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update

Market Abuse: 'Mad' Changes to the Regime

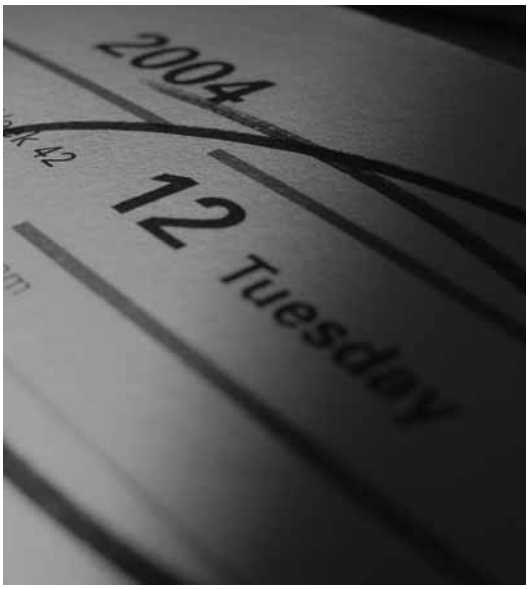
The EU Market Abuse Directive 2003/6/EC of 28 January 2003 (MAD or the Directive) came into force on 12 April 2003. Daniel Jacob reviews the effects of the Directive in the UK.

Structure and progress so far

The Directive marks the first step in the introduction of a uniform insider dealing and market manipulation regime on an EU level. It provides framework principles for the new regime and has recently been followed by technical implementing measures. The Committee of European Securities Regulators (CESR) was given a mandate by the European Commission to advise on the adoption of these further provisions and earlier this year published its first set of comments. Having reviewed CESR's advice, the Commission has now submitted its formal proposals to the European Securities Committee for approval. CESR released a second set of draft provisions on 12 June 2003 and after consultation published their advice on 3 September 2003. The Financial Services Authority (FSA) have participated in providing comments to CESR throughout the consultation process.

Content of the Directive

The purpose of the Directive is to harmonise the EU approach to market manipulation, to remove competitive distortions in EU financial markets and to bring certainty to the marketplace. The Directive must be implemented by Member States by 12 October 2004. It is important therefore that the UK market abuse regime is reviewed in light of the developments contained in the Directive. The FSA has commented that the implementation of the Directive will entail significant changes to the FSA's Code of Market Conduct and the current regulatory framework. However, a formal review and consultation will not take place until early next year.



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The offences of insider dealing and market manipulation under the Directive to an extent mirror the market abuse regime in the UK created by the Financial Services and Markets Act 2000 (FSMA). An example is the requirement for a "competent authority" under the Directive to ensure compliance, which is already satisfied by the FSA which polices FSMA compliance. Although breaches of the Directive will only result in civil sanctions, the criminal offences of insider dealing under Part V of the Criminal Justice Act 1993 (CJA) and market manipulation under section 397 of FSMA will continue to apply. Any 'safe harbours' under the Code will not be applicable in relation to a civil offence committed under the Directive unless specifically provided for in the Directive.

The intention is that harmonisation of the insider dealing and market abuse regimes will aid cross-border enforcement. Under the Directive, if a competent authority in jurisdiction A becomes aware of a breach of the Directive in jurisdiction B, the competent authority in jurisdiction A is required to notify the competent authority in jurisdiction B.

The Directive also states that persons who produce or disseminate research concerning financial instruments must take reasonable care to ensure that the information is fairly presented, with appropriate disclosure made of any interests and/or conflicts of interest concerning the instruments to which the information relates.

Issuers and persons acting on their behalf must draw up a list of persons who have access to specific inside information and persons who may have access to inside information must also be made aware of their legal and regulatory duties and the sanctions which may arise from misuse of information.

CESR's draft second set of implementing measures

In its second set of draft provisions CESR has given guidance and interpretation on the following areas of the Directive.

- The factors which a competent authority should take into account when deciding whether a practice can be accepted as "market practice". Where a market practice is legitimate and accepted as "market practice" by the competent authority, the practice will not amount to market manipulation.
- The Directive recognises that there needs to be a specific approach to inside information on commodity derivative markets and the advice sets out clarification of when users of such a market would expect to receive information.
- Further provisions for the responsibility of creating and maintaining the list of persons with access to inside information which all issuers and third parties acting on their behalf (for example, the issuer's banks, auditors, financial advisers and legal advisers) are required to keep.
- The Directive requires those in managerial positions within an issuer to disclose dealings in the shares of the issuer. CESR has identified the people to whom this would apply and have clarified what information the notification must contain.
- The criteria for determining when a transaction should be notified to a competent authority as a result of suspicion of insider dealing or market manipulation are set out.

A full summary of CESR's comments on these provisions is outside the scope of this article. However, a copy of their technical advice is available on the CESR website at www.europefesco.org. The Commission is expected to finalise the text of these provisions by the end of 2003.

Differences between the existing UK regime and the Directive

The offences of market abuse under section 118 of FSMA consist of behaviour based on relevant information, behaviour likely to give a false and misleading impression and behaviour likely to distort the market. In each case, the behaviour must fail to satisfy the "regular user", who is, in relation to a particular market, a reasonable person

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who regularly deals on that market in investments of the kind in question.

The Directive definition of market manipulation comprises insider dealing, transactions likely to give false or misleading signals or which secure financial instrument prices at an artificial level, or transactions employing fictitious devices and dissemination of false and misleading information. The Directive does not incorporate a regular user test. There is a defence against the offence of market manipulation (but not insider dealing) of "accepted market practice on the regulated market". CESR has given comments (see above) on how a competent authority should determine whether a practice can be described as "market practice". However, the final drafting of these provisions will come from the Commission later this year.

The definition of "inside information" in the Directive refers (in summary) to information that is precise, has not been made public, which relates to issuers of financial instruments or to one or more financial instruments and which would have a significant impact on the price of those financial instruments or related derivative financial instruments. This is similar to the definition of inside information contained in the insider dealing provisions of the CJA but goes further by extending to related derivative financial instruments. However, the provisions relating to behaviour based on information in FSMA and the Code are based on information which a "regular user" would regard as "relevant" and which has to be disclosed under any legal or regulatory requirement (or is routinely the subject of a public announcement).

The future

Once the European Securities Committee finalises the text of the second level measures the FSA will begin to consult on changes to the Code and the current regulatory framework. As national implementation is required by October 2004 it is likely that this will be done on a tight timetable.

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Consumer Protection or More Small Print?

Sean Geraghty considers the FSA's proposals to improve information and protection provided to consumers investing in products which may put their capital at risk.

In July 2003, the Financial Services Authority issued a consultation paper[1] suggesting improvements to the advertising rules relating to "Structured-at-risk products" (SCARPS) (including products previously described by the FSA as "precipice bonds" [2]) and financial promotions for structured deposits.

In addition, the FSA is proposing to include further guidance to reorganise the existing guidance in Conduct of Business (COB), chapter 3, annexure 4 to make it easier for consumers to understand the financial products offered.

What are SCARPS and what are the FSA's concerns?

The FSA proposes to include in its handbook a new definition of a SCARP, being a product (other than a derivative) which provides an agreed level of income or growth over a specified investment period, where the customer is exposed to a range of outcomes in terms of the return of initial capital invested (indicating the loss of some or all of it) linked by a pre-set formula to the performance of an index or indices.

The FSA is concerned that customers may be unaware of the extent to which their initial capital is at risk or how the income is calculated. It is proposing that firms include with direct offer financial promotions for SCARPS either the FSA fact sheet on high-income products[3] or equivalent information. Furthermore, the FSA considers that firms should provide customers with a risk warning both in direct offer financial promotions for SCARPS and when making advised sales.

Customers will also have to be provided with periodic information about the current value of the SCARP, projected maturity values and a clear warning about the nature of equity indices and their impact on the value of the investment.

The promotion of structured deposits

Structured deposits (unlike normal deposits) link any interest or financial return to the performance of an equity index or basket of selected stocks.

While these products may be attractive to consumers who seek higher returns than those achievable from standard deposits offering low interest rates, the recent falling stock markets have highlighted the inherent risk in structured deposits for many investors of receiving no interest or financial return on that deposit.

The FSA is concerned that, due to the risk of a lower (or even zero) return on a structured deposit, the consequences of non-compliance with the financial promotion requirements are more serious than for other deposits. The FSA concludes that the existing rules in COB3 applying to financial promotions for structured deposits need to be strengthened (at present, promotions for deposits are generally only required to be "clear, fair and not misleading"). It is proposed that structured deposits be subject to a limited number of the high-level rules and guidance which currently apply to other financial promotions. These include the rules requiring a fair and adequate description of the nature of the investment, the commitment required and the risks involved, and

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the rules relating to the way past performance information could be presented.

What additional guidance in COB3 is proposed?

The new guidance in COB3 proposed by the FSA is designed to clarify and expand on certain of the existing guidance. Briefly, the FSA is keen to ensure that where there is a possibility of capital loss, the financial promotion should state this prominently and should also indicate the likelihood of such loss. Firms should not be allowed to use headline rates where these rates are unrealistic and are unlikely to be attained. Also, promotions must include a proper explanation of the counter party risk in relation to a product where capital protection benefits are not guaranteed.

Finally, the FSA is also seeking to reorganise and consolidate existing guidance in the section of its Conduct of Business Rules (COB3, annex. 4), which applies to firms which communicate or approve financial promotions, to make it more accessible to readers.

The way forward?

The consultation period ended on 31 October 2003. Final rules and guidance are due to be published in January 2004. Any new provisions for SCARPS will take effect from 20 February 2004 with the other rules taking effect in July 2004.

It remains to be seen whether any clarification or additional requirements in the areas covered by the consultation paper will, in fact, increase a potential investor's understanding of the nature of the investments and risks concerned or whether they will lead merely to the production of more unread small print.

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[1] CP188 – *Clarification and revision of financial promotion Rules and Guidance*

[2] See Guidance Note GN7 (2003): *Precipice Bonds* (which expires in February 2004).

[3] FSA Factsheet: *High-income Products - Make sure you understand the risks* (November 2002)

US Continues to Enhance Anti-Money-Laundering Regime

The Patriot Act provides the basis for radical changes to the US anti-money-laundering regime. Susan Ervin reviews some of the changes for the financial community.

Following the September 11, 2001 terrorist attacks, President Bush signed into law the USA PATRIOT Act of 2001[1] Title III of the Act represents a landmark expansion of financial institution anti-money-laundering (AML) obligations and constitutes the most sweeping legislation in this area in over three decades. The Act generally directs or authorises the US Treasury Department and other financial regulators to issue regulations requiring enhanced AML reporting and record-keeping requirements in several areas, discussed below.

- AML compliance programmes – As required by the Act, the US Treasury Department, through the Financial Crimes Enforcement Network (FinCEN), has issued regulations that now require banks, securities broker-dealers, mutual funds, futures commission merchants and introducing brokers to develop and implement comprehensive AML compliance programmes.[2]

- Customer identification programmes – The Act mandates regulations requiring financial institutions to verify the identity of new accountholders.[3] Names of new account-holders also must be compared to a designated list of known or suspected terrorists and terrorist organisations. In May 2003, FinCEN and several federal financial regulators jointly issued final regulations that required banks, securities broker-dealers, mutual funds, futures commission merchants and introducing brokers to implement "customer identification programmes" to verify the identity of each new customer by 1 October 2003.[4]

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- Suspicious activity reports – The Act directs the Treasury Department to require securities broker-dealers to file suspicious activity reports (SARs) on certain unusual transactions. Under implementing regulations issued by FinCEN, broker-dealers were required to file SARs as of 1 January 2003.[5] FinCEN also has proposed similar rules under its existing authority which would require mutual funds, life insurance companies, futures commission merchants and introducing brokers to file SARs.[6]

- Correspondent and private banking – The Act requires financial institutions to conduct due diligence on correspondent and private banking accounts maintained for non-US persons.[7] Banks currently are required to comply with these due diligence obligations, while securities broker-dealers, futures commission merchants and introducing brokers are required to conduct due diligence only on private banking accounts.[8] FinCEN has issued a proposed rule that would broadly expand these due diligence obligations to mutual funds and certain other financial institutions.[9]

- Non-US shell banks and bank due diligence – Among the Act's most important provisions is a prohibition on banks and securities broker-dealers from maintaining correspondent accounts in the US for non-US 'shell banks', i.e. banks with no physical presence in any country. Banks and securities broker-dealers also must conduct special due diligence on any non-US bank for which they maintain a correspondent account in the US to ensure, among other things, that such institutions are not "shell banks."[10]

- Information sharing – As required by the Act, FinCEN recently issued regulations designed to promote information sharing between the financial community, federal regulators and law enforcement about suspected money-laundering or terrorist activity.[11] The regulations require financial institutions to respond to information requests from FinCEN about suspect persons, and permit financial institutions to voluntarily share information among themselves about suspected money-laundering and terrorist activity.

- Areas of primary money-laundering concern – Finally, perhaps the most important provision in the Act authorises the Treasury Department to designate a certain type of non-US transaction, account, person or jurisdiction as posing a "primary money-laundering concern", and to impose countermeasures, including the denial of access to the US financial community.[12] The Treasury Department recently designated Nauru as posing a primary money-laundering concern and has proposed to prohibit US financial institutions from maintaining accounts in the US for Nauru financial institutions.[13]

The US government continues to issue regulations implementing the USA PATRIOT Act's anti-money-laundering requirements. In the coming months, for example, FinCEN is expected to issue final regulations extending anti-money-laundering obligations to life insurers, hedge funds, offshore funds and certain investment advisers and commodity trading advisers.[14] In this regard, it is clear that the aftermath of the September 11 terrorist attacks will continue to affect the US financial community for many years to come.

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[1] Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. L. No. 107-56, 115 Stat. 272 (Oct. 26, 2001)

[2] See 31 C.F.R. §§ 103.120, 103.130.

[3] 31 U.S.C. § 5318(l) (USA PATRIOT Act § 326)

[4] 31 C.F.R. §§ 103.121 (banks), 103.122 (securities broker-dealers), 103.123 (futures commission merchants and introducing brokers), 103.131 (mutual funds)

[5] *Id.* § 103.19

[6] *Id.* §§ 103.15 (proposed rule – mutual funds), 103.16 (proposed rule – life insurance companies), 103.17 (proposed rule – futures commission merchants and introducing brokers)

[7] 31 U.S.C. § 5318(i)

[8] 31 C.F.R. §§ 103.181, 103.182

[9] Id. §§ 103.176, 103.178 (proposed rules)

[10] *See* 31 U.S.C. § 5318(j–k); 31 C.F.R. §§ 103.177, 103.185.

[11] *See* 31 C.F.R. §§ 103.100, 103.110.

[12] 31 U.S.C. § 5318A

[13] 31 C.F.R. § 103.184 (proposed rule)

[14] See 31 C.F.R. §§ 103.132 (proposed AML program rule – unregistered investment companies), 103.133 (proposed AML program rule – commodity trading advisors), 103.137 (proposed AML program rule – life insurance companies), 103.150 (proposed AML program rule – investment advisers).

Update - VAT Treatment of Investment Management Services

Maria Edsall reviews the VAT treatment of investment management services which has been the subject of some important recent developments.

The new legislation, which came into effect on 1 August 2003 ensures that no VAT needs to be charged on outsourced services provided to UK fund managers or onshore funds.

In addition, if this new legislation was applied as drafted, certain UK investment managers supplying their services to offshore open-ended investment companies (OEICs) would not have been able to recover VAT on their associated costs or their ability to so recover would have been restricted. However, following a period of intensive consultations with industry groups and professional advisers, Customs has agreed that, notwithstanding the new legislation, the position of investment managers of offshore funds shall not be affected.

The position under the old law

VAT treatment of outsourced services – Previously, only the services provided by the manager of a UK unit trust scheme to a unit trust scheme or by the authorised corporate director of a UK investment company with variable capital (the UK form of OEIC) to such a company were covered by an exemption from VAT, so that where such services were outsourced, VAT was payable on the outsourced services.

Investment management services provided to offshore funds – Investment management services provided to an offshore fund (whether closed or open ended) are outside the scope of VAT. However, because such services would have been taxable if provided to a UK recipient, a special provision allows UK investment managers to recover VAT they incur on their costs in providing the service. Thus, UK investment managers providing services to offshore funds are able to

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recover input VAT, irrespective of the structure of the fund.

The position under the new legislation

The amendments to the UK VAT legislation were made with effect from 1 August 2003. The amendments were primarily driven by certain court decisions which concerned the VAT treatment of outsourced services provided to investment managers of regulated investment funds and which confirmed that UK legislation was inconsistent with the relevant European legislation.

VAT treatment of outsourced services – The changes have extended the exemption to any management of the scheme property of a UK OEIC or of a UK unit trust, thus enabling the outsourced services to benefit from the exemption whether provided directly to the UK unit trust or UK OEIC or to the primary investment manager.

Investment management provided to offshore funds – The effect of the new provisions is to make the supply of all investment management services provided in relation to OEIC property exempt from VAT. Therefore, if the new legislation was implemented as drafted, investment managers providing their services to offshore OEICs or trust-based schemes (whether regulated or unregulated) would no longer have been able to recover VAT on costs associated with this activity, and this could also have impacted on their recovery of VAT on residual costs.

Following a period of intensive consultation with industry groups and other interested parties, Customs issued a business brief in which they have agreed to continue to treat investment management of offshore investment funds as being outside the scope of VAT and to continue to allow such managers to recover VAT on their costs. The changes are therefore to be confined to UK OEICs or UK unit-trust schemes.

Conclusion

The good news is that the new legislation exempts from VAT fund management services supplied by third parties to UK investment managers or to onshore funds and it will not affect VAT recovery for investment managers supplying their services to offshore funds.

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Prospectus Directive

Danny Brower reports on the European Union's efforts to implement the recently approved Prospectus Directive.

The European Union's Prospectus Directive was adopted in July 2003 and aims to coordinate the regulatory regime for investment schemes throughout the European Union. The directive requires that a prospectus be published if an offer of securities is made to the public or securities are admitted to a regulated market.

In order to raise capital in each European Union Member State, an issuer usually, but not always, had to obtain approval separately in each country. This generally involved publishing a different prospectus and complying with different regulatory regimes in each country. The intended objective of the Prospectus Directive is to streamline this process so that once regulatory approval is obtained in one European Member State, no further approvals will be necessary to raise capital in any other European Member State. It is anticipated the Directive will be implemented in European Member States by 2005.

The Committee of European Securities Regulators (CESR) has, since the adoption of the Prospectus Directive, advised the European Commission on the practicalities of its implementation. CESR's aim is to create a Europe-wide standard format for prospectuses. This will help unify the regulatory approach across Europe in line with the new Directive.

CESR's advice was that securities issuers should be required to disclose the following information in their prospectuses – key financial information, operating results, risk factors, a statement of their compliance with national corporate governance codes, details of the remuneration of key management figures and potential conflicts of interest.

CESR also suggests that certain previously published information should be included in the prospectus, specifically audit reports, financial statements and articles of association. In order to improve access to capital for recently formed companies, the CESR also proposes limiting the requirement for three years' financial information to the period of a company's existence.

The European Commission will consider these proposals before it comes to a final decision on exactly which information should be disclosed by issuers.

The Prospectus Directive also aims to relax the regulatory requirements for small and medium sized businesses. If the capital sought from the public is less than two and a half million Euros then no prospectus is required. Financial reporting requirements for such companies will be limited to a reference to the company's financial statements.

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Danny Brower, a senior lawyer in the Financial Services Group, is also the editor of Dechert's **Developments for European Union Financial Services** update which gives an outline of the activities of the EU institutions in the financial services sector.

The update is published on email only by Dechert. Copies may be obtained by emailing your contact details to nicole.entwistle@dechert.com, inserting 'EU Financial Services Update' in the subject field.

News Round-Up

Soft commissions and bundled brokerage – update

The period for responses to the FSA's consultation paper 176 'Bundled Brokerage and Soft Commission Arrangements' closed on 10 October 2003 (for further details on the consultation see *Fundamentals Summer 2003/Issue 6*). The Investment Management Association (IMA) urged the FSA not to introduce the proposals and suggested that a combination of market solutions and improved transparency would be sufficient to deal with the issues set out in CP176.

The FSA will now prepare its feedback statement which it anticipates will be released in late first quarter or early second quarter of 2004, and there may also be a public statement about the FSA's broad conclusions after Christmas. The FSA will need to publish a further consultation paper if it intends to introduce new rules and guidance; this might either be combined with the feedback statement or may appear subsequently.

Update on money-laundering regulation by the financial action task force (FAFT)

FATF's 40 recommendations were last amended in June 2003. FATF held its latest plenary meeting on 3 October 2003. This focused on the organisation's role in preventing terrorist finance and added little of relevance to most businesses to the position last June.

In June 2003 the most important change was the extension of the list of businesses expected to adopt anti-money-laundering procedures to include casinos, lawyers, accountants, estate agents, trust companies and dealers in precious metals and stones. The due diligence process for financial institutions was expanded and a list of offences amounting to money-laundering was drawn up.

The current list of Non Co-operative Countries and Territories remains the same as in June 2003, comprising the following – Cook Islands, Egypt, Guatemala, Indonesia, Myanmar, Nauru, Nigeria, Philippines and Ukraine. FATF therefore continues to request that extra vigilance is used in dealings

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and transactions with persons, companies and financial institutions in these places. This list is due to be reviewed at FATF's next plenary meeting 25-27 February 2004.

Update on conflicts of interest

The FSA's consultation paper 171 "Conflicts of Interest: Investment Research and Issues of Securities" was reported on in the last issue of *Fundamentals*. As we go to press with this issue, the FSA has published feedback on CP171 in the form of a new consultation paper: 205. The closing date for comments on CP205 is 24 December 2003.

Sizing up the City: London's ranking as a financial centre

In a recent report compiled by the Centre for the Study of Financial Innovation entitled 'Sizing up the City: London's Ranking as a Financial Centre', London came a very close second to New York as regards international financial centre competitiveness. The other centres covered by the survey, Paris and Frankfurt, were some way behind.

London is perceived as having the most competent regulator and was the clear leader in the lightness of its regulatory touch, although it must be said that the steady rise in the regulatory burden is a matter of concern. Respondents to the survey did not see this lead being lost in the next five years unless it is jeopardised by ill-judged regulatory and/or government actions, especially those emanating from Brussels.

The physical dimension of the financial services industry in London is still remarkably strong despite the growth of remote access, telecommunications and virtual markets, etc. People still value information picked up through informal contacts, which is perceived to be more 'exclusive' and more likely to lead to new business. A large Continental fund management firm found that its Belgian clients preferred to deal remotely with London than directly with staff in Brussels. They felt more 'plugged in' to the markets.

The recent economic downturn may be hurting London to a certain extent. However, most foreign firms responding to the survey said that the cutbacks they were making in London were because operations affected by the downturn happened to be located there; they were not the result of firms heading home.

Unsurprisingly, Paris leads the field for having an attractive living and working environment. Equally unsurprisingly, London is rated last for public transport!

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The Dechert London office will be converting from a traditional partnership to a limited liability partnership (LLP) with effect from 1 January 2004. This will involve the transfer of the Firm's business to Dechert LLP, a new entity incorporated pursuant to the provisions of the Limited Liability Partnerships Act 2000. This development reflects the increasing recognition that the conventional partnership structure is no longer appropriate for large international professional organisations and our decision reflects a trend that it is increasingly likely to be followed by international law firms. This change will not in any way affect the quality of the service we provide to our clients.

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