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Quarterly reporting for listed companies still unresolved

The European Commission's proposal for a Transparency Directive, which establishes the new requirement of quarterly reporting for listed companies, faces an uncertain future with only limited time remaining for approval by the Council of Ministers and the European Parliament.

Despite being a 'priority' under the Financial Services Action Plan (FSAP), there has been no apparent movement in a positive direction since this was presented in March 2003.

The Transparency Directive is one of three major items of unfinished legislative business in 'FSAP 2005', along with rules on investment services and corporate takeovers.

Since the Commission has already conceded that the practical deadline for approval is April 2004, this sets an ambitious agenda for the Italian and Irish presidencies in the run-up to parliamentary elections next spring.

Under the Directive, there are minimum reporting obligations for listed companies based on regulation by the home Member State. The purpose is to enhance investor protection, improve the efficiency and integrity of European capital markets, and stimulate cross-border investment by eliminating local discrepancies which deter firms from issuing securities in more than one jurisdiction.

The most contentious element is the introduction of unaudited quarterly reports which will be a big change for many European companies. Critics consider this unnecessary, expensive, and unduly burdensome.

It also comes at a difficult time in view of the ongoing transition to International Accounting Standards (IAS) and the stringent reforms contemplated by the recent Action Plan on corporate governance.

However, the Commission points out that this is less onerous than rules in certain other countries, including the US, where audited reports on a quarterly basis have been the norm for decades.

According to Frits Bolkestein, EU internal market commissioner, "A true internal market in financial services needs investors to be able to invest across borders easily and with confidence. I want to achieve that without excessive burdens on issuers so compared to current practice in the US, we have opted for less demanding publication

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(continued from page 1) periods and a more pragmatic mix of more detailed half-yearly reports and light, but reliable, quarterly financial information."

The provisions on quarterly reports and other key items in the Directive are summarised below:

- **Non-periodic information** - there are measures to facilitate shareholder participation in general meetings including information about proxy voting under the laws of the issuer's home Member State.

The obligation to disclose major shareholdings would generally start at an initial threshold of 5% and increase in similar increments up to 30%.

Strict time limits call for the investor to inform the company within five business days with an additional three days for full public disclosure.

- **Periodic reports** - firms must issue an audited annual statement of accounts, based on IAS, and a management report within three months after the end of each financial year. Interim reports are required semi-annually and quarterly within 60 days after the relevant period.

The half-year data is in accordance with IAS 34 and includes an update of the latest management report. Information for quarters one and three is limited to net turnover along with profit and loss before or after tax.

The issuer also has the option to review short-term trends such as strategy and developments for the remainder of the financial year. This is therefore very different from the US practice of audited quarterly accounts with a full management discussion and the provision of earnings guidance.

Finally, companies which only issue debt need only report annually and semi-annually, with no periodic requirement at all for those dealing exclusively with large denominations as in the Eurobond market.

- **Languages/dissemination** - at present, each Member State where a company is listed may require its own official language for information disclosed to the public.

The Directive would simplify this by enabling issuers to use the language of their home Member State as well as 'a language customary in the international sphere of finance'.

Dissemination could be through a single source, such as the company website, as long as there is an efficient system for electronic alerts on important developments.

The Directive does not deal with the conditions for electronic voting which are covered by the Commission's Action Plan on corporate governance.

- Technical implementation - if adopted, this will be a framework directive requiring detailed technical implementation measures based on consultation with experienced professionals including the Committee of European Securities Regulators (CESR).

Among other things, these will prescribe the arrangements for timely and effective dissemination such as disclosure by electronic means.

Highlights in next month's issue include:

- Feature on the implications and impact of the Prospectus Directive by David Toube, partner, Ashurst Morris Crisp.
- Feature on the development of EU accounting directives and obstacles facing the implementation of international standards by Jeremy Foster, partner, PricewaterhouseCoopers (PwC).
- Commentary on the European Commission's campaign against discrimination of foreign funds in Europe by Travis Barker, European Policy Analyst, Investment Management Association (IMA).
- Analysis of issues related to the Transparency Directive by the London Stock Exchange.

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FSA outlines roadmap for a single European market

The recent FSA Annual Public Meeting (17 July, London) that EFSR attended was significant for three particular reasons.

First, as a record of the FSA's work over the last 12 months in what has been a turbulent and unsettled period in the financial services industry - within the UK and globally *(see www.fsa.gov.uk for the FSA Annual Report 2002/03)*.

Second, in the context of the 2005 countdown to an integrated EU single market through the Financial Services Action Plan (FSAP) and its collection of directives and regulation coming into force now and in the near future.

Third, it was one to remember purely by the fact that it was the final meeting Sir Howard Davies would be attending as FSA chairman.

Davies' work within the FSA, the UK's financial industry, and international markets is well established and respected. As Stewart Boyd, FSA deputy chairman, affectionately commented, "one of Howard's qualities is his ability to combine authority with charm and humour".

In his speech, Davies raised a number of important issues, one of which was "the regulatory challenge rooted in overseas development".

Though he noted that not all changes in regulation coming through from Europe were "obviously beneficial to firms, consumers and investors in the UK", he accepted the value that the "dynamism of a European market" could create.

The rising importance of Europe on the FSA's agenda was reflected by Boyd's statement that the FSA has allocated additional resources to "deal with EU and international issues".

The future of a EU single market in financial services was the subject of a presentation by Diane Moore, International Policy Co-ordination and EU Affairs, FSA, following the Public Meeting.

"Although 2005 is the final legislative deadline for implementation of the FSAP, it is clear that the EU will not achieve a genuine single market by then," she began.

"However, there is persuasive evidence that greater cross-border competition will stimulate efficiency and price reduction, and that a commitment on the part of politicians, regulators and practitioners to achieve a

NEWS IN BRIEF

EU capital adequacy measures on track

The European Commission has published a third consultation paper, along with an analysis of the Third Quantitative Impact Study (QIS), which confirm that good progress is being made on the new capital adequacy requirements for banks and investment companies. A proposal for a revised EU Directive will be presented in early 2004, with the rules set to come into force at the end of 2006 in accordance with the schedule for Basel II at international level. Certain critics, notably the US, have cast doubt on this timetable by calling for additional detailed studies on the structural impact of these measures. Public comments on the Commission's latest consultation paper may be submitted until 22 October 2003.

Expert forum to promote user interests

The European Commission plans to establish a network of 12 qualified experts, the 'FIN-USE Forum', to promote the development of financial services policy from the perspective of retail consumers and small businesses. This will complement the advice already received from professionals in the financial services industry. The Forum will deal with important issues affecting users including their own policy initiatives. They can also expect support from a capable research organization under an arrangement to be concluded with the Commission. The deadline for applications to the Forum is 10 September 2003.

IAS endorsed and set for 2005 deadline

The Accounting Regulatory Committee (ARC) unanimously voted in favour of adopting International Accounting Standards (IAS), including related interpretations (SICs), on 16 July. The European Commission welcomed the decision as the endorsement of IAS is a fundamental element of the IAS Regulation requiring 7,000 or so listed EU companies to prepare their consolidated accounts in accordance with IAS from 2005 onwards. However, IAS 32 and 39 (which deal with accounting for financial instruments) remain the rogue standards causing friction and debate. Both are exempt from current adoption and ARC has allowed the IASB time to improve and refine the standards by 1 January 2005. In addition, the European Commission and ARC will consider the revised IAS 32 and 39 as soon as possible (at the latest in March 2004).

European single market is indeed well judged," she added.

Pointing to the need for clear articulation of performance measures, Moore explained that, "we have to understand what it is that we are aiming for, how to measure success [in terms of policy and regulation], and accordingly, how to monitor that success at both EU and Member State level".

She acknowledges that work on achieving the single market will remain a difficult process (15 Member States, plus enlargement candidates, covering a range of different regulatory frameworks) and that greater, more effective harmonisation will be required.

"The key is to determine which areas are suitable for harmonised rules now and which are more appropriate topics for the longer-term supervisory convergence agenda," she asserts.

Moore stresses the need to look beyond the FSAP and identified a number of priorities to focus on:

- **The EU/US agenda, particularly in the aftermath of Sarbanes-Oxley and application of International Accounting Standards (IAS)**

The EU and the US must settle their differences over the progress and consolidation of EU/US regulation, and, it is critical to clarify what issues should be on this agenda, who should tackle them and how.

- **The need to encourage greater use of non-legislative options by the Commission and Member States**

Moore believes that many Member States have not fully implemented or enforced the EU Directives they signed up to. This is due to various reasons such as differing legal and regulatory frameworks.

She considers practitioners and national regulatory bodies have a vital role to play alongside the Commission in addressing such problems.

- **Enlargement of the EU**

Moore explains that it is vital to understand the ten new Member States in terms of their regulatory background and the frameworks they have in place, as well as them understanding and accepting their role and responsibilities within the EU.

- **Implications of Lamfalussy**

She is cautious about the possibility of a single European regulator. "Although it may be an effective option in the long-term for the EU, there are many legal and practical difficulties in the way of establishing a single EU regulator in the short-term," she says.

DIARY

25 - 28 August — *Kampala, Uganda*

Eastern and southern Africa anti-money laundering group

www.imolin.org

28 August — *Connecticut, US*

Open roundtable on qualifying special-purpose entities

www.fasb.org

28 - 30 August — *Wyoming, US*

27th Economic Policy Symposium: 'monetary policy and uncertainty - adapting to a changing economy'

www.oecd.org

5 - 12 September — *Beatenberg, Switzerland*

19th international banking supervisory seminar - core supervisory issues

www.bis.org

8 - 12 September — *Pretoria, South Africa*

Joint OECD-SADC seminar on auditing multinational enterprises

www.oecd.org

9 - 11 September — *Basel, Switzerland*

Focused seminar - operational risk

www.bis.org

15 - 19 September — *Maçao, China*

Annual meeting and forum on technical assistance of the Asia-Pacific Group on money laundering

www.imolin.org

16 September — *London, UK*

FSA conference on implementation of the Basel proposals

www.fsa.gov.uk

16 September — *Brussels, Belgium*

European Commission conference on security of payments in the Internal Market

www.europa.eu.int/comm

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"Meanwhile, the concept of regulatory networks is already working well in the area of securities and can be extended effectively across to other sectors such as banking and insurance", she adds.

Looking at the UK specifically, there are key roles for the 'official sector' (such as the FSA, Treasury, and Department of Trade and Industry) to perform. Moore affirms that in the last 18 months joint discussions between official bodies have increased, as well as greater dialogue with the industry and consumers.

Other fundamentals include embedding the principles highlighted in the Financial Services and Markets Act 2000 (FSMA) into 'everyday' regulation, in the EU as well as domestically; and also, increasing influence over the regulatory process in Brussels through lobbying.

Equally, UK firms and consumers have their own part to play on the European stage. Again, greater communication is critical – between each other, and with the official sector; as is spending more time lobbying Brussels where necessary.

Moore also points to the need for 'acceptance of the winners and losers dimension' but is confident that, "although financial services in London will not remain the same, the advantages will certainly outweigh the disadvantages".

The message from the FSA is that a "positive, proactive approach" is the way forward in developing a European single market. Moore accepts that such a market will not create an automatic "financial utopia", but she considers the real opportunity to be the fact that "a single European market could be an exciting and profitable place to do business and...practise world-class regulation."

NEWS IN BRIEF

Prospectus Directive definitively adopted

In July 2003, the Council of Ministers formally adopted the Prospectus Directive as amended by the European Parliament to increase the freedom of debt issuers to choose the appropriate regulator. These amendments were forcefully resisted by France, Italy and Spain which wanted to restrict most regulatory approvals to the country where the issuer is registered. The Directive creates a 'single passport' which should make it easier to raise capital throughout Europe by establishing adequate and equivalent disclosure standards in all Member States. It is scheduled to be implemented within 18 months after publication in the Official Journal.

Unlawful to discriminate against foreign pension and investment funds

The European Court of Justice (ECJ) recently ruled that national tax legislation which unfairly discriminates against occupational pension insurance issued in another Member State is incompatible with Community law.

Specifically, this involved Sweden which distinguished between the deductibility of premiums for pension and endowment insurance based on whether the insurer was established in that country. In other similar cases, the European Commission has now decided to refer Denmark to the ECJ, and made formal requests to the UK and Ireland as the initial stage of infringement proceedings under Article 226 of the Treaty. Separately, the Commission issued 'reasoned opinions' to Austria and Germany seeking an end to discriminatory taxation which makes it difficult for foreign investment funds to market their services. This is the second stage under Article 226 and may result in a referral to the ECJ if not satisfactorily resolved. It also requested information from France on this subject.

Basel Committee issues risk-management principles for electronic banking

The Basel Committee on Banking Supervision has just published the final version of two reports on the management and supervision of cross-border electronic banking activities *(see www.bis.org)*. These were prepared by the Committee's Electronic Banking Group which consists of regulators from the European Central Bank as well as Australia, Belgium, Canada, France, Germany, Hong Kong, Italy, Japan, Luxembourg, the Netherlands, Singapore, Spain, Sweden, Switzerland, the UK and the US.

The purpose is to increase the safety and soundness of electronic banking by developing principles in critical areas such as oversight by the board of directors and management, appropriate security controls, legal and reputational risk, the need for effective home country supervision, and ongoing international cooperation among regulatory authorities. The reports also distinguish between different degrees of due diligence and disclosure at the wholesale and retail levels with more rigorous standards required for the latter.

UCITS impact on European funds

by Vincent Mercer, Speechly Bircham

All markets within financial services in Europe face great transformation and challenge - the funds industry is no exception. What impact have UCITS I, II and III Directives had and what has been the European Commission's focus in their implementation?

These are interesting times for financial services in Europe. Three years ago, the European Heads of Government at the Lisbon Summit set themselves the objective of making the EU the most competitive economy in Europe. This included creating a single European capital market to rival that of the US.

The resulting Financial Services Action Plan (FSAP) envisages achieving this, in legislative terms, by 2005 - 32 of the 42 core measures in the action plan have already been completed.

This feature looks at the current state of play in relation to the European Commission's attempts to completely change the face of the European funds industry through UCITS (Undertakings for Collective Investments in Transferable Securities) I, II and III Directives. (To avoid confusion, in this feature, funds include collective investment schemes - CIS).

A large percentage of European retail investment is through funds but, as they have developed in different ways in jurisdictions, the European Commission is faced with a complicated landscape *(see box-out adjacent)*.

UCITS I – the first Directive

The process of harmonising legislation governing funds in Europe began in 1985 with the original UCITS Directive (UCITS I - 85/611/CEE).

Under the UCITS I Directive, any fund which achieved the UCITS standard was capable of being marketed in any European Economic Area (EEA) Member State.

This is an important right as it gives the promoter and manager of a UCITS qualifying scheme the right to market their qualifying product throughout the EEA. The EEA is a slightly larger economic grouping than the EU, covering the EU and a few additional participating states such as Iceland.

The basic characteristics of a UCITS scheme under UCITS I include the requirements that:

- the scheme's sole objective must be investing in transferable securities;
- the risk must be spread - there are limits on exposure to any particular investment (typically 5% of the fund's assets in the securities of any one issue and no more than 5% of assets in another UCITS fund); and
- the vehicle must be open-ended and allow ease of subscription and redemption which must come out of the fund's assets.

Whilst UCITS I set the benchmark, Member States have taken different approaches to the implementation of the Directive depending on their interpretation of it. These individual approaches to implementation have effectively hindered the European Commission's

A complex landscape

(i) Funds

UK - in the UK, there are Unit Trusts which are generally authorised (AUT) and, more recently, Open-Ended Investment Companies (OEICs) and Investment Companies with Variable Capital (ICVC).

France, Belgium and Luxembourg - in these countries, funds have developed in other ways including a vehicle similar to an OEIC, a Sociétés d'Investissement à Capital Variable (SICAV), and a contractually based arrangement, a Fonds Communes de Placement (FCP).

Germany - meanwhile, in Germany, funds have no legal personality and appear either as equity or fixed interest funds, Investmentfonds or Spezialfonds.

(ii) Tax treatments

The situation is further complicated by a confusing array of tax treatments of funds throughout Europe.

Luxembourg - in some jurisdictions like Luxembourg, funds pay an annual subscription tax but are free from income and capital gains tax.

France - in others, like France, the funds themselves are apparently not subject to tax but the resident investors are subject to income and capital gains tax on receipts from the funds.

UK - the situation in the UK is doubly complicated through a system which distinguishes between capital and income taxes. AUTs are exempt from capital gains tax but some forms of income are subject to income tax. UK resident investors will generally be subject to capital gains tax should there be an increase in the value of their investment

Fortunately, the harmonisation of taxation is outside the scope of this feature.

objective of creating a transparent harmonised market for funds throughout the EU.

To address this issue, the Commission adopted two additional directives UCITS II (2001/108/EEC) and UCITS III (2001/107/EEC) on 21 January 2002.

The UK has taken advantage of a concession in the Directive to depart from the maximum of 10% exposure to another UCITS scheme which is increased to 20%.

In assessing the exposure of a fund, the Directive generally requires the operator to have regard to the underlying investments of the scheme. However, taking advantage of another concession, in the UK, the FSA has relaxed this requirement.

> Individual approaches to implementation have hindered the Commission's objective of a harmonised market for funds in Europe.

UCITS II - the 'Product Directive'

The first and most radical change brought in by UCITS II is that the range of specific types of fund will end. Under UCITS I, it was only possible to create a Securities Scheme and a Warrant Scheme.

In the UK, outside UCITS I, the UK regulator, the Financial Services Authority (FSA) allowed Money Market schemes, Futures and Options schemes and Funds of Funds schemes which could all be formed as AUTs or ICVCs but which could only be marketed in the UK and other jurisdictions on a case-by-case basis.

Under UCITS II, all of these schemes will qualify as UCITS schemes, although some UK schemes will still not qualify, such as Feeder Funds, Property schemes and (the rarely used) Geared Futures and Options schemes.

In future, the strict demarcation between types of schemes will end and there will simply be 'mixed schemes'. It will be for the operator of the scheme to decide on the investment strategy for their schemes.

This will not alter the structures used to create funds which will continue to owe much to the vagaries of the laws of their place of formation. Only the arrangements for regulating the funds will change.

Some aspects of UCITS I still remain, such as the requirement to generally invest only in government and public debt and listed securities, although there is some relaxation increasing the range of eligible exchanges. Funds will also generally still be required to allow investors the ability to subscribe and redeem their investment at will.

Spread requirements

The freedom to develop mixed schemes is subject to various constraints including the accepted industry practice of spreading risk.

Here, UCITS II retains maximum investment limits similar to those already in place, limiting investment in the securities of any one issuer to 5% of the value of scheme property which rises to 10% for up to 40% of the overall value of scheme property. For deposits, the maximum exposure is 20% of the value of scheme property and for public debt 35%.

Up to 30% of the value of scheme property can be invested in a non-UCITS scheme provided that the scheme:

- is authorised in a non-EU state with equivalent law and adequate co-operation with the UCITS competent authority;
- affords equivalent protection to unit holders;
- reports regularly to unit holders; and
- limits holdings in other funds to 10%.

It seems fairly clear that different competent authorities will approve different non-UCITS schemes.

For example, in the UK there have been historic relationships with various overseas territories under which funds resident in these jurisdictions have been available to investors in the UK and the Recognised Territories, which include the Channel Islands and Bermuda.

Other Member States are likely to have other historic relationships allowing plenty of scope for innovative product development.

Derivatives

With the increasing use and understanding of derivatives, inevitably UCITS II has allowed their use as

Implementation of UCITS II

All funds must convert to the new UCITS II format by 13 February 2007 at the latest. As might be expected, the arrangements to implement the Directive may well vary from jurisdiction to jurisdiction but all Member States are required to have the necessary rules in place by 13 August 2003.

In the UK, the new rules were implemented on a voluntary basis from 1 November 2002. In line with the Directive, a new fund can be launched under the existing pre-UCITS II rules until 13 February 2004 but must convert to a UCITS scheme on or before that date.

Any fund launched in the UK before 1 November 2002 has until 13 February 2007 to convert to a UCITS scheme.

part of the overall investment strategy of a fund. Under the original UCITS Directive, derivatives could only be used for 'efficient portfolio management', a technique which allowed the limited use of derivatives to increase income or reduce risks.

There are, of course, rules proposed for investment managers who intend making any significant use of derivatives in their investment strategy which include:

- a requirement that the use of derivatives must be within the stated investment objectives of the fund;
- the use of derivatives must be monitored and the fund manager must employ a Risk Management Process (RMP) to do this and ensure the exposure of the fund to derivatives never exceeds its assets; and
- the type of derivative strategies and techniques used, and the investment limits governing their use, must be disclosed to actual and potential investors.

When assessing a fund's exposure to any issuer, derivatives are to be taken into account and the investment manager is required to look through into the security or other asset underlying the derivative contract.

In allowing the use of derivatives, investment managers are not limited to exchange traded products. They can if they wish, invest in off-exchange, over the counter (OTC) derivatives so long as the contracts are subject to daily pricing by the issuer.

> The first and most radical change brought in by UCITS II is that the range of specific types of fund will end.

UCITS II - Index funds

The original UCITS Directive did not contemplate index tracker funds as such, although they could be established as a UCITS scheme if they fell within the scope of the original UCITS Directive.

UCITS II now recognises funds replicating an index and where 'the aim of the UCITS investment policy is to replicate the composition of a certain stock or debt securities index' the 10% maximum exposure to any one issuer is increased to 20%. In exceptional circumstances this is raised to 35%.

To qualify, the index must:

- be composed of sufficiently diversified components;
- represent an adequate benchmark for the market to which it refers; and
- be published in an appropriate manner.

As the FSA consultation on the implementation of these rules notes, the emphasis is on replication of the index, not replication of the performance of the index which leads to some interesting side issues since virtually every index has a set of rules governing its composition leading to its constituents changing periodically.

There is a 5% of the value of scheme property exposure limit on any one issuer, rising to 10% for approved banks. Except for long calls (when all that is at risk is the premium paid), the investment manager must re-value the derivative by marking to market on a daily basis.

The development of an RMP is key to the use of derivatives by an investment manager. In the UK, the FSA proposes that it and the fund's depository approve the RMP and any changes to it.

Scheme particulars

Whilst UCITS III envisages the development of pan-European prospectuses, UCITS II makes some specific disclosure requirements.

As noted above, if a fund is to use derivatives as part of its investment strategy, it must disclose this to investors and potential investors including giving information about quantitative limits, methodology and developments in the policy.

In the case of other specialist types of fund, such as Fund of Funds, Index Funds, Money Market schemes and Derivative schemes, the funds' investment policy must be disclosed. If the fund is what is termed a 'higher volatility fund' the sales and promotional materials must clearly state this.

UCITS III – the 'Management Directive'

In the same way that the original UCITS Directive granted passporting rights to a limited range of products, it was equally lacking in relation to management companies.

UCITS European passport

The problem under the original UCITS Directive was that whilst an investment manager in one Member State (their Home Member State) could develop products which could be made available to investors in other Member States (Host States), the Directive did not necessarily allow the investment manager the right to promote their fund product in the Host State. They were effectively limited to operating in their Home State.

This changes under UCITS III and an investment manager can obtain an EEA passport allowing them to

UCITS III - Simplified prospectus

The Management Directive proposes a simplified prospectus to use as a marketing document throughout the EEA.

Each EU Member State generally has its own (often detailed) laws and rules on the content of any prospectus and, in many jurisdictions, these documents require specific regulatory approval.

There is currently much debate on a proposed EU Directive on the form and content of prospectuses generally, not just in relation to funds.

In the UK, there is separate but related debate about product 'mis-selling' in which investors have bought products which are unsuitable for them sometimes based on inadequate information about the nature of the product and risks involved.

In one of his last public addresses at the FSA's Annual Meeting (17 July 2003), Sir Howard Davies, outgoing chairman of the FSA, noted that the financial services industry in the UK had failed to learn the lessons of mis-selling.

"The biggest disappointment of my time at the FSA has been the failure of firms, and particularly their senior management, to learn the lessons of past mis-selling. Sadly, the recent history of the British retail financial services industry is proof of the adage that those who fail to understand the mistakes of the past are condemned to repeat them."

The position the FSA is taking in the UK is to adopt less prescriptive rules on the content of prospectuses for funds. Whilst in line with the UCITS III Directive, a full prospectus must be prepared and made available to investors on request.

The need to provide each investor with an often lengthy technical document will be replaced with an obligation to provide investors with a user-friendly key features document.

The FSA is still consulting on aspects of proposed prospectus rules as part of its consultation on establishing a UK disclosure regime and there is likely to be more to come on this subject. The current proposals will require a prospectus which must be translated into the language of any Host State in which the fund is marketed.

offer their services in other EEA Member States.

Previously, an investment manager could only offer their services in other EEA Member States if they obtained an ISD (Investment Services Directive) passport.

The ISD is one of the measures designed to bring about a single pan-European market in financial services and allows financial institutions established in their Home State to offer services and establish branches in any Host State.

The ISD did not cover managers of UCITS schemes so they were consequently unable to use the ISD to set up in another Host State and the original UCITS Directive did not include passport rights.

The UCITS passport will now join the ISD passport as an avenue through which an investment management company can offer its products in any Host State.

As with the ISD, there are various requirements including a system of notification and compliance with Host State rules. However, even this apparently simple move has contrasting consequences in different Member States.

The Directive differentiates between those UCITS schemes which are self-managed and those which are not. In the UK, a fund is generally not self-managed and UK legislation and rules have been established on this basis.

Another anomaly in the UK is that there are both investment management companies which are typically managers of AUTs and the directors of corporate ICVCs who are generally authorised as Authorised Corporate Directors (ACDs). Under the original UCITS Directive, an ACD will now become an investment management company for the purposes of UCITS III, forcing some of these organizations which have obtained an ISD passport to restructure

In the UK, the FSA has stated that whilst it will consider introducing self-managed UCITS schemes it believes that there is little demand to establish self-managed UCITS schemes in the UK.

In addition, management companies, if permitted by their Home State regulator, are allowed to undertake a wider range of activities including managing other collective investment schemes not covered by the Directive and undertake further investment activities including:

- the ISD core activity of discretionary portfolio management (including pension schemes); and
- the following non-core activities (provided the activities have been authorised by the Home State regulator) - investment advice, safekeeping and administration but only in relation to units in funds.

In the UK, the FSA has adopted powers to allow UK investment managers to undertake this wider range of permitted activities.

Financial resource requirements

Every European financial institution qualifying under the Investment Services Directive (ISD) is required by the Capital Adequacy Directive (CAD) to have adequate financial resources to meet its business commitments, i.e. to maintain minimum levels of capital. In the UK, there are similar obligations on financial institutions falling outside the ISD.

In the UK, these rules require the operator of a fund to maintain the greater of financial resources of £5,000

(€6,700) or the sum of various requirements.

These requirements are based on risk (position risk requirement, counterparty risk requirement, foreign exchange risk requirement, and other assets requirement) and expenditure (expenditure-based requirement).

A UK regulated firm must maintain enough liquid capital to be able to cover these requirements and for UK investment managers this will generally be higher than the £5,000 (€6,700) minimum.

The details of the proposed rules are fairly complex but in essence, and perhaps unsurprisingly, capital requirements are set to rise. Whilst in most cases in the UK the FSA has sought to allow UK investment managers maximum flexibility in the case of capital requirements, it has sought to impose higher requirements than those mandated in the Directive.

The Directive's financial resource requirements for investment managers will be an initial requirement of €125,000 plus additional capital of 0.02% of the value of portfolios managed by the investment manager, which exceed €250,000,000.

Irrespective of these requirements, the Directive requires that an investment manager's financial resources shall never be less than a quarter of their annual fixed overheads.

The term 'fixed overheads' is not defined in the Directive and, in the UK, the FSA proposes following its current formula of basing the requirement on a firm's annual audited expenditure with some allowances. The FSA notes that this approach is inconsistent with some other EU jurisdictions.

The FSA proposes dividing operators into UCITS firms which only operate UCITS schemes and UCITS investment firms which also provide the wider range of ISD services allowed under the Product Directive (UCITS II). They will have additional financial resource requirements.

Implementation

As with UCITS II, there is a timetable for implementation of UCITS III. The Directive requires that all Member States implement the legislation and rule changes, bringing the Directive into domestic law by 13 August 2003.

The Directive allows a period of transition and investment management companies need not comply with the new rules until 13 February 2004. However, like UCITS II, full implementation is required by 13 February 2007.

In the UK, the FSA is proposing to require the firms it regulates to adopt the new rules on 13 February 2004 except for the financial resource rules.

> The biggest disappointment of my time at the FSA has been the failure of firms to learn the lessons of past mis-selling. Sir Howard Davies

The position in relation to financial resource rules is different. Here, matters are complicated by a review of financial resource requirements in preparation for a new CAD.

Although the Directive requires a full review of the rules by 13 February 2005, the FSA appears to be deferring any significant changes to its financial resource rules for the time being.

It has stated that it proposes a long transitional period until 13 February 2007 but this is subject to a very significant catch as it only applies if the firm does not undertake any of the new activities permitted by the Directive.

Vincent Mercer

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Vincent has spent the last 20 years working within the financial services industry. Having worked with the London Clearing House and the London Stock Exchange, he founded his own specialist financial services practice in 1991 which merged with Speechly Bircham in 2002.

Anti-money laundering developments

by Arun Srivastava, Baker & McKenzie

The cornerstone of international efforts against money laundering has been the FATF's 40 Recommendations. However, the landscape of anti-money laundering regulation has undergone seismic shifts since their adoption in 1990 with particular prominence being given to specific measures to address terrorist related money laundering and financing. What are the latest developments and how is the financial services industry better protected by them?

The FATF's (Financial Action Task Force) 40 Recommendations were originally published in 1990 (revised in 1996 and referred to as the '1996 Recommendations').

Since then, anti-money laundering procedures have gradually become a more accepted part of the culture of financial services and banking institutions. This is partly because the increased focus on money laundering has resulted in a greater enforcement risk to individuals and institutions.

Recognising these and other trends and developments in money laundering typologies, the FATF has now published a revised version of its 40 Recommendations (the 'Revised Recommendations'). They have been described by the FATF's president, Jochen Sanio, as "one of the most important tasks it [the FATF] has undertaken since its inception in 1989".

The FATF has stated that its members will start work on implementing the Revised Recommendations 'immediately'. Accordingly, changes in domestic legislation may follow.

While important initiatives have been taken in relation to certain issues, in other respects the revisions constitute no more than a consolidation of aspects of the 1996 Recommendations. Many of the 1996 Recommendations have been amended or amalgamated into single provisions *(see box-out on page 13)*.

International co-operation

The task of combating money laundering cannot be undertaken in isolation and organizations such as the UN and the FATF have played a pivotal role in the development of anti-money laundering regulation throughout Europe and globally.

As well as influencing the development of domestic legislation, findings of international bodies in relation to deficiencies of anti-money laundering legislation in particular countries provide a useful compliance tool for financial institutions in assessing risks associated with customers from such countries.

For instance, in the UK, the Financial Services Authority (FSA) requires firms that it regulates to obtain and make proper use of the FATF's findings in relation to material deficiencies in anti-money laundering regulation in certain countries.

The international scope of efforts to combat money laundering has given rise to the potential for an overlap between the roles of the various organizations involved. Progress has, however, been made in addressing this concern and developing a co-ordinated approach at an international level.

FATF's NCCT programme

The FATF's Non-Co-operative Countries and Territories (NCCT) programme was reported to be the subject of debate between the FATF and the International Monetary Fund (IMF). In fact, the NCCT programme was suspended while the IMF carried out a pilot programme of assessments and reports on the observance of standards and codes which had regard, amongst other factors, to the FATF's anti-money laundering standards.

The FATF has worked with the IMF and the World Bank to develop a methodology for assessing compliance with international anti-money laundering standards.

Principal developments

Under the Revised Recommendations, the principal developments include the following:

1. More comprehensive provision made in relation to 'Know Your Customer (KYC)' or Customer Due Diligence (CDD) requirements.

2. Specific provision made in respect of higher risk customers such as politically exposed persons, shell banks and correspondent accounts.

3. FATF's Special Recommendations in relation to terrorist financing incorporated in the Revised Recommendations.

4. The list of predicate offences that give rise to a money laundering offence has been expanded.

5. The business sectors subject to anti-money laundering legislation have been enlarged beyond banking and financial services to include professionals (accountants and lawyers) and other sectors judged to be vulnerable to money laundering.

The 'Methodology for Assessing Compliance with Anti-Money Laundering and Combating the Financing of Terrorism Standards' was agreed between the FATF, the IMF and the World Bank in October 2002 and is now being used by these bodies.

It is understood that the IMF is working with countries which do not meet the standards set out in the methodology and that the FATF will not be adding further names to the NCCT list at least for the moment.

On 20 June 2003, the FATF published its Annual Review of NCCTs which resulted in the removal of St Vincent and the Grenadines from the list. There are now nine remaining countries on the NCCT list - the Cook Islands, Egypt, Guatemala, Indonesia, Myanmar, Nauru, Nigeria, the Philippines and the Ukraine.

> Anti-money laundering procedures have become a more accepted part of the culture of financial services and banking institutions.

Customer Due Diligence

CDD was addressed to some extent by the FATF in the 1996 Recommendations. It has also been considered by other organisations since then such as the Basel Committee on Banking Supervision in its paper on 'Customer Due Diligence for Banks' (October 2001).

Effective KYC or CDD procedures are often an institution's best line of defence against potential money launderers and focus on this area is therefore unsurprising.

Recommendations 5 to 12 deal more thoroughly with CDD requirements, providing more detailed guidance in relation to the particular steps that financial institutions should take to know their customers and understand their customers' business.

Recommendation 5 deals generally with due diligence requirements. It consolidates and expands on Recommendations 10 and 11 contained in the 1996 Recommendations and is further developed by comprehensive interpretive notes.

It also introduces a broader concept of CDD. The 1996 Recommendations referred to the need for financial institutions to identify their customers. The Revised Recommendations make it clear that identification of a customer is just one aspect of the CDD process.

Other steps that Recommendation 5 states that institutions should take include the following:

- Obtain information on the purpose and the intended nature of the business relationship with the customer. Recommendation 14 from the 1996 Recommendations referred to the need for institutions to understand complex and unusual transactions but the new requirement is more extensive than this, requiring the institution to understand the overall nature of the relationship with the customer from the outset.
- Perform ongoing due diligence throughout the course of the relationship with the customer and review transactions undertaken by customers to ensure that these are consistent with the institution's understanding of the nature of the business to be conducted by the customer. This emphasises the need for routine proactive monitoring of accounts.
- Recommendation 5 accepts that in carrying out these CDD measures, institutions can apply a risk-based approach. Enhanced CDD should be carried out in relation to high-risk customers or accounts, and, in lower-risk cases, more streamlined procedures can be adopted.
- Recommendation 5 potentially raises the issue of retrospectivity. It states that the recommended CDD measures should be applied to all new customers and existing customers on the basis of materiality and risk.

Clearly, monitoring can be applied on an ongoing basis across accounts but, in certain instances, information formerly collected at the beginning of a relationship may not satisfy the new CDD requirements in the sense described above. Accordingly, with certain existing customers, institutions may need to carry out further due diligence.

Reliance on intermediaries to perform CDD

While the FATF's intention is to tighten up the due diligence process, some pragmatic concessions have been made in line with market practice.

Recommendation 9 allows financial institutions to rely on intermediaries or other third parties to perform certain elements of the CDD process required by Recommendation 5 or to introduce business.

Broadly, according to Recommendation 9, reliance can be placed on verification carried out by another regulated entity with FATF equivalent standards.

The institution should also ensure that the relevant CDD has in fact been carried out and arrange for copies of supporting documents to be made available on request by the introducer/third party.

Focus: recommendations 6, 7, 8, 12 and 18

Politically exposed persons

Recommendation 6 deals expressly with politically exposed persons (PEPs). It requires financial institutions to perform additional due diligence procedures on PEPs.

These include:

- Establishing a risk management system to determine whether particular customers are PEPs.
- Obtaining approval at the senior management level for the acceptance of the PEP as a customer.
- Taking reasonable steps to establish source of wealth.
- Establishing procedures for enhanced monitoring.

Correspondent banks

Recommendation 7 now deals specifically with the risk arising from cross-border correspondent banking. In addition to performing the usual CDD measures, according to Recommendation 7, financial institutions must now gather specific information in relation to the nature of the respondent's business.

In order to fulfil this requirement, institutions are required to assess the reputation of the customer, the standard of supervision to which the customer is subject in its home state, and its compliance history (e.g. whether it has been subject to regulatory action or a money laundering or terrorist financing investigation).

Emphasis is also placed on ensuring that the other institution has appropriate anti-money laundering and terrorist financing controls of its own. In addition, senior management should sign off on accepting the customer.

New technology

Recommendation 8 deals with the risks associated with transacting business through the internet or other new media. It states that institutions should pay 'special attention' to this issue.

It expands on Regulation 13 of the 1996 Recommendations requiring institutions to have policies and procedures in place to address any specific risks associated with non-face-to-face business relationships or transactions.

Sector expansion

Importantly, owing to the increased sophistication of money laundering techniques, FATF has also considered the threat to non-financial business from criminal activities.

It sets out in Recommendation 12 specific situations where casinos, real estate agents, dealers in precious metals, lawyers, accountants and others may have to adhere to the same due diligence requirements as financial institutions.

These recommendations are broadly reflected in the EU's Second Money Laundering Directive, which is presently being implemented in EU Member States.

Shell banks

A shell bank is defined by the FATF as a bank incorporated in a jurisdiction in which it has no physical presence and which is unaffiliated with a regulated financial group.

Whereas the 1996 Recommendations merely warned of the risk of shell banks, Recommendation 18 of the Revised Recommendations calls on countries to prohibit the establishment or ongoing operation of shell banks.

It also requires that financial institutions should not enter into correspondent relationships with shell banks and that they should guard against establishing relations with foreign financial institutions that permit their accounts to be used by shell banks.

Reporting suspicious transactions

Recommendation 15 from the 1996 Recommendations provided that if a financial institution suspected that funds stemmed from criminal activity, the institution should be required to report its suspicions promptly.

Recommendation 13 of the Revised Recommendations expands on this obligation imposing an obligation on institutions to report their suspicions - not only where they actually suspect that funds are the proceeds of criminal activity or are related to terrorist financing - but also where the financial institution has reasonable grounds to suspect this.

This expanded requirement is consistent with measures already introduced in the UK. The UK's anti-money laundering regime has recently undergone a major overhaul with the introduction of the Proceeds of Crime Act 2002 (POCA). Part VII of POCA deals with money laundering offences and consolidates existing legislation in this area.

One of the most significant and controversial innovations under POCA is the reporting offence contained in Section 330. Under this section, a person in a financial services or banking institution can commit an offence where the person fails to disclose suspicions that another person is engaged in money laundering.

This offence is committed where the person concerned either knows or suspects that another is engaged in money laundering or should on reasonable grounds have so known or suspected.

Thus under Section 330 of POCA, a person can commit an offence where he has no actual knowledge or suspicion of money laundering but a Court finds that he should have had such knowledge or suspicion.

For example, where there is information available to the institution that would lead a reasonable person to suspect that a client or another person is engaged in money laundering, failure to disclose could constitute an offence.

The Revised Recommendations mark a step forward in anti-money laundering regulation. In many cases, financial institutions are already living with domestic legislation that mirrors the scope of certain new provisions proposed by the FATF.

> Effective KYC or CDD procedures are often an institution's best line of defence against potential money launderers.

This provision emphasises the need for institutions to analyse and monitor information relating to their customers so that they are in an effective position to identify indications of suspicious activity.

It remains to be seen whether the expansion in the scope of the UK's reporting offence will assist or hinder law enforcement bodies.

The expansion in scope of a reporting offence along the lines suggested by the FATF will undoubtedly make it easier for prosecution or other enforcement action to be taken against institutions and those who work for them. However, it may also encourage defensive reporting by institutions that may ultimately overwhelm Financial Intelligence Units.

An approach that emphasises quantity, as opposed to quality, of reporting may actually make it more difficult to detect genuine cases of money laundering.

Predicate offences

The 1996 Recommendations focused on the laundering of funds arising from drugs trafficking. The Revised Recommendations require countries to broaden the range of predicate offences (the underlying criminal offences which can result in the commission of a money laundering offence where the proceeds of the underlying offence are laundered).

Recommendation 1 states that countries should criminalise the laundering of proceeds of the 'widest range of predicate offences'. It recognises that certain countries may impose a threshold, including only specified offences or classes of offences as predicate offences.

Where such a threshold approach is taken, at a minimum it is recommended that countries should criminalise the laundering of the proceeds of all serious offences and also specifies a list of designated offences which should be included in any event (including racketeering, terrorist financing, fraud, insider dealing and market manipulation).

Under POCA, the UK already complies with this since a money laundering offence can be committed where a person seeks to launder the proceeds of any crime irrespective of its seriousness. The UK does not impose a *de minimis* threshold.

However, innovations in areas such as reporting obligations are likely to present new challenges as and when they are implemented.

Nowadays, there is greater acceptance of the need for compliance with anti-money laundering regulation. Yet, more emphasis needs to be placed on an evaluation of the effectiveness of the enhanced anti-money laundering measures that have been introduced by the US, the UK and other countries over the last two years (which in many respects, are repeated in the Revised Recommendations). This will ensure that the additional obligations faced by institutions are both proportionate and effective.

Arun Srivastava

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Arun's experience includes advising on the scope of FSA regulated activities; provision of cross-border services in Europe; and compliance with the requirements of the FSA's Handbook.

His focus also involves providing legal guidance to firms on anti-money laundering compliance procedures and reporting of suspicious transactions. Arun has acted for regulators and governments in relation to regulatory enforcement and money laundering proceedings.

Educated at Southampton University (LLB hons), Arun is a member of the Law Society of England and Wales.

The rise of integrated financial regulators

by Eddy Wymeersch, professor at the University of Ghent, Belgium and chairman of the Belgian Banking and Finance Commission (CBF)

The dynamic of financial regulators is changing. Where they once traditionally dealt with one or more specific business segments of the financial services industry; they are now evolving into 'integrated' regulators with wider supervisory authority. What are the driving factors behind this development and what added value can this new breed of integrated regulators provide the financial markets they serve?

In the field of banking, prudential regulation and supervision were frequently exercised by the central bank, while insurance business was supervised by a specialised 'insurance commission' independent from the central bank. A further body supervised the securities business, i.e. the stock exchange or other securities markets, and the issuance of securities or their post trading.

However, the use of this kind of supervisory scheme is decreasing and we now see the emergence of the 'integrated', sometimes referred to as the 'single', regulator *(see box-out adjacent)*.

Indeed, two degrees of integration can be distinguished, the first relating to banking and insurance, while the second includes the securities business.

Driving forces

The rise of the 'integrated regulator' is due to a series of factors where market evolution is fundamental. As the banking, securities and insurance industries are increasingly being integrated into financial conglomerates, the supervisory approach should follow the same pattern. Consolidated supervision will ensure a single entry point for supervised entities allowing group-wide issues to be dealt with by one regulator.

At the same time, the possibility of engaging in regulatory arbitrage would be reduced. Risks arising from the business of one entity would no longer be transferred automatically to another without the supervisor adopting the necessary risk control measures.

In fact, several of these financial conglomerates show evidence of developing into more integrated financial enterprises. For example:

- management now takes place on an integrated basis;
- boards sometimes have the same composition or are closely co-ordinated;
- risk control functions (internal audit, compliance, risk and financial policies) are located at top level and cover all lines of business, irrespective of their nature or level; and
- capital allocation is decided at group level, resulting in the optimal use of available capital.

Legal questions

A further development is that management lines now

Global variation in regulatory practice

EU Member States - in most EU Member States, the model of the 'integrated' regulator has recently been adopted. The UK, Ireland, Sweden, Denmark, Germany, Austria and Belgium – as well as the EEA countries, Norway and Iceland - have chosen this supervisory scheme.

In Finland, insurance integration has been discussed but not yet decided on.

Hungary, the Czech Republic and Switzerland - among the accession countries, Hungary has adopted the integrated regulator model, while the Czech Republic is considering the creation of a single regulator.

The same applies to Switzerland where the merger of the Federal Banking Commission with the Insurance Commission has been announced.

Southern European states - the southern European states, including France, Spain, Italy, Portugal and Greece, follow a different path and maintain three separate bodies.

Asia - outside Europe, there is clear evolution towards full regulatory integration. Singapore, Japan and Korea are such examples.

Canada and Australia - these two countries, for constitutional reasons, have limited integration to prudential matters.

The Netherlands - the Netherlands has pooled prudential supervision under the aegis of the central bank, while conduct rules have been allocated to a different government supervisor.

US - in the US, as is well known, regulation is dispersed over several federal agencies - the Federal Reserve, Controller of the Currency and the Securities and Exchange Commission (SEC) - and state bodies such as the State Insurance Commission.

cut across legal organizations leading to new and interesting legal issues.

Recently, questions have been raised as to whether banking and insurance should necessarily be lodged under two different legal entities, a requirement that, technically at least, stems from European directives.

The development towards integrated supervision should also be linked to commercial trends. Insurance products, although wrapped in different legal instruments, are becoming increasingly similar to banking products.

Both are distributed through the same networks ('banc-assurance') and hence have the same requirements. These include adopting 'know your customer' (KYC) rules; conflict of interest rules; disclosure obligations; and, products being 'produced' or assembled in the same 'factories'.

Current fashion or long-term value?

The move towards an integrated regulator is not a trend or fashion. It answers the call of financial markets for a single, well-equipped, well-staffed supervisor.

The decision to concentrate different types of supervision has also been triggered by recent developments in markets - in particular, the downturn in the equity markets and resulting financial difficulties - that have led insurance companies to more readily accept supervision being handed over to the banking supervisor. This action strengthens the authority of supervision and hence the sector's reputation.

Apart from these transitional factors, integration of regulatory supervision in Europe corresponds to a fundamental necessity - that of great efficiency.

Eddy Wymeersch

Eddy Wymeersch is professor of Law and founder of the Financial Law Institute at the University of Ghent. His specialised areas include banking, company law and corporate governance, financial transactions, and securities regulation.

He has extensive experience in financial services regulation and, since April 2001, he has been Chairman of the Belgian Banking and Finance Commission (CBF).

The CBF is an autonomous supervisory institution in charge of supervising banks, investment firms, securities transactions and markets, UCITS, and from 1 January 2003, insurance and pension funds as well.

Employee financial participation faces tax obstacles

by Fabrice Pourceau, European Federation of Employee Shareownership (EFES)

In July 2002, the European Commission issued a Communication on a framework for the promotion of employee financial participation. Significantly, in its provisions, it highlighted a series of cross-border obstacles that impede Europe-wide implementation. This commentary outlines the issues that should be tackled in order to improve the current situation.

The Communication of July 2002 *(see box-out below)* called for the creation of a group of independent experts responsible for identifying the main obstacles to the growth of employee financial participation, particularly transnational challenges, and the subsequent formulation of suitable remedies.

This commentary highlights the issues that are important for the expert group to address in order to improve the present situation.

Background

The Communication (from the Commission to the Council, the European Parliament, the Economic and Social Committee, and the Committee of the Regions on a framework for the promotion of employee financial participation, COM [2002] 364, 5 July 2002) was drafted in collaboration with the European Foundation for the Improvement of Living and Working Conditions.

It is based on PEPPER (Promotion of participation by Employed Persons in Profits and Enterprise Results) I and II reports.

Earlier this year, the Economic and Social Committee adopted a positive stance on the Communication, while in June 2003, the European Parliament passed a resolution on the Menrad Report on employee financial participation, thereby endorsing the proposals in the Communication and calling for better mutual recognition of different national systems.

The Menrad Report reaffirms some of the principles and good practices that were already stated in the Communication. These include voluntary participation, clarity and transparency, avoidance of unreasonable risks, and compatibility with worker mobility.

In particular, the European Parliament stressed that attention must be paid to new Member States where financial participation has not yet developed to any great extent and where the requisite legal and taxation frameworks are lacking.

Although financial participation gives employees the opportunity to participate in profit and enterprise results, under broader definitions, it can also include employee stock ownership (ESOP), possibly combined with direct or indirect participatory management.

Financial participation has flourished mainly in the US and the UK where profit-sharing, gain-sharing, savings plans, share-based plans and ESOPs have become relatively widespread on a voluntary basis with some government encouragement through tax laws.

In continental Europe, financial participation has been influenced more by ownership of capital or profit-sharing. In part, the growth of state-owned companies has contributed to wider employee ownership.

In many cases, from enterprise transfer to the creation of additional savings, and at a time when financing retirement schemes are at the forefront, financial participation can prove to be a useful tool.

Support for financial participation

In a report commissioned by the Directorate General for Enterprise (DG Enterprise), published in May 2002, a third of all EU companies are estimated to 'change hands' over the next ten years (from 25-40% depending on the Member State).

As a consequence, an average of 610,000 small and medium-sized enterprises will change ownership each year. This potentially affects 2.4 million jobs *(source: http://europa.eu.int/comm/enterprise/entrepreneurship/support_measures/transfer_business/best_project.htm)*.

If properly implemented and associated with an emphasis on participatory management, financial participation schemes are generally considered to have a positive effect on productivity, particularly through organizational innovation.

In a European, now often global, financial market where large companies operate in competitive and multicultural environments, employee financial schemes can also be used as defensive or offensive tools. A defensive tool by being used to form blocking minorities intended to fend off hostile takeover bids, while raising fresh money from loyal investors.

In contrast, employee financial schemes can be used as an offensive tool as greatly diversified multinational companies, or even start-up firms, seek to create or strengthen their corporate identity.

Fiscal diversity across Europe

A glance at tax rules across Europe provides a clear picture of the daunting tasks facing companies that consider implementing cross-border participation schemes. In the area of personal income tax and capital gains, a rapid stock take of Member State tax rules reveals the extensive diversity.

1. Ireland, France and the UK

In the EU, three countries stand out as examples of tax regimes that are 'more friendly' to employee financial participation.

Ireland - shares issued under approved profit-sharing schemes are exempt from tax income. Moreover, subject to limitation, certain income derived from dividends out of profits that qualify for the 10% rate of corporation is not chargeable.

France - in the case of Company Savings Schemes, capital gains are tax exempt except for social levies.

UK - the Government is committed to encouraging employee share ownership through targeted tax incentives. Employees who are given shares, or able to buy shares at a discounted price upon exercise of share options, are not required to pay income tax or national insurance on this valuable benefit if one of several Inland Revenue approved employee Share Plans is used.

Under a Share Incentive Plan (SIP), employees can now buy tax-advantaged shares in their company out of pre-tax income.

2. The Nordic countries

Denmark - the country applies a progressive tax on distributed dividends at source regardless of the holder. Additionally, the State levies a duty on share transfer that affects buyers and sellers. A tax on employee bonds is payable by employers who pay out profits in the form of bonds to employees in their business. Employees are not required to include the value of such bonds nor the amount of the tax thereof in their taxable income.

Finland - capital gains tax and dividend tax come under the scope of tax on investment income.

Sweden - the country obeys the rules of personal income tax.

3. Southern Europe

Italy and Portugal - tax law does not provide for any exemptions from capital gains tax or dividends tax.

Greece - the country's fiscal system does not make allowances for employee financial participation.

Spain - certain transactions by co-operative societies with special status are exempted from tax on capital transfers.

4. The Benelux countries

Belgium, the Netherlands and Luxembourg - there are no specific fiscal provisions that deal with employee participation.

5. Germany and Austria

Germany - double taxation of distributed profits (i.e. taxation of corporate profits and of income in the form of dividends received by a shareholder) is avoided because shareholders liable for income tax are taxed on only half of any profits distributed in the form of dividends.

The same applies to capital gains from the sale of shares. A shareholder liable for income tax, and having a significant holding in the equity of a company, or selling his shares within the one-year speculative period, pays only half the income tax. An equity holder liable for corporation tax pays no income tax on dividends.

Austria - dividends and capital gain tax are governed by capital yields tax and income tax. The allocation of free shares in companies limited by shares is exempt from income tax.

This kaleidoscopic view will certainly become even more complicated from 1 May 2004 with the accession of ten new Member States into the EU.

Discrepancies in national tax systems

It still remains true that in the present European context, persistent discrepancies in national tax systems weigh heavily on the implementation of employee financial participation schemes *(see box-out above)*.

Indeed, given the lack of harmonised legislative framework, companies face a diversity of tax rules on personal incomes, equities, dividends and capital gains which force them to resort to complex financial engineering solutions.

As a result, the implementation costs and lack of legal transparency increase and render such schemes less appealing to employees and employers alike.

Due to Article 93 of the Treaty of Rome (consolidated version), fiscal policy is still a no-go area. Indirect taxes, turnover tax and excise duties are subject to unanimous voting while any national or Commission initiated move towards greater convergence of direct taxation rules have so far been wishful thinking.

Overcoming the obstacles

A summary of the key obstacles facing the expert group on the Communication follows:

European harmonisation

The diversity of the national tax regimes, the heterogeneity of financial participation schemes, and more urgently, the need for appropriate legislative frameworks in the acceding countries, call for some degree of harmonisation at European level. However, the use of the EU's usual legal instruments for harmonisation (a directive constitutes the most suitable one) would face various difficulties.

Indeed, the tenuous legal basis - as well as the absence of political consensus on the subject - renders the prospect of seeing the adoption of an *ad hoc* regime for employee ownership more than unlikely.

Solid legal basis

Employee financial participation falls under the ambit of Article 140 of the EC Treaty, which supports co-operation and co-ordination in the fields of employment, vocational training, and collective bargaining between employers and employees. This gives employee financial participation a fragile and awkward legal base. Article 140 only deals with a few limited characteristics of employee financial participation and restricts its actual scope.

It would therefore be necessary to broaden the legal basis to include Article 157 which encourages an environment favourable to the initiative, and to the development of policy throughout the Community.

Influence of EU directorates

Administratively speaking, any progress of employee financial participation is crippled by the dual management of the DG Enterprise on one hand and the DG for Employment and Social Affairs (DG EMPL) on the other.

Besides their inherent conflicting philosophies and culture of dealing with job creation (more broadly, employment policy), the two directorates also often disagree on the objectives and priorities given to the promotion of employee financial participation.

While the former favours a dynamic and proactive approach, the latter holds conservative, or merely indifferent, views on overcoming employee participation obstacles.

The DG EMPL generally encourages limited and short-term actions such as awareness-raising campaigns where comprehensive and long-term initiatives are needed. Moreover, it would rather strictly follow the lines of the national employment policies.

Ironically, though, it is the DG EMPL that has a near monopoly on the funds destined to finance the support of employee financial participation actions.

Political barriers

All in all, there is no deep-rooted resistance or reluctance towards employee financial participation. However significant the contribution of employee financial participation to the Lisbon strategy for employment, it is nowhere near the top of the Council's agenda.

The Lisbon strategy originates from the Lisbon summit

Political differences in Member States

The members of the Council of Ministers display a vast array of attitudes towards employee financial participation. This ranges from long-term familiarity and eagerness, to ignorance and apathy.

These diverse inclinations derive from specific national traditions and ideological influences.

France - tradition dates back to 1966 when the first laws on profit-sharing schemes were voted in, ever since which successive governments have given their support to financial participation schemes.

Britain and Ireland - both countries have followed a similar path towards widespread financial participation.

Germany - in spite of her advance in participatory management, the country has no real legal employee financial participation framework.

The Benelux countries - some progress has been achieved in the Benelux countries where the Belgian law on employee financial participation entered into force in January 2002. In the Netherlands, there is some level of legal framework in place.

The Nordic countries - Finland stands ahead in legal innovation. Others such as Denmark and Sweden are, as a matter of course, very sceptical and would rather remain non-committal.

The southern European countries and Austria - except for the Statutes regulating the labour limited companies in Spain, the southern European countries, in addition to Austria, face employee financial participation with little understanding or expertise.

(March 2000) when the EU set itself the objective of becoming 'the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs, and greater social cohesion'.

Direct taxation is beyond the scope of the EC Treaty and therefore falls within the exclusive competence of national governments. Unless there is a repeat of the recent successful negotiations over the tax package on EU-wide financial transactions, other similar breakthroughs will be difficult to make on lower-stake items.

As for the European Parliament and other bodies of the EU, the trend is much more encouraging. Employee financial participation has managed to gather broad support across most of the political spectrum.

The mainstream political groups sitting in the European Parliament - PPE-DE/EPP (Parti Populaire Européen et Démocrates Européens/European Peoples' Party), PSE/ESP (Parti Socialiste Européen/European Socialist Party), and the ELDR (European Liberal Democrat and Reform Party) - have thus far not only favourably greeted all the initiatives on employee financial participation, but also called for more active involvement of the Commission.

In so far as direct taxation is still excluded from the scope of the EC Treaty, national governments retain exclusive jurisdiction over personal income or equity tax issues. Consequently, however loud or supportive, the voice of MEPs is a far cry from being a deciding influence.

Bearing all this in mind, the probability of the Commission drafting a specific directive to tackle the fiscal imbroglio encountered by the development of employee financial participation is still minimal.

In that respect, we can only stand by the Commission and the European Parliament's strong emphasis on the non-feasibility, and therefore non-desirability, of an EU-made *sui generis* fiscal regime on employee financial participation schemes.

Moving financial participation forward

The Commission should pursue its efforts in favour of the promotion of employee financial participation by undertaking selective and focused actions. In this way, every facet of employee financial participation would be tackled individually whenever EU legislation is liable to have a bearing on it.

Special provisions should be introduced whenever possible and are necessary. This should be the case particularly when fiscal packages or rules affecting European company law are in preparation.

Concurrently, genuine and proactive initiatives should be launched in order to increase awareness of employee financial participation schemes at national level. Such actions should lead to progressive co-ordination of direct taxation policies.

The preservation and creation of thousands of direct and indirect jobs depend on the rapid removal of tax obstacles. In addition, employee financial participation schemes could generate the potential rise in demand for tailor-made business support services, such as legal and financial advice.

Fabrice Pourceau and EFES

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The EFES aims to be an open, democratic and participatory European organization founded on shared values and mutual respect. It seeks to establish sustainable employee ownership and participation by promoting across Europe developments in legislation, and in financial and organisational structures.