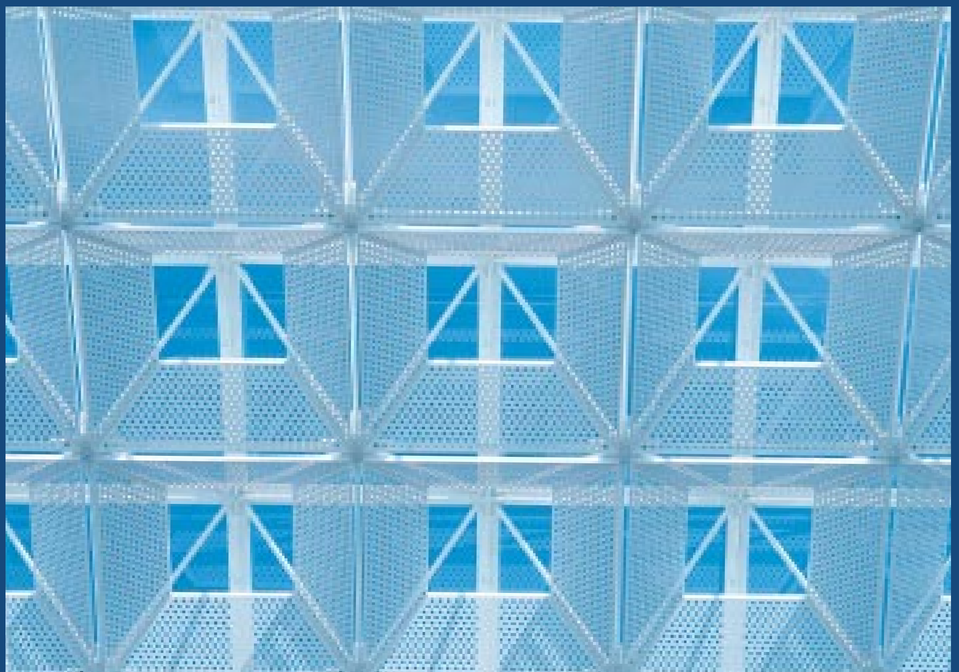
UK FS Regulatory Focus



The political hiatus created by 'no' answers to the referendum on the European constitution has drawn attention to the dependence of British regulation on Brussels. The Capital Requirements Directive ('CRD'), which may be promulgated before the end of 2005, will have a significant effect on prudential regulation for banks and investments firms for many years to come. The regulations which member states are required to implement under the Markets in Financial Instruments Directive ('MiFID') will similarly have a significant impact on the shape of Conduct of Business Rules in the UK for some time, including on the independence of risk and compliance functions. Notwithstanding the apparent ability of the European Securities Committee to reject advice from the Lamfalussy Tier 3 committee, CESR (the Committee of European Securities Regulators), the Tier 3 committees generally are of enormous importance, and banks in particular would do well to pay close attention to the various consultative papers emerging from CEBS, the Committee of European Banking Supervisors, on such issues as consolidated financial reporting, model approval and Supervisory Review. *(continued overleaf)*

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Summer 2005

PricewaterhouseCoopers

Editor: John Tattersall

Distribution: Kirsty Parker

If you would like to receive this newsletter regularly (by e-mail or in hardcopy) please e-mail kirsty.parker@uk.pwc.com

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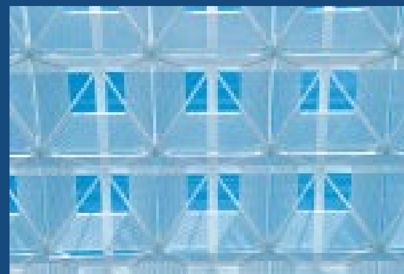

PricewaterhouseCoopers LLP's Financial Services Regulatory Practice comprises over 120 partners, directors, managers and staff dedicated to providing pro-active regulatory advice to authorised firms and other financial institutions within the UK, Europe and worldwide*. Our team blends the experience of former senior regulators, compliance managers, industry personnel and staff from an assurance/client-facing background, to provide clients with an unparalleled knowledge of the regulatory rules, codes of conduct and the prudential supervisory framework.

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Sensitivity at the FSA about the cost of regulation continues. We may well have to wait until the end of the year for the results of the review by the FSA and the Practitioner Panel announced earlier this year, though the firms to be covered by this review will no doubt be involved in detailed discussions with the FSA in the meantime. It is important that such firms give careful consideration to identifying the incremental costs of regulation that they have incurred, and indeed that there is senior ownership of the process. The FSA's sensitivity to the escalating costs can be seen in Sir Callum McCarthy's comments in his Chairman's Statement in the Annual Review published in June 2005: 'Our efforts have been devoted to finding means to restrict regulatory intervention to those areas where no market solution is possible, and where regulation has the prospect of doing good rather than harm'. There may be firms who question whether this has been achieved in the past but there is no doubting the sincerity of the statement.

One area of friction between firms and their regulator, the ARROW process for risk assessment of individual firms, may be eased as the FSA's proposed reform to the ARROW process comes into effect later this year. There is genuine desire at senior levels within the regulator to allow firms to discuss findings at close out meetings with those responsible for their assessment, and also to give firms a chance to agree the facts on which the recommendations for risk mitigation are based. It is in neither party's interests if the actions proposed in the ARROW letter are not accepted by firms as either valid or valuable going forward. To achieve the full benefit of the ARROW risk assessment process, the competence of the FSA staff in the relevant sector must be assured by core training within the FSA: in this context it is encouraging to see from the FSA's Annual Review 2004/5 that staff turnover is only 10.8%, and that the FSA is prepared to pay emoluments (excluding pension contribution) of over £100,000 to 190 of its key people, as well as investing heavily in their training. The industry has a strong interest in having the FSA staffed by able people, empowered to exercise informed professional judgement in their day-to-day supervisory activities.

The enforcement review under David Strachan reported on 20 July: this has recommended improved processes surrounding the enforcement division and the Regulatory Decisions Committee in the wake of the Legal and General case, and provided new ground rules for the enforcement division under its new director, Margaret Cole. It is to be hoped that the enforcement team will take Sir Callum's words quoted above to heart in considering whether to take enforcement action.

This edition focuses on some of the key issues currently facing firms: the implementation of the new 'market abuse' regime, the rules on bundled and softed commission, and MiFID; the outcome of the trading book review rules; and the FSA's initiatives to ensure business resilience at the heart of the financial community. It also looks at the impending focus by the FSA on payment protection insurance and on business conduct generally. Firms also need to read carefully the FSA's new pronouncements on hedge funds, stress testing and the confirmation and settlement of sophisticated derivatives (particularly credit derivatives): these will undoubtedly be the focus of further attention by their supervisors over coming months.

John Tattersall

Chairman,
Financial Services Regulatory Practice,
PricewaterhouseCoopers LLP

*connectedthinking

The market abuse regime in 2005

The Market Abuse Directive has arrived. After much consultation and debate, one of the cornerstones of the Financial Services Action Plan is finally being implemented across Europe. Change to the existing UK regime to implement the Directive has been required. New challenges are now being faced as the financial services industry strives for clarity in applying the features of the new UK regime alongside the differing interpretations of the same Directive being put into effect by key jurisdictions such as France and Germany.

Whilst the FSA has declared that, in broad terms, the effect of the changes to the legislation from 1 July 2005 is limited, because behaviour which used to constitute market abuse under the old regime will continue to do so under the new regime this statement does not reveal the whole picture.

New offences, less guidance

Legal and Compliance departments must now contend with a doubling in size of the offence structure from four to eight, and staff re-training is underway in many firms. Whilst the offence structure has become larger and more complex, the FSA has chosen this period of transition to remove a number of safe harbours which firms used to be able to rely on for guidance in interpretation of what was definitively acceptable as compliant behaviour in the market. Whether the Directive's concept of Accepted Market Practices achieves the same conformity of behaviours regulated by safe harbours remains to be seen. In the run up to implementation, CESR has been unable to attain the harmony that the Directive was meant to achieve, observing that common positions on Accepted Market Practices cannot be achieved when European countries still have different securities legislation.

New obligations

Further expansion to the existing regime has been achieved by the introduction of mandatory Suspicious Transaction Reports and new requirements to compile Insider Lists. More markets and products are caught under the new regime as the rules on disclosure and market conduct are cast wider than ever before.

Whilst investment banks lobbied hard for the FSA to simply replicate the Directive in its legislative changes, this campaign did not prove to be successful. The FSA has adopted its own approach to drafting changes to the Financial Services and Markets Act 2000, the FSA Handbook and HMT's regulations on research. The methodology adopted has been described by the FSA as 'intelligent copy out' of the Directive.

Some commentators have used this rather unfortunate label to criticise the FSA's approach as being nothing of the sort. In public forums, the FSA has defended its approach by stating that it has added value in implementing the changes by adopting a pragmatic reading of the Directive. The FSA has also sought to justify the removal of trading information safe harbours on the grounds that this is part of a wider trend of progress to reduce and simplify the size of the Handbook as per the long-standing demands which have been made by the industry since the previous market abuse regime was implemented in 2001.

Whilst most market practitioners would not agree that the removal of safe harbours is something they have been asking for, the changes are here to stay and firms now must turn their approach to ensure they have successfully implemented the required changes and that the new regime is becoming embedded in the business.

Practical challenges – defensive reporting

Firms now face the challenge of playing their own part in helping to enforce the market abuse regime due to the new requirements regarding the notification of suspicious transactions to the FSA. Firms which reasonably suspect that a transaction might constitute either market manipulation or insider dealing must notify the regulator without delay. In the past, most well run firms have, after conducting their own preliminary investigations, always notified the FSA as a matter of course. Spread-betting firms in particular have been quick to do so whenever they suffer a significant loss without explanation!

Wary of the unfortunate experience of the National Crime Intelligence Squad (NCIS) in being deluged with reports following changes to the anti-money laundering regime which saw a backlog of hundreds of thousands of reports which have yet

to be investigated, the FSA has, following consultation with CESR, privately and publicly made it clear that it will not tolerate defensive reporting of suspicious transactions. The threatened sanction is that firms making too many reports will face the scrutiny of supervision teams who will descend upon errant firms to 'sort out' this new aspect of regulatory reporting, which is not something the holders of the CF10 function are relishing.

Despite such a clear lead from the FSA on reporting, firms are mindful that the FSA has not and never will remove their regulatory obligation to have in place systems and controls of sufficient quality to ensure that firms:

1 Identify suspicious transactions; and

2 Make appropriate reports to NCIS and the FSA without delay.

The risks and potential cost of mixed messages

Whilst it is a pragmatic approach for the FSA to state that it is more interested in 'quality not quantity' when it comes to receiving suspicious transaction reports, the reality is that firms face a mixed message from the regulator. However much reassurance is given on public platforms by speakers who come and go, or supervisory teams with high levels of turnover, all firms know that when rule breaches are identified, cases are often escalated from supervision to enforcement in fairly short order. The following questions arise:

- Is the threatened sanction of supervision teams being deployed against a firm to improve the 'quantity and quality' of its reporting better or worse than risking an enforcement investigation into its systems and controls following a market abuse rule breach?
- Is anything other than zero an acceptable number of suspicious transactions reports for a director of compliance to 'sit on' for fear of being criticised by the FSA as being over-defensive in the approach to regulatory reporting? What limits, if any, are acceptable?
- Will firms adopt a risk-based approach using quantitative analysis to limit the number of transactions being reported? What limits are appropriate? Will the FSA definitively approve a quantitative risk-based approach as an appropriate control?

Taking a lead in implementing the new regime

Firms should decide their own answers to these questions by reviewing their appetite for regulatory risk using the same approach to defining other risks as part of their Risk Assessment Framework. Undertaking such a review enables a firm to objectively demonstrate and evidence that it is effectively considering its regulatory obligations to be a good corporate citizen observing both the Handook requirements of the regime and the non-defensive spirit that the FSA is hoping to achieve as the new regime beds down.

How far can technology assist with reporting?

Firms need to review and refine their existing surveillance systems and controls to assess whether they produce sufficiently refined results for compliance officers to begin to form a view over whether a transaction or series of transactions is suspicious.

In an ideal world, controls flag or even block potential issues before or as they are happening. Few firms, if any, can claim they achieve success with this exceptionally difficult task across the wide number of trading platforms and jurisdictions. Analysis post-transaction of information on trading activity in restricted listed securities, excessive price changes in watch list securities and look-backs following the announcement of a deal will always be the starting point.

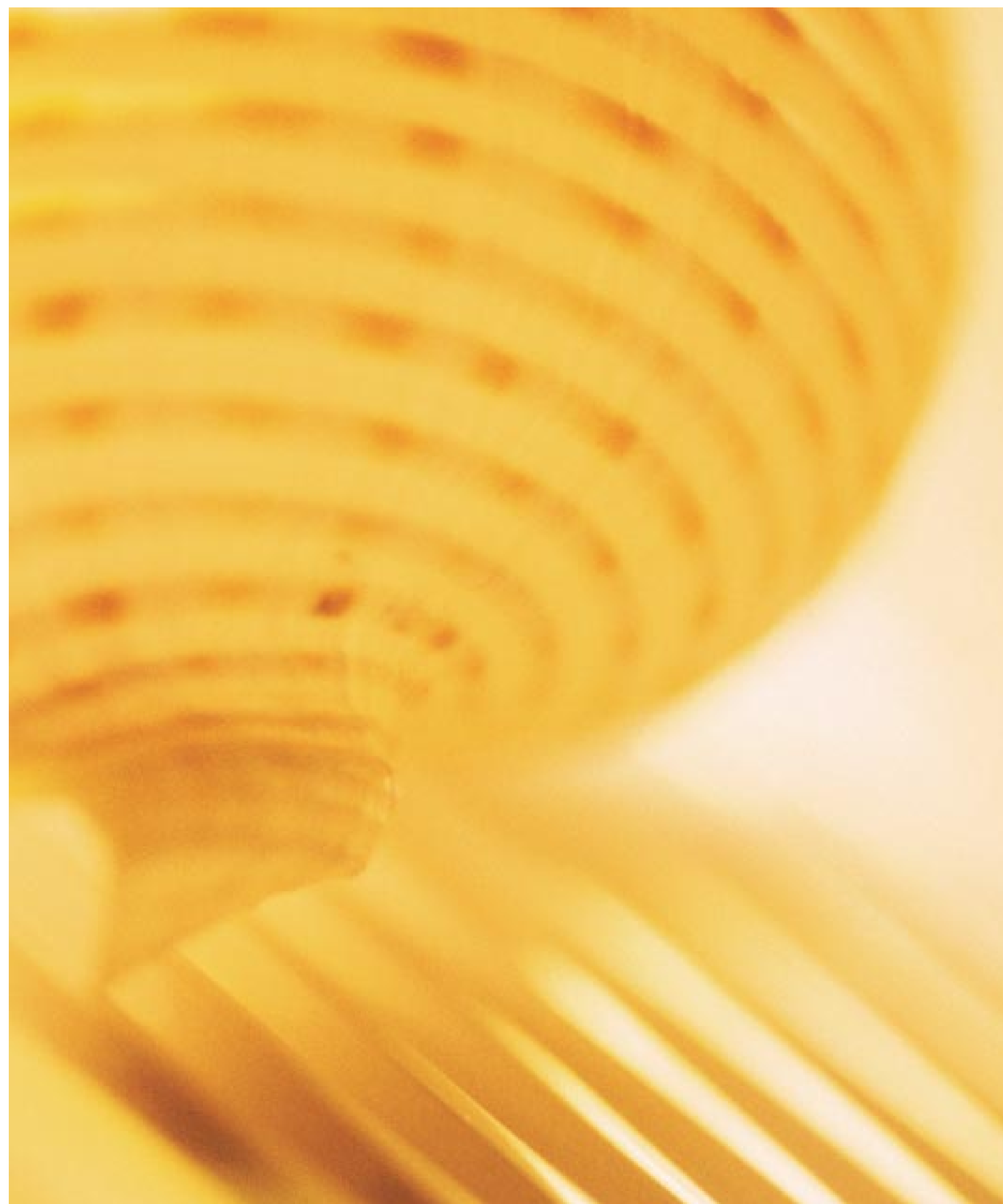
A wide perspective needs to be achieved in surveillance from proprietary trading to personal account dealing. Breadth of vision needs to be applied to attempt to capture structured products underlying a trade. Where information on stock, options, convertibles, swaps and structured products exists, the position needs to be pulled together into a coherent narrative of the trading event. This is often easier said than done as transactions are made across different IT platforms, often routed via different jurisdictions where they are housed and may involve corresponding transactions on different exchanges. Ultimately, it is the FSA which will only ever have the complete picture of suspicious transactions as it sits in the middle of and receives surveillance reports from the surveillance divisions of the London Stock Exchange and Euronext LIFFE, neither of whom share their own reports with each other.

Systems and controls answers lie in the risk framework

In the grey areas of trading, in a regulatory environment which has seen the removal of some trading information safe harbours, one person's definition of a suspicious transaction will inevitably differ from another's. Facing a lack of clarity from regulator(s) firms should take their own lead in managing the risks and challenges posed by the new market abuse regime:

- Technology undoubtedly assists in reporting as a first line of defence in identifying and addressing market abuse risks. Reviewing and refining existing technological tools used to detect suspicious transactions is important now that firms have new regulatory obligations to make suspicious transaction reports.
- A high quality of decision-making applied by individual compliance officers armed with sufficient levels of information to inform and support their judgement as to whether a transaction is suspicious or not will take a firm a long way forward as another line of defence.
- Firms must attempt to consider objectively, on the basis of the evidence available and the judgement of the individual concerned, whether or not making a report to the FSA is appropriate and whether they are being 'defensive' in their approach to reporting.
- The new regime should be applied as part of a firm's risk assessment framework, with recorded definitions of the appetite for regulatory risk in the field of investigating and deciding whether or not to make a Suspicious Transaction Report. A positive system with appropriate controls which sits within the overall risk framework will enable a firm to justify both its level and standard of reporting to the FSA from a 'defensive' standpoint and defend any allegation that it did not have an adequate system should an incident of market abuse slip through the surveillance net in the future.

For more information, contact:
Graham O'Connell on 020 7212 3826



MiFID: The end of the beginning

On 30 April 2005, the Committee of European Regulators (CESR) delivered its final technical advice document in relation to the Markets in Financial Instruments Directive (MiFID). This brings to a close the consultation process and leads us onto the development and implementation of final legislation for MiFID. Of course the Level 2 Committee, the European Securities Committee, is under no obligation to accept CESR's advice, and looks likely to make some amendments. Now, however, the real work begins!

In its final technical advice document, CESR dealt with the remaining areas of consultation in respect of MiFID. This final document confirms the scope of MiFID and covers a number of areas, including Best Execution, Suitability and the definition of investment advice where CESR feels there has been most debate during the initial consultation.

Scope of the MiFID

The final technical advice document confirms the following points:

List of Financial Instruments to include commodity derivatives

The recommendation by CESR that commodity derivatives will be included in the regime will result in a fundamental shift in the way in which firms in specific market sectors approach regulation. A key area of uncertainty that remains is the determination of whether a contract is or is not made for 'commercial purposes', and therefore falls within or outside the MiFID regime. Whilst CESR's Level 2 text attempts to provide guidance on where the divide exists, it is an issue that will need to be addressed by the FSA, as well as market participants and trade bodies to ensure a consistent approach across the marketplace.

Definition of investment advice

CESR has determined that advice will be considered 'investment advice' if it relates to the carrying out of transactions relating to one or more financial instruments. However the definition will include recommendations that relate to financial instruments generally as well as a specific recommendation. It should also be noted that the definition of investment advice will cover communications in which 'there is no explicit recommendation but where, taking into consideration all the relevant circumstances, an implicit recommendation is being made'. The implications of this broader definition will need to be considered carefully by firms advising corporations about strategy.

Substantive issues covered by CESR

In all there are approximately 17 substantive issues that financial institutions need to consider.

For FSA regulated entities, certain requirements will fit in with the existing regulatory requirements in the UK. For example, client order handling requirements, including the recording of trade details, aggregation and allocation of orders and prompt execution and transmission of orders should not present a significant additional regulatory burden for FSA regulated entities. However, FSA regulated entities will still need to consider that they can demonstrate compliance with these regulations to the standards set by MiFID.

The following requirements may need more attention from FSA regulated entities:

Pre-trade market transparency for regulated markets and MTFs

Elsewhere, Recognised Investment Exchanges (RIEs) and Multilateral Trading Facilities (MTFs) will need to ensure that they are able to meet the requirement for continuous publication of trading prices during normal trading hours. In this regard the exemptions set out in the Level 2 text are likely to need considerable consultation to ensure that an appropriately transparent, consistent and clearly understood approach is adopted by 'execution venues' such as the RIEs and MTFs in the UK.

Conflicts of interest

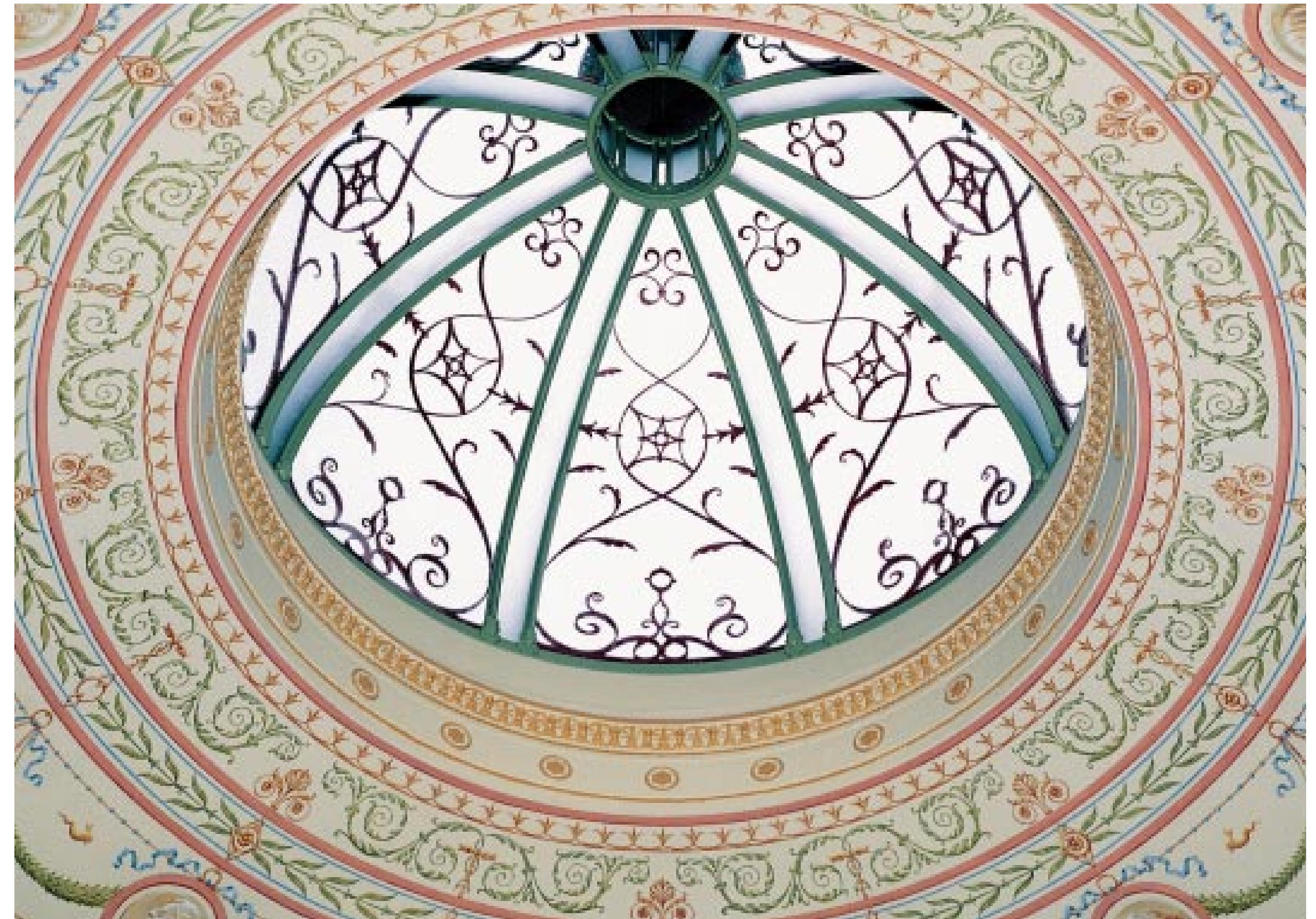
The CESR document also addresses the management of conflicts of interest arising from the provision of investment research, where the research is for external publication, and provides a number of minimum organisational measures to be considered by investment firms when setting out their conflicts policy. This includes the establishment of effective Chinese walls ('information barriers') between research and corporate finance, or any other business unit where a potential conflict may arise. In addition the research staff may not deal ahead of the publication of the recommendation, or trade against their recommendation. The research staff may not be involved in marketing initiatives or client pitches, where that would be inconsistent with their objectivity as a research analyst.

Suitability test

All firms covered by the Directive will be required to obtain information about their clients' investment experience in relation to the specific service or product being offered to the client. In addition the firm will be required to obtain other relevant information including the client's financial situation, income, assets and investment objectives. The firm must assess the suitability of 'each envisaged transaction', taking into account the client's investment objectives and their personal circumstances. The suitability test must be carried out for each personal recommendation or decision to trade.

Best Execution

MiFID requires that 'Member states shall require that investment firms establish and implement effective arrangements for ensuring that they take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement size'. In establishing its policy towards Best Execution, the firm must consider



the characteristics of the clients, the orders to be executed, the financial instruments to be traded and the execution venues at which the trades will take place. The firm's policy must include information on the different venues where the investment firm executes its client orders and set out the factors affecting the choice of execution venue.

In respect of execution venues, the Directive will require firms to 'provide appropriate information to their clients on their execution policy and obtain the prior consent of their clients to their execution policy'. Firms will also be required to monitor the effectiveness of their policy and, in particular, must assess, on a regular basis, whether the execution venues included in the order execution policy provide for the best possible result for the client. Firms will be required to review their execution policies and arrangements no less than every 12 months to ensure that their execution policy includes venues that enable them to obtain the best possible result for the execution of their client orders.

Next steps

This final technical advice is the conclusion of CESR's work in relation to MiFID. The next step will be for the Level 2 committee to conclude its response to CESR's advice, and for the EU to turn Level 2 text into formal EU legislation. It is likely that the MiFID requirements will be implemented through a mixture of 'regulations' (i.e. prescribed text which must be used by all Member States) and directives (i.e. non-prescriptive text, from which Member States will be required to develop their own requirements). For those requirements where directives are used, there is likely to be a gradual move towards supervisory convergence across the EU market (known as 'Level 3').

In the UK the FSA is currently analysing the impact of MiFID on its requirements and is expected to publish its proposals later this year.

The potential scope of changes required to policies and procedures, as well as certain systems and controls, for regulated entities under MiFID is likely to be substantial. It is therefore time for firms to fully digest the requirements set out in the CESR technical advice documents and begin to develop a strategy for meeting the new requirements.

For more information, contact: Stuart Crotaz on 020 7213 8576

Basel II – Trading Book Review: The final pieces begin to move into place?

When the Basel Committee on Banking Supervision issued the agreed text of the new Accord in June 2004, there was a key piece of unfinished business – a review of the trading book rules. There were two key concerns. The industry was concerned that the new Accord did not adequately deal with counterparty risk, the risk on unsettled trades and with double default. The supervisory community was worried that the trading book had been abused to house instruments that were not properly part of a trading book.

Given the interest of banks and securities firms in these issues, the Basel Committee and the International Organisation of Securities Commissions (IOSCO) set up a joint working group to take the review forward. A consultative paper was issued in April. In short the proposals were:

- There should be an option to calculate capital charges for counterparty credit risk for over-the-counter derivatives, repo-style and securities financing transactions based on expected positive exposure (EPE);
- Cross-product netting arrangements should in principle be recognised for risk reduction purposes, subject to meeting strict criteria;
- Double default effects for covered transactions should be recognised, not just for trading book exposures but also in the banking book. However, to be eligible, protection providers must be financial firms with a credit rating of at least A-;
- Firms can, for some limited types of transactions, adopt a maturity of less than the one year that is normally stipulated in the internal ratings-based approach;
- Certain instruments should be excluded from the trading book;
- Where a bank has permission to use VaR to calculate specific risk, the specific risk model must now explicitly capture event and default risk; and
- There should be a specific capital treatment for unsettled and failed transactions that encourages the use of Delivery Versus Payment ('DvP') systems and considerably increases capital requirement for fails.

It should be noted that although called a trading book review, the proposals on counterparty risk and double default are equally applicable in the banking book.

Consultation closed at the end of May. The thrust of comment was that regulators were being unduly conservative. On closer examination it became clear that – on issues such as the trading book exclusions and the modelling of specific risk and on the use of cross-product netting – there was a good deal of convergence on the substance, but that supervisors had used language that was either insufficiently principles-based or that lent itself to an unduly harsh interpretation of their intentions.

The final paper was issued on 18 July. The main outcomes on the points for contention were:

- Trading book exclusions and specific risk modelling – as expected, and as pressed for by the industry, supervisors have adopted a principles-focused approach;
- Unsettled transactions – regulators have retained the approach set out in CAD1 for DvP transactions. For non-DvP transactions, a capital charge will be levied from the day after the failure to settle, with the exposure deducted from capital if the transaction remains unsettled after the fifth day;
- Cross-product netting – the policy and criteria have been reworded so that they are no longer expressed in terms that suggest that they are unachievable: national supervisors should now be able to approve more cross-product netting arrangements; and
- Double default – as expected, regulators continue to insist that protection providers should be of very high quality. This means that a credit derivative purchased from a house that is rated at less than A – will not have the same regulatory capital reducing benefits that the same product purchased from a house that does.

The final version of the trading book proposals will now be incorporated into the Basel II framework before its implementation in G10 countries and in the EU.

This means, in the EU, that the proposals must be incorporated into the Capital Requirements Directive (CRD) currently being debated by the European Parliament. It is already too late for these amendments to be considered by the Economic and Monetary Affairs Committee of the Parliament. However, it is intended that the results of the Trading Book Review will be incorporated intothe CRD when it comes up for consideration at the plenary meeting of the Parliament in Strasbourg in September.

This should be the last major piece of the Basel Accord, and its impact will be assessed in the QIS 5 that will take place later this year. Whether it is, in fact, the last piece will depend on whether the US comes back to the table seeking amendments to the Accord following the results of its QIS4 and the subsequent debate that has taken place there.

For more information, contact:
Richard Quinn on 020 7804 9991

Protecting the brand: The evolving role of the compliance function and the challenges for the next decade

At the end of May 2005, PricewaterhouseCoopers published the results of an international study into the evolving role of the compliance function in financial institutions. The study covered banks, insurers and securities firms in 17 countries, and was undertaken through face-to-face interviews with senior compliance executives from 73 internationally-active and major domestic institutions.

Respondents expressed concern about the increasing complexity of the regulatory environment. When financial institutions are operating across borders and the same business is located in several jurisdictions this complexity is compounded. It would appear that compliance functions can find themselves stuck between management's belief that the function plays a pivotal role in managing reputational risk and a rising expectation bar on the part of regulators and other stakeholders.

Given this, compliance functions could be forgiven for attempting to rein in the scope of their responsibilities. Instead the study showed that the role of the compliance function is perceptibly expanding along a spectrum ranging from a 'police officer' to a trusted advisor to business and management. Generally speaking, compliance officers seem prepared to rise to the challenge: but there are some issues on which they will need to focus.

Defining compliance risk and the role of the compliance function

'Compliance risk', in its broadest sense, encompasses anything from tax, through health and safety, to conduct of business rules. Non-compliance in any area could damage an organisation's reputation with stakeholders, including the public at large.

Management needs to gain a holistic view of the organisation's risks – business, market, operational and compliance risks – within the context of prevailing regulations, and put in place policies and internal control processes and procedures to manage these risks effectively.

A clear delineation of its responsibilities within the overall control framework – an effective mandate from the board and senior management – is essential for the compliance function. For example, it is important to clarify who monitors transactions on a daily basis, who then checks that this process is working effectively, and who ultimately determines whether it operates well in the context of overall compliance activities. The report provides examples of how organisations are targeting this delineation.

Clearly, an understanding of what differentiates the compliance function from other functions is also important. Its role needs to be both 'real-time' – monitoring transactions as they occur – and forward-looking.

Risk-based compliance risk management

As with other risks, managing all compliance risks to an equivalent extent would be unnecessary, costly and inefficient. 41% of study respondents indicated that their organisations are increasingly adopting a risk-based approach to compliance risk management.

However, there was limited evidence of organisations undertaking a comprehensive assessment of the compliance risks they face – throughout their operations – in order to implement effective risk-based compliance management processes. Furthermore, a risk-based approach requires initial risk assessment, and iterative reassessment. On this point, the study revealed several potential causes for concern, including:

- The compliance function's access and/or reporting to the board was not always direct or frequent, even though changing regulations, together with changing stakeholder expectations, suggest the compliance risk profile should be kept constantly under review by both management and the board.
- In parallel, compliance officers often showed limited awareness of the needs of the broader range of external stakeholders, that is, beyond the regulators. For example, very few respondents felt that the compliance function's goals should incorporate protecting customers' interests or building client

confidence in the organisation (9% and 10% respectively). Even in terms of regulators, compliance officers were not always involved in monitoring regulatory developments and assessing their impact on the business, nor extensively involved in interfacing with the regulator.

A risk-based approach recognises that breaches are not totally avoidable in complex regulatory environments, but it is essential to reduce the chances of such incidents occurring, and to mitigate their impact when they do. The study revealed that many organisations are focusing on one key mitigating factor – taking steps to ingrain and/or strengthen their compliance culture.

To do this, some organisations are relying heavily on global compliance policies to promote common appreciation of their internal compliance requirements. However, such policies, often derived from home office regulations, can seriously downplay the intricacies of local regulatory requirements. Recognising this, other organisations are now rationalising their approach, keeping global, generic policies in only a few selected areas (such as anti-money laundering, conflicts of interest and know-your-customer requirements), and encouraging significant tailoring to local rules. The approach of the compliance function here, though, has to be balanced against local societal and business receptivity to the compliance culture. In certain business areas, or geographic locations, the compliance function needs greater emphasis on 'policing' than 'counselling'.

A compliance culture is good but compliant behaviour is better. These are not necessarily the same thing. People may want to do the right thing, but be hindered by practices and processes not designed to be inherently compliant. With changing regulations and indeed ethical expectations, practices and processes that were compliant in the past may no longer be. A patchwork of legacy systems and business processes and internal controls geared towards outdated ways of doing business cannot achieve optimal compliance results, however strong the compliance culture.

The growing role of the compliance function as a trusted advisor in new business ventures, albeit transactions, products, markets or acquisitions, suggests increased recognition of the benefits of being compliant from the outset. Nevertheless, the extent of the compliance function's involvement ranged from a veto possibility to just being informed. Concerns were sometimes raised about the pragmatism the compliance function displayed – business was better at finding workable compliant solutions. Also, the study showed that only 30% of respondents were systematically involved in IT systems development or upgrades, raising the question of how many projects have to go back to the drawing board when they are found to be non-compliant.

Understanding the value

Helping the organisation to avoid mistakes is the key role of the compliance function. However the majority of respondents stressed the difficulties of measuring the potential damage of events that did not happen.

Compliance officers realise that not quantifying the value – the return on the investment in effect – could relegate the compliance function (and compliance generally) from management's priority list. Amongst international institutions, increasing consideration is being given to the means by which to measure the value. Some organisations have been using generic performance indicators for some time, but are looking to improve their granularity. The report highlights certain measures currently being used: both 'logical measures' and 'inverse logic measures', but this is an area where more work is needed.

Inherent conflicts of interest?

Operating along the spectrum of 'police officer' to 'counsellor' can create conflicts of interest for the compliance function. It also presents challenges in terms of the skills set of compliance officers and the compliance function more generally.

Many respondents stressed the personal qualities of the compliance officer as key to managing potential conflicts of interest, including discretion, neutrality, independence of judgement, professional knowledge and experience of the business. Respondents, however, flagged the 'safety valves' needed to manage potential conflicts of interest, including independent audit reviews and internal alert programmes. Perhaps the most significant of all the checks is the configurations of the compliance function itself, its communications and reporting lines, and the effectiveness of escalation procedures. The compliance functions may be:

- Decentralised (with compliance staff embedded in the businesses having dotted line reporting to the compliance function);
- Centralised (direct reporting within the compliance function); or
- A combination of the two.

To be appropriate the configuration selected needs to take into account the strength of the compliance culture overall within the organisation (or part of the organisation), the evidence of compliant behaviour, the nature and complexity of the business, and the business and societal backdrop.

Compliance officers, in the years to come, need to focus on the 'professionalisation' of their function, developing compliance associations or institutes in order to provide both an independent, external voice through which to converse with management and regulators, and a forum for improving their profession generally.

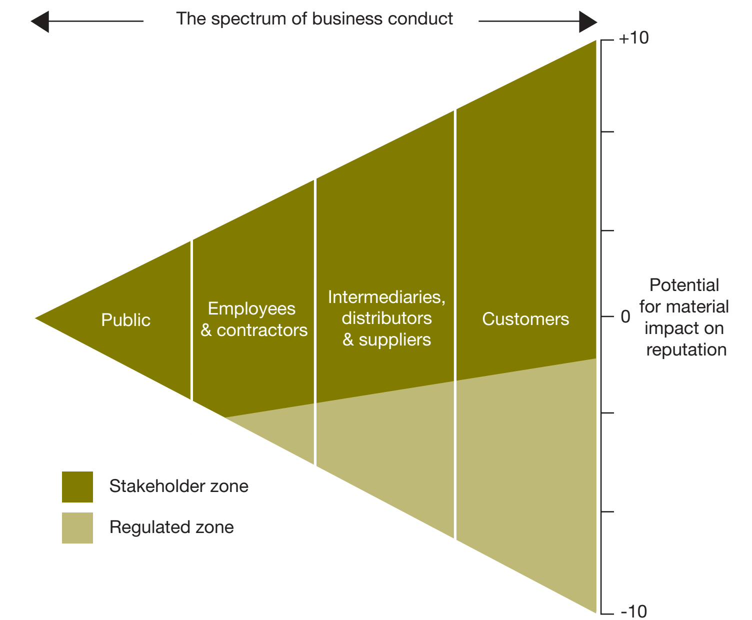
So... the future

The role of the compliance officers and functions is likely to continue to evolve in the coming years. One can anticipate ongoing convergence in terms of the goals and modus operandi of the compliance function – internationally and cross-sectors – with growing recognition of its potential benefits as both 'counsellor' and a 'police officer'. Compliance functions can play a critical and unique role in helping management ensure the safety and soundness of operations. However, determining the responsibilities of the compliance function will remain a question of balance: weighing the 'police officer' and 'counsellor' roles against the organisation's increasing ability to operate compliantly.

For more information, contact:
Wendy Reed on +32 2 710 7245

Business Conduct – The need for self-regulation

Conduct failures surround us. In public and private organisations, collective and individual misdemeanours abound. Personal or organisational conduct is the single most important factor influencing trust and confidence, and so reputation. It is increasingly recognised that reputation can no longer be simply inherited; it is an asset that needs constant, structured and conscious management. Yet rarely is business conduct (or indeed reputation) an explicit item on the management agenda; standards at best usually remain high level words of aspiration and actual performance is seldom able to be articulated and demonstrated.



The challenge originates in the subject

Conduct has no limits. It applies to every interaction with an internal or external party (this includes the human and physical environments). Judgements on suitability of conduct are subject to individual interpretation and, further to this, are affected by the personal position within the interaction (for example the customer conclusion on the suitability of conduct may be entirely counter to that of a shareholder evaluating the same decision). Furthermore, conduct does not fit neatly into organisational structures, it cuts across divisional and department boundaries with abandon.

Regulators have responded

The FSA's principles have been in existence for a considerable time. The SEC (through Sarbanes) and wider governance rules make implicit and explicit reference to business conduct. Through these statutory instruments there is increasing focus on developing a structured and demonstrable response to conduct. Although the responses are still work in progress needing more time to develop, there are some signs that conduct is being addressed with a response of 'form', which could prevent a response of 'substance'.

This was not the intent of the regulators. Their goal was to catalyse a substantive reaction by raising this issue up the regulatory agenda in the form of principles. In the short term a response of form will be commended but there will be an expectation that this materialises into substance over time and so effects some changes in practices and behaviours. There are some early indications that this expectation has not been fully appreciated.

From regulators to investors… to management

This is a difficult space for regulators to be prescriptive – law works best where there is a wrong and a right. The potential for so many permutations creates some dependency on the emergence of case law and further regulation is unlikely to be helpful except to stipulate details in specific areas.

The investment community has recognised the gap and its own direct self interest. Through increased inclusion of extra financial information in their research and valuations, and consideration of quality of management in determining stock ratings, investors are cutting to the heart of the challenge and putting responsibility onto companies to identify and manage material issues. Those organisations that respond with both form and substance should capitalise through improved stock rating, higher share valuation, greater investor confidence and so improved access to, and cost of, capital.

Conduct needs to become a core, explicit issue for internal governance. Management needs to accept accountability for defining what constitutes appropriate conduct and making sure it is achieved. Management decisions are essential to achieve a conduct outcome that balances conduct expectations with the fundamental need to secure sustainable commercial success. Executive and non-executive directors and senior management cannot afford to leave conduct as a matter for others.

For more information, contact:
Tina Trickett on 020 7804 2569

Is regulation good for business?

Financial services regulation is usually considered from the viewpoint of the customer but is regulation good for them? There are clear benefits in a number of respects. Prudential regulation minimises the chance that they lose money in a bank or insurance company, and it should also minimise the risk of a systemic collapse which brings damage to the economy.

Conduct of business rules ensure that customers are treated fairly both as they buy a product and throughout its life. This is of particular importance in the financial arena since financial products are different from most others. Their performance can be influenced by the provider after purchase, they are complex and often opaque, the outcome may be unknowable in advance, and they are purchased infrequently but impose a significant cost if they turn out wrongly. Indeed a customer may be treated unfairly and not know it.

Addressing these problems with regulations always implies a restriction of competition. And restriction of competition usually affects the best firms the most. So it might appear that regulation to protect consumers damages the best firms the most.

Or does it? If there are no regulations bad firms may behave opportunistically, betting on not being found out. Moreover, unbridled competition can lead to firms taking practices and products close to the wire. If this behaviour occurs and is later exposed, consumers, unable to differentiate properly between good and bad firms and products, will view all firms and products as equally culpable and the whole industry is damaged.

If the correct balance of regulation is found between competition and regulation, it is the best firms which have most to gain from regulation. So, in that sense, regulation can be good for business.

None of this addresses the question of the level and cost of regulation. Not all risks should be treated with equal weight and in wholesale markets the information asymmetry arguments are weaker or absent, but public interest reasons for maintaining efficient and orderly markets come into play.

There are other, positive effects for business. Firms are known to have been established in London because they wanted to be able to say to clients that they meet the standards of a world-class regulator, even if their practices would have met UK standards wherever they were located.

Which leads to a paradox. The UK is viewed as having one of the best regulatory systems in the world. But it has also had a series of regulatory failures in most parts of the market: insurance failures, life assurance and pension mis-selling, split cap trusts, Equitable Life, BCCI. Are there really more failures, or do we, and our regulators, deal with them in a more open, perhaps too noisy way?

There is some evidence that, in terms of changing firms' behaviour, the announcement by a regulator of concern about a particular practice or class of business, accompanied by immediate follow-up with firms' management, is more effective than the announcement of a large fine. The latter can be dismissed by other firms as irrelevant since it usually relates to events months, if not years, before. And it can lead to customers turning away from a sector or product that may be suitable for them.

Whatever the answer to the last question, the answer to the original question is that regulation is not necessarily good for business, but that good regulation is good for good businesses, and for customers.

For more information, contact:
Phillip Warland on 020 7212 6345

Payment Protection Insurance ('PPI') – the balloon is inflating

'We recommend that once the transfer of responsibilities for insurance regulation to the FSA has been completed the FSA should begin an investigation into the selling of Payment Protection Insurance. This should include the safeguards in place to prevent the mis-selling of PPI to customers who would not be able to benefit from it due to exclusions, how more competition could be introduced into the market, and how the provision of information to consumers could be improved to allow better informed choices about whether to take out PPI and about which policy is appropriate for individual circumstances.' The Treasury Select Committee Report (5 April 2005).

The publication of the above report is an example of the unprecedented scrutiny that PPI has attracted in the last six months. To put this into context PPI is being debated by all the industry stakeholders including consumer groups, regulators, trade bodies, the Competition Commission, the media and investment analysts. The media comments on PPI are increasing month-on-month.

What is PPI?

PPI, also known as Creditor Insurance, is an insurance product, sold as a package with unsecured loans, mortgages or credit/store cards. In a case where the borrower becomes sick, unemployed or has incurred an accident that prevents the claimant from working, the insurance will make repayments towards the loan up to a pre-specified amount over a pre-specified period.

Why is PPI in the spotlight?

Despite the benefits of PPI, there are three main areas under scrutiny:

- Potential mis-selling;
- Treating Customers Fairly; and
- Competition, product margins and commissions.

An interesting theme that runs through all of these issues is disclosure and transparency, which for obvious reasons would improve consumer awareness about what coverage they are buying and its cost. A secondary impact of this greater transparency, disclosure and more informed consumer buying would be an increase in the propensity for consumers to shop around to purchase the best value product, possibly unbundled from the underlying credit sale.

The short-term focus appears to be on potential mis-selling and fair treatment. Pressure from various stakeholders, including politicians, has prompted the FSA to put the selling of PPI to the top of its list of emerging financial services market risks. In addition, PPI has been under increasing scrutiny from the national press for being overpriced and the

Competition Commission has extended the review of store cards to include PPI. Many companies are grappling with understanding what Treating Customer Fairly means in the context of PPI. However, as TCF principles are likely to impact how PPI is sold, marketed, priced and how claims are handled, they cannot be ignored.

What is the potential impact on the PPI industry?

To put into context the potential impact on the PPI industry, we believe that there are three possible industry scenarios:

a) Status quo;

b) Product meltdown; or

c) Product overhaul.

If the current scrutiny from the various stakeholders is short-term in nature and the current regulatory threats are successfully rebutted by both PPI product providers and distributors without any significant operational change then the status quo would be maintained.

The product meltdown scenario could occur if there is a significant loss in consumer appetite for PPI as a result of sustained adverse media and consumer group coverage. This may at first appear sensational, but interesting parallels can be drawn with endowment sales which have fallen dramatically over the last four to five years causing a fundamental shift in the life assurance market. In the event of this scenario, we would expect the sales of legacy PPI products to fall dramatically and there to be a radical shift in consumer behaviour to buying new 'substitute' untied protection products and the emergence of new 'substitute' channels of sale.

Product overhaul would be required if the current regulatory and consumer environment requires remediation and significant change in all, or part, of the following areas: product design, pricing, marketing, sales process, claims handling, remuneration, disclosure etc. As a result this may lead to lower PPI volumes and more pressure on margins as consumers are making more informed decisions and greater transparency increases competition. We would also expect a degree of migration from the legacy PPI products to the new substitute protection products and channels of sale.

In addition to the regulatory and consumer environment, any challenges arising from the above scenarios may be further compounded by any deterioration in the economy and the subsequent impact on unemployment. Recent reports by the UK lenders indicate that consumer bad debt is on the increase, which may be an early indication that claims ratios are on the rise.

What are companies doing to respond?

The eventual outturn of the PPI industry is, of course, all conjecture, but what are companies doing to prepare and respond to the current environment? There are three emerging positions being taken:

a) Continuing to reap the margins and worry about the adverse scenarios if they arise;

b) Preparing a robust defence and addressing gaps relative to best practice; or

c) Leading the market by researching the development of new business models and strategies for radically different PPI and alternative protection products.

Companies are now taking action; a CEO of a UK banking group advised us recently that for them the regulatory risk and bad publicity from PPI is considered the number one risk to group profits. To this end, most companies have done some risk assessment on the potential impact on their PPI profits, but few have included the product meltdown scenario which, for most distributors, would elevate the issue to the board agenda. However, the recent interest in PPI from the city analysts and the potential knock-on impact for share prices is likely to keep PPI on the senior executives' radar.

As a general rule, the product providers are being more pro-active and are considering the latter two options, whilst the distributors are naturally more resistant to change that may threaten the existing PPI profit stream.

Each of the approaches identified above carries its own risks and potential rewards however, firms should now be fully analysing these risks, and understanding the profitability of the product across the entire economic cycle, both from an insurer's and distributor's perspective. They should also be looking to design solutions to increase profitability of the current book as well as the profitability of any new business given the changed environment. In addition, management information should be designed to monitor and control the risk and performance of your creditor business, including the critical controls over potential mis-selling.

The balloon is inflating, but there is plenty that can be done to avoid a nasty bang!

For more information, contact:
Vincent Branch on 020 7804 3218 or
David Morey on 020 7804 2684

Are you prepared for the unexpected?

The Commissioner of the Metropolitan Police is on record as saying that London was likely to experience a terrorist attack. Earlier this month that expectation became a reality. Last month, the National Infrastructure Security Coordination Centre ('NISCC') warned UK businesses about an 'industrial strength' hacking attack intended to covertly gather and transmit sensitive commercial information about companies and/or their customers. Coupled with the ever present risk of accidental damage, it is clear that UK businesses need to be prepared for a wide range of threats that could disrupt critical business activity.

The Civil Services Contingency Secretariat is responsible for coordinating the activities of organisations considered critical to the national infrastructure. In the financial services sector the responsibility for resilience rests with the Financial Services Authority (FSA), the Bank of England and HM Treasury, collectively known as the Tripartite.

The Tripartite has been active in promoting resilience in recent years through work in Market wide exercises performed in 2002 and 2004. However, until now a more detailed health check of the financial sector's resilience and recovery capabilities had not been undertaken. In January 2005 the Tripartite set about changing that. The FSA is leading a Resilience and Recovery Benchmarking Project, the objective being a detailed assessment of the readiness of key financial services participants to withstand major operational disruption.

Other countries, most noticeably the USA, have also recognised the importance of resilience and recovery to their financial markets and undertaken some assessment of their own financial services organisations' capabilities in this area. The UK exercise extends this by assessing the capability using a comprehensive online questionnaire.

The Resilience Benchmarking project will:

- Establish what the levels of resilience are in the financial services sector;
- Assess the effectiveness of financial institutions' Business Continuity Management; and
- Determine whether improvements are needed and make proposals for how this might be achieved.

Approximately 60 key firms and market infrastructures are participating in the exercise. The criteria for selection were those firms or infrastructures whose ability to respond to major operational disruption could undermine critical elements of the UK's financial sector. Indeed, the scope of the exercise focuses on what is 'in the pipeline', with wholesale payments, settlement and trade clearing the highest priorities. The participants include major clearing and investment banks, exchanges and providers of liquidity to key UK financial markets.

The importance of Business Continuity Management (BCM) is something the FSA has recognised for some time. It is already a common theme in the FSA's Risk Mitigation or ARROW Program for most regulated financial institutions.

The results of the Resilience Benchmarking project will help the FSA understand the extent to which the UK financial markets are prepared for major operational disruption. Using this information they will be better placed to have constructive conversations with organisations on the need for improvements. Together with the training provided to FSA line side staff it will also ensure the FSA have better information on which to base visits under the RMP or ARROW programs.

The Resilience Benchmarking project will lead to the publication of a Tripartite discussion paper in December. The paper will set out significant observations from the exercise and help inform a wider community about the levels of resilience and recovery of the financial markets' most significant participants. Another key area of focus for the survey is to identify common dependencies for market participants. Such dependencies may be with other participants, but equally may include third parties such as Telecomm providers and providers of disaster recovery facilities.

The exercise will help raise the levels of resilience and recovery in the financial market place. It will also provide participants with information that will help them focus their business continuity activities on the areas where attention is most required.

For more information, contact:
Andrew Beard on 020 7804 3971
or John Bromfield on 020 7804 2823

Investment managers get soft with brokers!

In March 2005 the FSA published its Consultation Paper 05/05 'Bundled brokerage and soft commission arrangements: proposed rules' which looks like bringing to a close the debate in the UK on the use of bundled brokerage and soft commissions arrangements which has been running since the Myners report on institutional investment of March 2001. The market reacted slowly following the Myners report, and whilst some pension funds reviewed their arrangements many did not. In April 2003 the FSA claimed that bundled brokerage and soft commission arrangements resulted in incentive misalignments between investment managers and their clients which created a conflict of interest. Following heated debate the industry agreed with the FSA that it would develop an approach to improved transparency and accountability. A disclosure code was created through work led by the Investment Management Association ('IMA') and involved the National Association of Pension Funds and the London Banking Association. This is referred to as the IMA code.

The draft FSA rules and the IMA code work together to try to give investment managers better incentives to make efficient decisions about the purchase of trade execution and other services (such as investment research), and are fully accountable to their clients for those decisions. The FSA proposes that investment managers:

- Limit the use of dealing commission to the purchase of 'execution' and 'research'; and
- Give their clients better information about the respective costs of 'execution' and 'research', and the overall expenditure on these services.

The FSA has said that investment managers should also instruct brokers to provide clear payment and pricing mechanisms that enable individual services to be purchased separately. The proposals apply to customer transactions in relation to shares as well as share-related warrants, options and certificates representing securities (and rights to or interests in these investments). The proposed rules do not apply to fixed income investments, but the FSA promises to revisit this if it identifies similar conflicts of interest.

Key to this regime are the definitions of 'execution' and 'research' goods and services. In their draft rules the FSA gives guidance on the goods and services which may fall outside their definitions.

Execution goods and services are those linked to arranging and concluding specific (or a series of related) investment transactions and are provided between the investment decision and the point of conclusion of the investment transactions.

Research goods and services are those that are capable of adding value to the investment decisions by providing new insights that inform the investment manager when making investment decisions about customer portfolios. They represent original thought in the critical and careful consideration and assessment of new and existing facts. Such research needs to demonstrate intellectual rigor and analysis/manipulation of data to reach meaningful conclusions.

It will be for each firm to put in place processes to establish reasonable grounds to satisfy themselves that these definitions are met and to build up their precedents of what is appropriate. They will also need to establish operational controls to ensure that the processes operate effectively. Compliance will also need to consider the relative risk of these processes and their approach to monitoring.

Initially, and at least annually thereafter, investment managers must make disclosure to their customers of their use of dealing commissions to purchase goods and services, providing details of those related to 'execution' and those related to 'research'. The FSA expects firms to follow the IMA code (or other industry code) in making its disclosures.

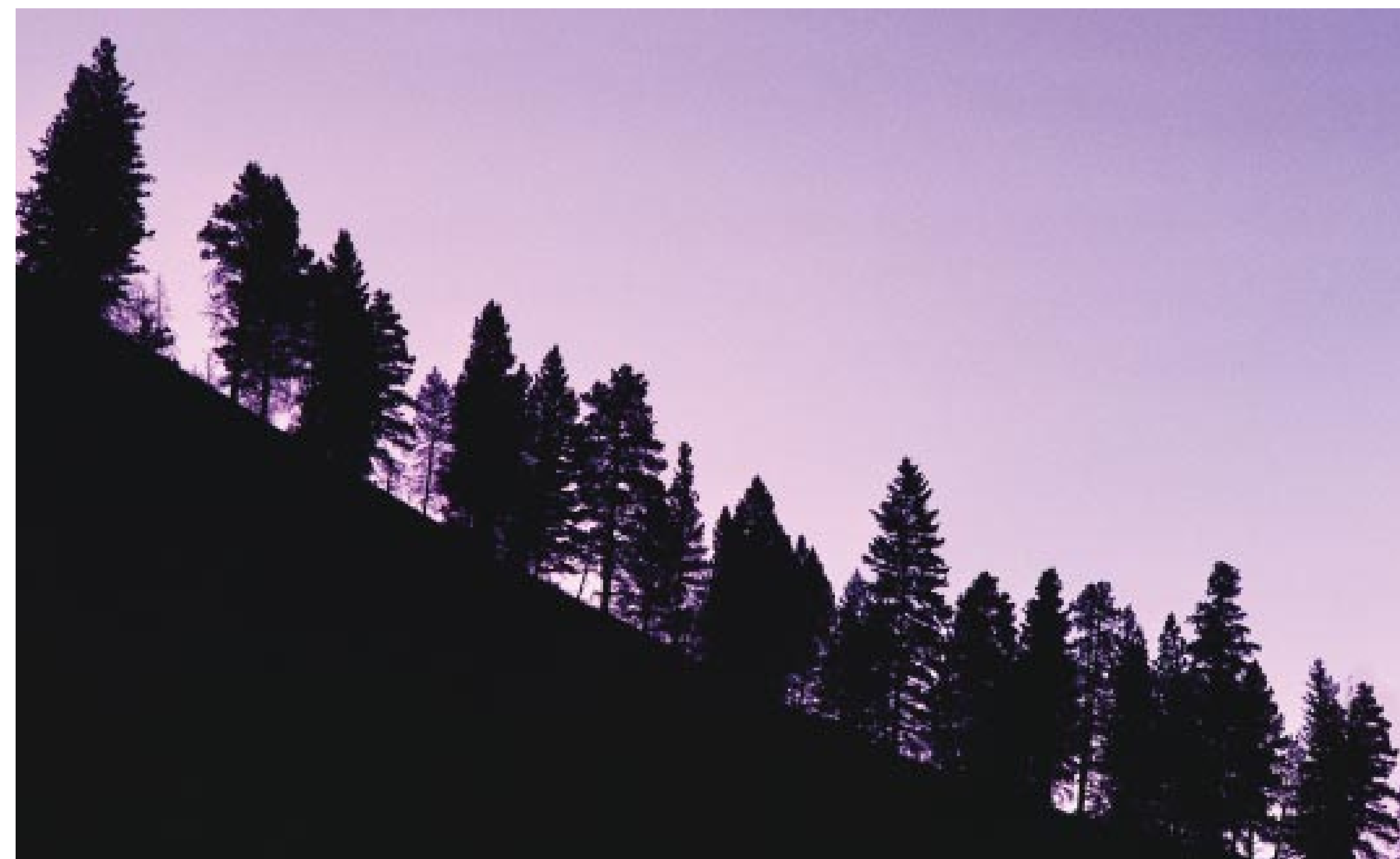
It is difficult to say whether the settlement of this regime will reverse the decline of the use of soft commissions. In its 2004 Annual Asset Management Survey the IMA found that the use of 'softing' had continued to fall in 2004. Using a matched sample, weighted by assets under management, 3.8% of business was subject to soft commissions compared with 4.5% last year. It identified that 23 groups out of 41 indicated that they did not use soft commissions and of those who did, only nine did so for more than 10% of commissions paid.

The SEC has also been examining soft dollar arrangements and may be looking at outcomes that are similar to those that are proposed by the FSA and so the debate on dealing commissions to purchase goods and services looks likely to continue for a little longer. Clearly, UK-based firms who also need to meet US requirements will need to keep an eye on these developments as well.

The FSA consultation period has closed. It is proposed that new FSA rules will commence on 1 January 2006, with transitional provisions that will run for six months.

For more information, contact: Stephen Burke on 020 7804 3318

European Watch



Constitution puts Lamfalussy in crisis?

No article about the EU at the moment can avoid at least a passing reference to the now frozen Constitutional Treaty. Readers could be forgiven for thinking that constitutional arrangements are far too high falutin' to have any relevance to humble workers in the fields of financial services. Think again.

There are unlikely to be direct effects on issues under consideration such as the Capital Requirements Directive (CRD). However, it has been a key objective of financial services players to achieve more flexible EU legislation. It was thought that this had been achieved with the Lamfalussy process, whereby full directives involving the Member States and the Parliament are reserved for general principles (so called level 1) and implementing rules made by committees of member state representatives (level 2) following advice from national supervisors meeting in EU committees, with these same supervisors' committees responsible for co-ordination, convergence and guidance (level 3).

The European Parliament is not represented in levels 2 and 3 and is concerned that actions here may escape Parliamentary scrutiny, worsening the EU's 'democratic deficit'. Therefore the Parliament has inserted sunset clauses into the legislation creating the Lamfalussy process. These kick in from 2007 unless removed or extended. The Constitution would have given the EP powers to 'call back' measures agreed under levels 2 and 3 if it thought that democratic scrutiny was required and was a condition for extending the Lamfalussy approach.

It is not clear what the Parliament will do. If Lamfalussy procedures do disappear, the world will not end. But it will make passing complex financial services legislation, such as Solvency II, much harder, and it will make technical amendments to complex directives such as the CRD and the Markets in Financial Instruments Directives extremely difficult as they will have to go through a full directive procedure.

Commission launches competition enquiries into banking and insurance

The financial services commissioner may be preaching restraint and targeted action in the Commission's approach to financial services, but the Competition Directorate is creating new issues for financial services players. Readers that have been through Cruickshank and the other UK competition enquiries into the operation of the financial services markets could be forgiven for feeling a sense of déjà vu with the news that the Commission is to launch sector enquiries into retail banking and business insurance.

The enquiries follow concern that competition is not working in these markets and that consumers (including SMEs) are not benefiting from the single market. As with the Cruickshank enquiry, regulatory arrangements will also be probed to ensure that they are not working to raise undue barriers to entry and preventing proper competition.

The Commission will begin its enquiries with an investigation into retail banking, and in particular payment cards. The enquiries into other aspects of retail banking and into business insurance will follow later in 2005.

This is overtly a 'fishing expedition'. Essentially the Commission opens a sector enquiry if it has concerns that competition may not be working as it should, but the reason for that is not clear.

The enquiry into retail banking will cover, in particular, the following issues:

- Conditions for market entry and for the supply of retail products and services;
- Conditions of competition in selected networks or joint infrastructure for retail products, for example payment systems; and
- Degree of effective choice for consumers and SMEs.

The enquiry into business insurance will examine the provision of insurance products and services to businesses including relevant reinsurance aspects, in particular:

- Conditions for entry (e.g. access to risk data, access to statistics, access to distribution channels, existing regulation, market structure);
- Existence of possible vertical agreements between brokers or other insurance and reinsurance intermediaries and insurers;
- Role of insurers. associations, coinsurance arrangements and other horizontal agreements, involving insurance and reinsurance market participants;
- The agreement on and use of standard policy clauses; and
- Sharing of risk-relevant data (access to databases).

The Commission has powers to require companies or trade associations to supply information, documents or statements, but says that it wants to co-operate and communicate closely with industry and consumers.

The results will be published in 2006.

More European Consultation and Guidance on Pillar 2

Meanwhile, practical work on implementing the CRD goes on. The Committee of European Banking Supervisors (CEBS) has issued a rather delayed second consultative paper on the Supervisory Review Process. This expands on the guidelines published in the first consultative paper.

The proposals in the second consultation paper are addressed to both supervisors and firms, and emphasise the dialogue between them based on the firm's internal assessment of its risks and capital needs.

CEBS has redrafted some of its proposals as a result of comments received during the first consultation, but the principal changes contained in the new proposals focus on guidelines on the general application of internal governance, and more specifically on how internal governance applies to banks' and investment firms' internal capital adequacy assessment processes. The new paper also includes more detail on how the dialogue between the institution and its supervisor should be conducted, and how supervisors will use their own risk assessment systems as part of the Supervisory Review and Evaluation Process.

The guidelines are still very generic and high level. CEBS has stated that more detail will be added to flesh out the review and evaluation processes with regard to specific types of risks to which firms may be exposed. CEBS is also considering whether and how to provide guidance for small institutions on how to develop their internal capital adequacy assessment processes.

The current consultation period runs until 21 October 2005.

For more information, contact: Richard Quinn on 020 7804 9991

Summer 2005: Technical Round-up

This article contains reminders of regulatory developments that may be significant to some firms but are not covered in more detail elsewhere in this issue.

Conduct of business rules

In the anti-money laundering arena, the Joint Money Laundering Steering Group has issued a consultation draft of its guidance notes amended to take account of risk. This follows the FSA's public acceptance of a risk-based approach in this area.

Following its indications, in February, of the priority regulatory themes for 2005/06 in the Wholesale Firms Division (including conflicts of interest, corporate governance and business continuity), the FSA has now published details of how it identifies and responds to emerging issues in the retail market. It confirms that recent issues have included, inter alia, the sale of payment protection insurance, mortgage disclosure documents, Child Trust Funds and the sale of Venture Capital Trusts.

Also in the retail area, the FSA has issued a statement of good practice for fairness of terms in consumer contracts. This statement is produced in the context of the FSA's enforcement role as a Qualifying Body for financial services firms under the Unfair Contract Terms Regulations.

Depolarisation

On 1 June 2005 the FSA's new disclosure rules for depolarisation came into force for all financial advisers. Advisers must now provide consumers with two 'keyfacts' documents, entitled 'About our services' and 'About the cost of our services'. These documents are intended to give consumers much clearer information earlier in the sales process about the type of advice and level of service being provided by the adviser. Consumers are also to be given a 'menu' of commission rates, providing a benchmark showing the average cost of advice. Additionally, under the new rules, those advisers who want to call themselves independent will have to offer consumers the option to pay for advice by a fee.

These disclosure rules are part of the official commencement of depolarisation after a six month transition period. The new regime is intended to give the industry the ability to be more flexible in providing advice to customers and to offer a wider range of products. Previously advisers were 'independent', advising on products from the whole of the market, or 'tied' to the products of only one provider. Following the new rules advisers can also offer 'multi-tied' advice using a panel of providers.

The FSA expects the removal of polarisation restrictions to allow market participants to create innovative business models that respond to current market challenges and the needs of their customer base. It is also expecting the changes to result in more competitive pressure on commission levels and firms explaining more clearly the services they provide.

Treating customers fairly

Following the publication of the Treating Customers Fairly (TCF) progress report last year, the FSA wrote to the chief executives of 35 major retail groups asking them to assess their delivery of TCF. The FSA said it was encouraged by the early progress of the initiative but still believes that firms have a long way to go to meet the spirit of the TCF requirements. The FSA is looking to senior management of all firms to take the lead in driving their organisations to think through how to ensure TCF is built consistently into the operating model and culture of all aspects of the business to produce fairer outcomes for customers.

The FSA has said that, whilst at this stage, it does not expect to find all firms having fully embedded TCF throughout their business, it does expect to find that firms have started to analyse how they will ensure it is delivered and over what period. So far the FSA has mainly focussed on larger firms, but now it is widening its review to encompass smaller firms and businesses.

Investment products

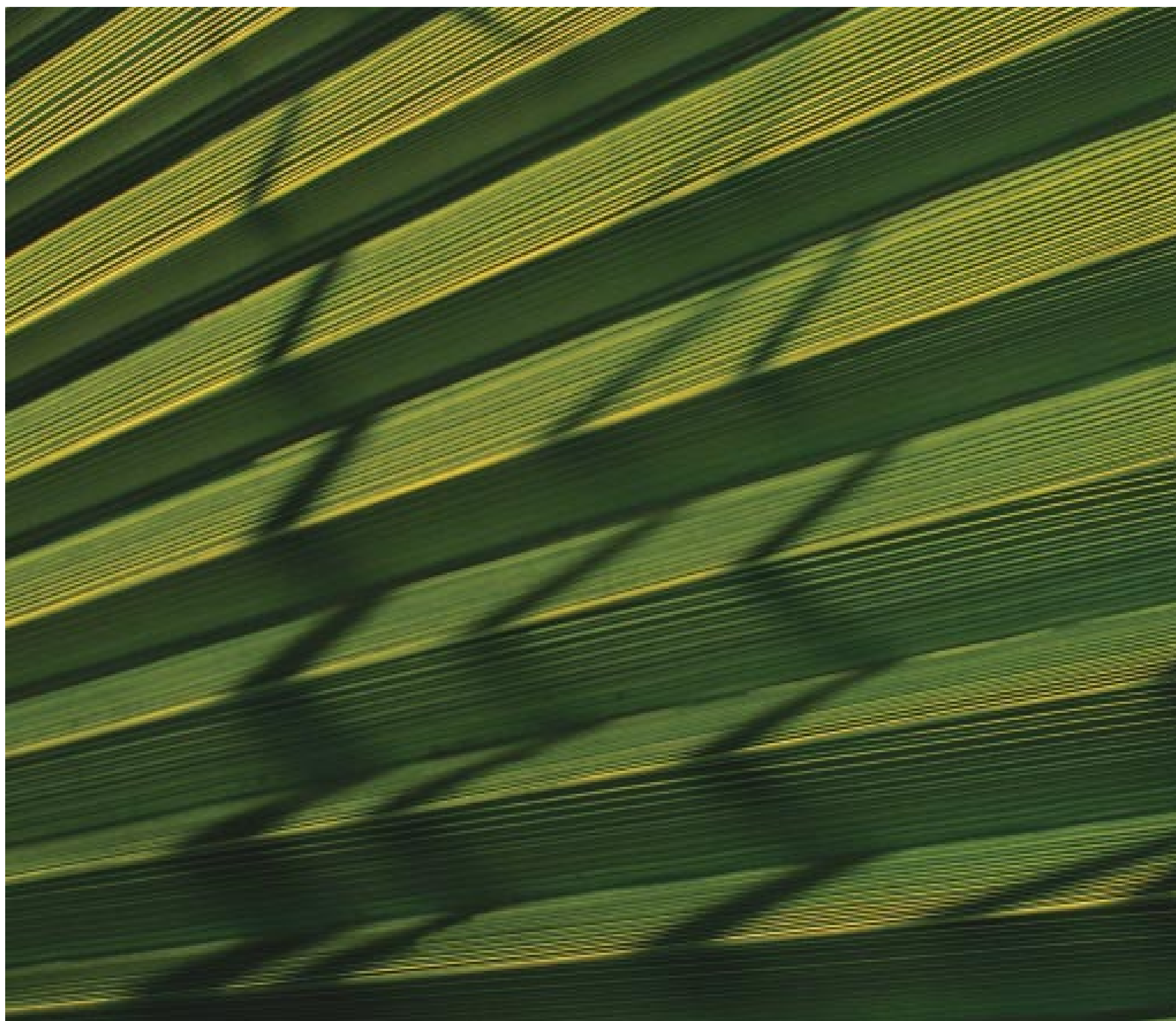
For collective investment schemes, the new rules on simplified prospectuses were published by the FSA in PS05/4 which is effective from 1 May but with a transitional period to the end of September. To assist managers who wish to introduce performance fees, the Investment Management Association (IMA) has produced an issues paper jointly with the Depositary and Trustee Association and Fitzrovia, an investment fund research company. The IMA has also published a study, jointly with EFAMA (formerly FEFSI), calling for simplification of the registration requirements for investment funds in various European jurisdictions.

The risks of poor administration in relation to OTC credit derivatives were the subject of a 'Dear CEO' letter from the FSA, which expressed concern about the level of outstanding confirmations.

In the retail arena, the FSA has criticised the equity release market following a mystery shopping exercise which identified a significant number of cases where advisers did not gather sufficient information about their customers to assess suitability. In addition, the Treasury has announced an extension of scope to bring more types of equity release scheme within the FSMA regime.

Prudential rules

The FSA has published a discussion paper containing the results of surveys it has conducted on stress tests and



scenario analysis (together abbreviated to 'stress tests') undertaken by a number of banks, securities and insurance firms. It also held a workshop with a small cross-section of firms earlier in the year. The paper is targeted at larger, more complex firms but is also relevant to management of other authorised firms. The FSA restates the importance it attaches to this as a management tool. Stress testing of market risk was generally found to be more advanced than stress testing of credit or liquidity risks, although Basel II is forcing the pace of development for credit risk stress tests. Stress testing is particularly relevant for the new ICAS regime and also for liquidity in deposit takers, insurers and own account dealers. The paper seeks to disseminate examples of good practice as well as provide background to a conference that the FSA is planning for later in 2005.

The FSA has published PS 05/05 with changes to the FSA Handbook in response to the introduction of International Accounting Standards by many UK companies from 1 January 2005. There is little change from the proposals set out in CP04/17. The FSA has kept to a minimum the consequent changes to the regulatory capital and regulatory reporting requirements, restricting amendments to those instances where the impact has been identified as significant. The FSA will undertake a more detailed review in two year's time when IFRS reporting has settled down and further convergence of UK GAAP with IFRS has occurred. The FSA Handbook changes took effect from 21 April 2005. In effect, P505/05 confirms the case-by-case approach to IFRS already being taken by the FSA.

Insurance companies

The FSA has published a review of the progress of the Tiner Reforms in order to mark the transition from policy development to implementation, and to emphasise the changes brought about since the FSA was given responsibility for the regulation of insurers.

The Tiner Reforms are aimed at transforming methods used in regulating insurers and in particular introducing significant changes to the way in which insurers:

- Interact with their customers;
- Calculate how much capital they need to support the risks of their business; and
- Manage their business.

However, although the completion of this step in the development of the regulatory approach for insurers is important, it will not mark the end of policy development in the UK given a number of key European and worldwide initiatives in progress. The FSA is monitoring these developments and the ways in which the industry responds to the new regulatory environment with the intention of continuing to refine the UK's regulatory regime as appropriate.

The next major challenge facing insurers is implementing the new reporting requirements for the 31 December 2005 Annual Return. The majority of the changes that the FSA is proposing at present are aimed at simplifying the FSA return, standardising requirements and introducing new materiality criteria for reporting business. Whilst in theory the proposals appear straightforward their introduction is likely to give rise to problems for many firms given the need to redesign reporting systems, reclassify business and restate historical data. These changes are only an intermediate step in the development of reporting requirements because of further amendments likely to be required by changes to International Accounting Standards and the impact of Solvency 2.

The main change to the FSA return for general insurance business is the introduction of standardised reporting categories. This also necessitates a one-off transitional requirement to report historical development data in the same categories. For long-term business the changes include:

- Simplification of the long-term business annual return forms to make the annual return easier to compile and understand;
- Turning the Valuation Report into a mainly narrative document with a prescribed structure; and
- Standardising the classification of product categories.

Compliance arrangements and outsourcing

Recently some guidance has been published on compliance arrangements which will be helpful to firms in benchmarking their compliance functions:

- The International Organisation of Securities Commissions' (IOSCO) consultation report on the Compliance Function at Market Intermediaries;
- The Financial Services Skills Council's draft Standards for those working in compliance and anti-money laundering; and
- The Basel Committee's Guidance on the Compliance Function in Banks.

There is an increasing focus on outsourcing and how to manage the inherent regulatory risks:

- IOSCO's Principles on Outsourcing of Financial Services for Market Intermediaries;
- The Joint Forum's guidance Outsourcing for Financial Services (The Joint Forum comprises the Basel Committee, IOSCO and the International Organisation of Insurance Supervisors); and
- The FSA's Review of Offshoring Operations to India.

A major driver will inevitably be the final wording of the regulations relating to compliance functions to be issued under the Markets in Financial Instruments Directive, still the subject of revision by the European Securities Committee, the Level 2 committee in the Lamfalussy structure.

FSA under the spotlight

The previous issue of UK FS Regulatory Focus referred to the starting of the FSA's examination of the enforcement process and of the costs of regulation in response to the Legal & General case and the Treasury's N2+2 Review respectively. The FSA has also published its performance against existing service standards and added some new ones. Meanwhile, there have been mixed verdicts from some outside bodies: the Hampton Review on corporate regulation and inspection complimented the FSA on its risk-based approach; the Centre for Policy Studies asserted that the FSA had lost the respect of the industry because of its heavy-handed compliance requirements; and an Oxera report for the Corporation of London and the Investment Management Association (IMA) identifies over-regulation as a long-term threat to the UK's position as a leading centre for asset management. Reaction to the FSA's new website has been mixed.

The FSA's responses to theses issues, together with the need to implement Directives such as the CRD and MiFID, point to a continuing pattern of change in the regulatory environment.

For more information, contact: Andrew Hawkins (Banking) on 020 7212 5270, Tania Lee (Insurance) on 020 7804 8167 or Peter Milroy (Investment Firms) on 020 7212 5282.

Financial Services Regulatory Practice contacts

United Kingdom
In the UK, we have a dedicated team of over 120 regulatory compliance specialists offering proactive regulatory advice to authorised firms and other financial institutions in the UK, within the EU and across the World. The group comprises teams of partners, directors, managers and staff with extensive knowledge of regulatory rules, codes of conduct and prudential supervision focusing on delivering particular solutions and products to certain sectors of the financial services industry. The team blends the experience of former senior regulators, compliance managers, industry personnel and staff with a broader industry/professional background. Our principal contacts are as follows:

Overall enquiries

UK FSRP Chairman
John Tattersall (020 7212 4689)
john.h.tattersall@uk.pwc.com

UK FSRP Leader
Chris Jones (020 7804 2393)
chris.p.jones@uk.pwc.com

Regulatory issues

Authorisations
Alex Shapland (020 7213 8618)
alex.shapland@uk.pwc.com

Anti–Money Laundering and Financial Crime
Andrew Clark (020 7804 5761)
andrew.p.clark@uk.pwc.com

Compliance Strategy, Risk and Cost
David Taylor (020 7804 2892)
david.j.taylor@uk.pwc.com

Embedding Compliance/FSMA
Roger Turner (020 7804 3249)
roger.turner@uk.pwc.com

Distribution, Polarisation & Market Entry
Roger Turner (020 7804 3249)
roger.turner@uk.pwc.com

Prudential Regulation
Patrick Fell (020 7212 5273)
patrick.w.fell@uk.pwc.com

Regulators & Governments
John Tattersall (020 7212 4689)
john.h.tattersall@uk.pwc.com

Regulatory Remediation
David Taylor (020 7804 2892)
david.j.taylor@uk.pwc.com

Training & Competence
Mark Clinch (020 7804 3679)
mark.clinch@uk.pwc.com

Treating Customers Fairly
Philip Cooper (020 7212 5440)
philip.cooper@uk.pwc.com

Industry areas

Banking & Capital Markets
Iwan Griffiths (020 7212 3004)
iwan.griffiths@uk.pwc.com

General Insurance and Mortgage Regulation
David Morey (020 7804 2684)
david.morey@uk.pwc.com

Insurance (Wholesale & Prudential)
Paul Clarke (020 7804 4469)
paul.e.clarke@uk.pwc.com

Insurance (Retail)
Pat Newberry (020 7212 4659)
pat.j.newberry@uk.pwc.com

Investment Management
Roger Turner (020 7804 3249)
roger.turner@uk.pwc.com

Pension Funds
Andrew Evans (020 7804 3887)
andrew.evans@uk.pwc.com

Europe
In addition to our UK regulatory practice, PricewaterhouseCoopers LLP has unparalleled regulatory expertise in locations across Europe. The team is led and coordinated from Brussels by Charles Ilako, our European Leader, with the support of a multinational team, comprising experienced individuals who bring both knowledge of regulation in the European Union and sectoral expertise. We have experts in each industry in over fifteen EU/CEE countries (with regulatory reach into many more) where we are able to advise on local regulatory matters relevant to our clients' needs. Whilst we have an extensive network throughout Europe, the principal contacts are as follows:

Overall enquiries

Charles Ilako (+32 2 710 7121)
charles.ilako@be.pwc.com

Banking

Erik Musch (+32 2 710 9747)
frederik.musch@be.pwc.com

Richard Quinn (+44 20 7804 9991)
richard.quinn@uk.pwc.com

Investment Management

Philip Warland (+44 20 7212 6345)
philip.warland@uk.pwc.com

Insurance

Wendy Reed (+32 2 710 7245)
wendy.reed@be.pwc.com

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