena Ross (Head of our Market Infrastructure Department) participated in a CFTC open hearing in late June on this topic. We believe that the current approach, in which the CFTC defers to overseas regulators, so long as they provide a comparable level of regulation, offers the best basis for continued market supervision, and

8 The international committee structure was summarised on p18 of the November 2005 IRO

9 Callum McCarthy, Implications of ownership of a UK Recognised Investment Exchange by a US entity, FSA, June 2006.

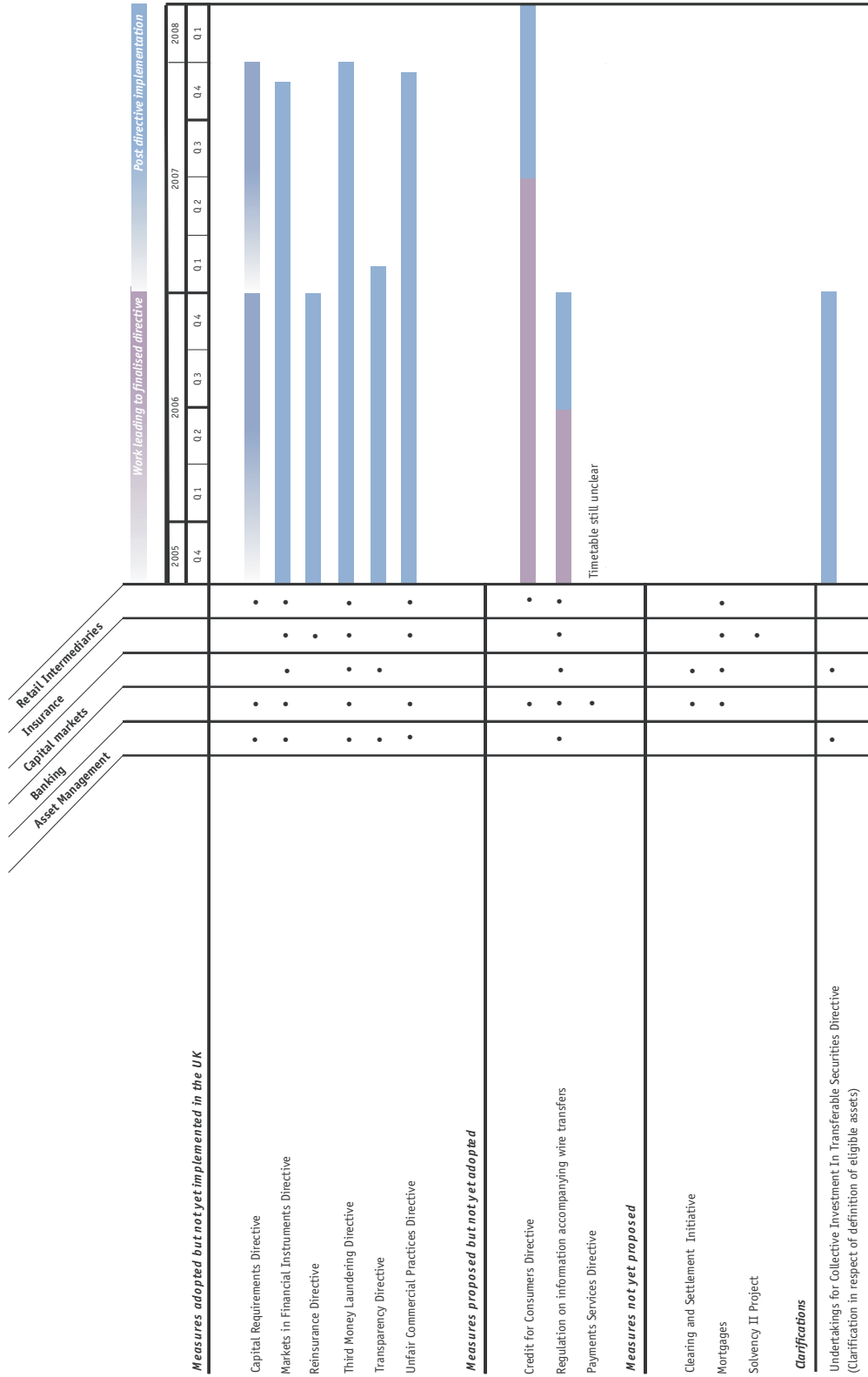
which is mirrored by the treatment of US exchanges operating in the United Kingdom.

National Audit Office value-for-money study

Following an invitation from the Treasury (under Section 12 of the Financial Services and Markets Act) the National Audit Office (NAO) has been asked to review our economy, efficiency and effectiveness in using resources when discharging our statutory functions. The review will cover five broad areas of our work, including our performance in influencing the development of international and EU financial

supervision. The NAO will also consider suggestions for improving our performance in the future. As part of any consultation that the NAO may initiate, we would encourage our stakeholders to offer their views and comments. The NAO has said that it aims to complete its report during the first half of 2007.

Directive timelines



The timetable for some measures are subject to change

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