

# LIBA

LONDON INVESTMENT BANKING ASSOCIATION

ANNUAL REPORT

2006

LIBA is the principal trade association in the United Kingdom for firms active in the investment banking and securities industry. The Association represents the interests of its Members on all aspects of their business – both international and domestic – and promotes their views to the authorities in the United Kingdom, the European Union and elsewhere.

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Lord Aldington  
Mr H. Angest  
Dr. R.D.F. Barnes  
Mr A. Defriez  
Mr C. Keogh  
Mr M.S. Klein  
Mr R.J. Levy  
Mr M. Ridley  
Mr B. Wigley  
Mr J. Taylor *Director-General*

Mr M. Ericson (SSDA) and Mr I. Mullen (BBA) also attended meetings of the Committee during the year.

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## FOREWORD BY THE CHAIRMAN

This report covers the activities of the London Investment Banking Association during 2006 and early this year. The Association has been active in a wide range of areas affecting our industry: compliance; trading; policy development in the UK, Europe and elsewhere; prudential issues; tax and accounting, and many others. The report looks at the work done in each of these areas in turn, through the prism of the oversight of LIBA's Chairman's Committee, and the particular responsibilities of its individual subject committees.

As always, the breadth, depth and complexity of the individual issues is striking. In this Chairman's Foreword, I want to stand back a little from the detail, and highlight one or two of the more thematic issues which have provided the context for the Association's work.

The first is the growing awareness of London's competitive position as a financial centre, and the need to ensure that in all aspects of policy, action is taken – or not taken – with an eye to maintaining an environment conducive to innovation, growth and customer service. During 2006, the Government has shown its commitment to supporting London's position as an international financial centre through the establishment of the Chancellor's High Level Group and the reinforcement of the efforts of UK Trade and Investment. The personal involvement of the Chancellor and the Economic Secretary in this work has been greatly appreciated. Specific action taken to ensure that the competitive position is maintained – for example, the Investment Exchanges and Clearing Houses Act – has been rightly applauded.

London's advancing position across the wholesale markets has been widely documented, and this is not the place to repeat these statistics. But the very success of London has, naturally enough, been noted elsewhere – in the various studies undertaken in the United States, for example – and the reasons underlying that success carefully analysed. We can expect other financial centres to compete, vigorously, to recover the ground which they have lost. That competition must be welcome, if it is founded on liberal rather than protectionist principles. In turn, we must ensure that we do not fetter our own ability, here, to compete. So we – the industry, policy makers, and regulators alike – must work to ensure that we maintain both the highest of standards, and the flexibility and nimbleness that is necessary to provide the best possible service.

A second point which emerges from the detail is the extent to which, increasingly, market and regulatory developments take place on an international stage. Cross-border linkages and corporate structural changes require standards to be set at an appropriate level. This includes pan-European policies, but goes beyond those. That in turn, underlines the need for the industry and its representatives to work co-operatively with partners in other jurisdictions to ensure that our messages are delivered as effectively as possible.

A third emerging theme is the sheer pace of change in the markets, and the volume and complexity of the policy response. Again, this provides an intensive and demanding workload for LIBA and its sister associations. Good momentum has been maintained in deepening our involvement and co-operation with our European colleagues and the benefits of this are already tangible. Importantly, I do think we have benefited as an industry from a realistic, pro-competition attitude in the European Commission, which is most encouraging. We must endeavour not to lose the ground gained by continuing to push for market solutions where appropriate, and maintaining focus on getting the right result.

The staff of the Association and the many volunteers from firms who share on its committees will continue to do their utmost to meet the challenge that presents. We look forward to continuing to serve our Members in the year ahead.

Alan Yarrow  
Chairman

March 2007

## INTRODUCTION BY THE DIRECTOR-GENERAL, JONATHAN TAYLOR

In last year's report, I described the policy environment in which the Association was working as complex, diverse and challenging. The succeeding year has proved to be no exception. As policy makers strive to adapt the framework of measures surrounding our industry in the continually changing market landscape, so we must continue to help shape that framework in a way which best fits the needs and requirements of the industry and of our Members.

This report summarises the key developments which have taken place, and our responses to them. But to be truly effective, we need to instigate change and to lead the debate: the report also brings out where we have done that. As usual, the main themes are highlighted in the statement by our Chairman in the Foreword to this report.

Once again, the contribution made by senior practitioners from amongst our Members has been central to our efforts. Representative organisations can only be effective if they truly reflect the wishes and concerns of their Members; they can only be authoritative if they are fully abreast of trends in the industries they represent; and they can only add value to the policy formation process if they are seen by policy makers to do both of these. LIBA is lucky to have Members who devote much time and energy, from all levels within their firms up to the most senior, to chairing and participating in our committees and working groups, and to contributing in many other ways to our output. Warmest thanks are due to them. This year, I would particularly like to thank Simon Dingemans of Goldman Sachs, who has stood down from his very successful chairmanship of the Corporate Finance Committee, and to welcome in his place Alistair Defriez of UBS.

This is also the place to note a number of developments in LIBA's co-operation with fellow associations here and elsewhere, in pursuit of our common interests.

LIBA agreed with the Swedish Securities Dealers Association (SSDA) in May 2005 to co-operate more closely. This co-operation was extended by a further agreement between SSDA and the Finnish Association of Securities Dealers (FASD) in November 2005. SSDA's then Chairman, Matti Kinnunen of Carnegie Group, joined LIBA's Chairman's Committee; he was succeeded in this role in October 2006 by the new SSDA Chairman Mikael Ericson of Svenska Handelsbanken. SSDA has furthermore seconded Lars Nordström (formerly Vice-President of SSDA) as a director and liaison officer to LIBA on a full-time basis since May 2005. Lars retires shortly from this role: thanks are due to him for making such a success of his time with us.

The closer co-operation has led both to a substantial interchange of information between the three associations, in a wide range of policy areas, and to the preparation of joint representations to, for example, the EU authorities.

Joint representation has become an increasingly effective way of delivering messages, and in this regard we work ever more closely with a wide range of associations. Numerous examples are contained in the report. During the course of 2006, we have worked particularly closely not only with our Nordic partners, but also with our French and Italian counterparts (AFEI and ASSOSIM), and we have recently taken the step of forming an umbrella organisation, the European Forum of Securities Associations (EFSA), in partnership with these sister organisations, to help us work even more effectively together.

Finally, we continue to be active members of the International Council of Securities Associations (ICSA), which is made up of the leading organisations in our field. Through ICSA we work to influence and shape policy at a wider international level. ICSA's Annual Conference in October saw the approval of principles on better regulation, and agreement for its Working Group on Better Regulation (which LIBA chairs) to promote the adoption of these to regulators worldwide, together with agreement on principles on the governance of market structures. ICSA has met with representatives of IOSCO's Technical Committee, and the Technical Committee's Annual Conference in London, hosted by the FSA, provided a further opportunity for industry representations. The Committee is now considering ways in which it can have a more continuous structured dialogue with industry. Further work on this is expected in the months to come.

Jonathan Taylor  
Director-General

March 2007

## REPORT OF THE CHAIRMAN'S COMMITTEE

LIBA's Chairman's Committee is the Association's central decision-making body which oversees our activities. Work on the great majority of matters that we cover on Members' behalf is led by the committees referred to at the end of this Report.

### **INTERNATIONAL DEVELOPMENTS INCLUDING IMPLEMENTATION OF MiFID AND THE BASEL ACCORD, EUROPEAN LEGISLATION AND REGULATION**

#### *Overview*

Although 2006 marked the end of the flow of initiatives under the European Commission's Financial Services Action Plan (FSAP), it saw an increased volume of work in relation to secondary and national legislation, as well as arrangements to implement the measures themselves. The Markets in Financial Instruments Directive (MiFID) continued to preoccupy LIBA and its Members, and more details of this are set out below, but follow-up to Basel II and implementation of the Capital Requirements Directive (CRD) have also been particularly significant.

European financial services policy is made through the "Lamfalussy" process, which we continue to support strongly while seeking to maximise the effectiveness of its implementation. In particular, we contribute to the work of the Inter-Institutional Monitoring Group (IIMG) set up to review and advise on the new arrangements. Outside the formal consultation process, we have also continued, with other associations, to liaise informally with the Commission and Committee of European Securities Regulators (CESR) on practical experience of the application of the procedures. (We have worked too with the Committee of European Banking Supervisors – CEBS – as summarised below.)

More generally, we continue to contribute to the work arising from the Commission's forward-looking White Paper on Financial Services Policy 2005 - 2010. The White Paper is consistent with our main priorities: a focus on consistent implementation of EU law rather than on developing new legislation; not legislating unless there is a well-evidenced need; ensuring legislation is based on clear objectives and agreed fundamental principles of public policy; promoting the EU's international competitiveness and ensuring that innovation is not inhibited; continuing to improve the application of the Lamfalussy arrangements; and converging supervisory practices and coordinating supervision of international groups.

We urged the Commission to learn the lessons from past problems in our response to its evaluation of the FSAP published towards the end of 2005, and we contributed to the Commission's initial work on developing an evaluation methodology.

## MiFID

As MiFID implementation increasingly dominated the agenda, it became clear that the original April 2006 implementation date was far too optimistic. We strongly welcomed, therefore, the adoption of the Amending Directive which extended the deadline for Member States to transpose MiFID by nine months, and for firms to comply with MiFID provisions by a further nine months. The extension of the deadlines, and the separation of the transposition date and implementation date, demonstrated that the EU authorities recognised the need for a practical approach to introducing new legislation. It provided much needed additional time for thorough consultation on the “Level 2” implementing measures, and for firms and other market participants to make systems changes to comply with new requirements. Unfortunately, however, much of the benefit of the extension has been eroded, first by delays in finalising the MiFID Level 2 measures, and then by many Member States’ slow preparation of national requirements. We comment in more detail below on the practical implications of these delays in this case but, in general, it would be desirable if in the future the implementation dates of EU measures were set as a stated period after all the associated EU legislation is completed, rather than a date fixed at the outset before the secondary legislation is settled.

*Extension of  
deadlines –  
Directive  
amendments*

During the first half of the year we worked closely with the European Commission, European Parliament, and Member States to ensure that the Level 2 measures under MiFID were as consistent as possible with the needs of users of and participants in the markets, commenting on a series of drafts of the measures which the Commission produced for discussion in the European Securities Committee, and advising the European Parliament on its proposed amendments. We highlighted the dangers of adding unnecessarily to the high level of detail in the main “Level 1” Directive, particularly as regards the treatment of business for professional clients and with market counterparties. We stressed that such prescription could damage the flexibility and international competitiveness of EU markets, and prevent intermediaries from providing the range of services that investors and issuers demand. The ‘official draft’ of the Level 2 measures, published in February 2006, though still more detailed than we would have wished, was considerably improved in many respects as a result of the earlier consultations; and we were able to achieve many further important amendments before the Level 2 measures were adopted in June.

*“Level 2”  
measures*

One area where we are concerned that the final Level 2 measures did not provide for an optimal regime was in the reporting to the market of very large trades. Providing liquidity efficiently and cheaply to investors who wish to acquire or dispose of very large positions is essential so, difficult as it may be, the appropriate balance must be found between providing information to the market that such trades have been executed on the one hand, and giving firms an appropriate period before they must report to enable them to unwind their positions. The measures provide for an early review, however, and we will seek to ensure that full information about the effect of the new regime is provided for that exercise.

*The problem of late implementation*

It is apparent that many Member States will transpose MiFID into national legislation well after the 31 January 2007 deadline. It also appears that some Member States may miss the 31 October 2007 implementation deadline as well. A situation in which some Member States have implemented MiFID rules, and some have not, raises a number of practical difficulties relating to cross-border passporting rights; the treatment of branches in other Member States; potentially the incidence of liability to third parties as a result of firms' inability to comply with new rules in time; and the project management of complex systems changes by groups that operate internationally. We plan to continue to work closely with both the Commission and national authorities on practical solutions to the problems raised by timetable difficulties, so that the transition to MiFID rules does not interrupt the orderly conduct of market operations, and so that firms are not penalised by a failure to comply with MiFID provisions when this is beyond their control because national implementation legislation has been delayed.

*UK implementation: the FSA Handbook*

Throughout the year we played a leading role in coordinating the wholesale market associations when responding jointly to the FSA's consultation programme on the transposition of MiFID provisions into the FSA Handbook. Overall, we supported the FSA's "intelligent copy-out" of MiFID provisions, and our main concerns arose where the FSA proposed to depart from this policy and introduce new, additional requirements or expectations. Our work in this area focused on the following FSA papers referred to below.

**CP06/9, on the transposition of both MiFID and CRD provisions relating to systems and controls.** The FSA proposed a "common platform", which we supported, to accommodate differences in detail between overlapping provisions in the two Directives.

**CP06/14, on market transparency, transaction reporting, and custody of client assets.** The main difficulties were in the area of transaction reporting, where a number of the FSA's proposed requirements were super-equivalent to MiFID, and would have involved firms in substantial systems development cost without obvious benefit. With fellow associations, we worked closely with the FSA to alleviate many of these specific concerns. We also commented on an informal FSA discussion paper on Approved Transaction Reporting Mechanisms.

**DP06/3, on best execution.** Although we generally supported the FSA's approach, this Discussion Paper raised for consideration ideas about the assessment of best execution in dealer markets which would have significantly impeded the operation of those markets. Throughout the year we worked intensively to agree with both the FSA and market users an approach to implementation that is consistent with both the legislation and market needs.

**Informal discussion paper on client classification.** MiFID introduces a number of changes to the thresholds that define retail clients, professional clients, and market counterparties. Our main priority, given the legislative requirements, was to preserve as much flexibility as possible for current users of wholesale markets.

**CPs 06/19 and 20 on conduct of business.** Although we supported the FSA's broad "copy-out" and proposed simplification of conduct of business rules, we remained concerned about the extent to which the FSA had sought to retain additional provisions in certain areas. We have also worked, in particular, to ensure that the provisions on best execution and suitability take full account of the special features of wholesale markets. We will continue to discuss these issues, and the application of MiFID provisions to non-MiFID business, with the FSA during 2007.

As noted above, most other Member States have prepared for the transposition of MiFID into their national law on a slower timetable than the UK, and much legislative preparation in these countries will be taken forward in 2007. We will continue not only to track the transposition and implementation of MiFID across Europe, but will also seek to ensure that measures are not only as consistent as possible between countries, but also with the needs of wholesale markets and their users. For example, as well as commenting on the FSA's discussion paper on best execution – referred to above – we also, with other wholesale market associations, responded to the French regulator's consultation on best execution, which in most respects was consistent with the needs of markets, including dealer markets (the AMF started the formal consultation on its draft rules in this area, and other MiFID provisions, in January 2007).

*Other countries' implementation*

From late-2006, CESR launched a series of consultations on how European regulators should coordinate their implementation of MiFID in certain areas, to which we have responded jointly with a group of other associations from across Europe.

*CESR "Level 3" consultations*

Following a call for evidence early in the year, CESR consulted formally on the implications of MiFID for the **publication and consolidation of market transparency information**. We urged CESR to leave the initiative in this area with the market, and not to pursue a level of detailed regulatory prescription that would cut across market-led developments and firms' implementation plans.

In response to CESR's consultation on **standards for the exchange of transaction reports between regulators**, we again stressed the need for the regulators' internal data standards not to have the effect of imposing on firms standards that are not widely used at present.

On **practical issues relating to the European passport**, we welcomed CESR's commitment to finding practical methods of ensuring that firms that operate through branches are not exposed to duplicative regulation. In discussions with both the Commission and CESR, we have stressed the need for branches to apply only host State rules to services and activities provided or conducted by the branch: at the time of writing, the outcome of this important debate is still uncertain.

In responding to CESR on **inducements**, we stressed the need to limit MiFID provisions to payments which are made to induce firms to act inconsistently with client interests (and not to a broader range of commercial payments or commission sharing arrangements).

CESR's consultations on **transaction reporting** and **best execution** were awaited at the time of writing

*MiFID Connect  
industry  
guidelines*

Last but not least, we have participated fully in the work of MiFID Connect, a group of trade associations covering most financial services firms in the UK, one of whose main purposes has been to develop, in consultation with the FSA, industry guidelines on how firms might organise themselves to comply with new requirements under MiFID. Guidelines, in varying states of completion at the time of writing, have been drafted on suitability, conflicts of interest, best execution, investment research and outsourcing. Other MiFID Connect activities include conferences and the preparation of the "MiFID Survival Guide" for firms on current issues.

### **Basel developments**

Although the revised Basel Accord was agreed in 2005 with the completion of the Trading Book Review, the Basel Committee continues with a forward-looking agenda. The new Chair of the Basel Committee has announced three broad objectives: to provide a forum for dialogue and information exchange among supervisors; to promote improvements in bank risk management practices and the framework for banking supervision; and to promote mechanisms for pragmatic implementation of the principles developed by the Committee. In terms of a work programme, definition of capital and review of liquidity risk management have been highlighted and are discussed in the section below on EU prudential developments. Proportionality and flexibility are overarching themes that permeate the Committee's policy work, and LIBA's work on the most important issues that we have had to address during the year is noted below.

*Trading Book  
Review  
implementation*

The work of the Basel Accord Implementation Group (AIG) in relation to the Trading Book review continued through the year. LIBA together with the International Swaps and Derivatives Association (ISDA) and the Institute of International Finance (IIF) continued to work on the interpretation of the requirement regarding incremental default risk. We submitted a paper setting out key principles to which modelling approaches would conform, and subsequently met the regulators to discuss their reaction to our work and to identify how it may need to be developed.

The industry objective in the dialogue has been to ensure that any further guidance issued by the regulators will permit a diversity of modelling approaches. In principle the regulators have stated that diversity should be acceptable, but at the same time it has become clear that some regulators favour something closer to "hard-coding" of standards for default risk modelling. Initially firms were concerned that regulators might try to reach premature conclusions, and we pressed the AIG – and individual regulators – to maintain the dialogue as firms gained increasing experience of good modelling principles in this field. The regulators have indicated that the dialogue can continue, but the overall timetable for producing guidance has still not been confirmed.

The Basel Committee also produced a number of consultations during the year, including a consultation on information sharing in the context of the implementation of the Basel 2 framework across jurisdictions, a revised version of its Core Principles of banking supervision, and revised guidance in relation to the risk management and valuation of loans. LIBA was able to respond positively to all of these consultations. In respect of the paper on information sharing, we worked jointly with ISDA and the British Bankers' Association (BBA), and emphasised the need to take a consolidated group approach. We also worked with the BBA on the response to risk management and valuation of loans.

*Other consultations*

The divergence between the US and EU implementation timetables of the Basel Accord remains one of the major practical issues facing international groups. In brief, the US banking supervisory agencies have chosen to delay implementation of the Accord by at least one year, until 2009. By contrast, the timetable set out in the EU Directive conforms with the original Basel plan – implementation of the non advanced approaches to credit and operational risk from January 2007, and advanced approaches from January 2008.

*US delays in implementing the Basel Accord*

There is clear potential for the project planning of international groups to be disrupted by uncertainties in US implementation. In practical terms, the priority is to ensure that home-host regulatory relationships remain sensitive to potential US/EU or US/UK divergences. The quality of firms' supervisory relationships and the effectiveness of the coordination between supervisors will be paramount, and this is a message that LIBA has stressed to the AIG, European Commission and CEBS, as well as to the FSA.

LIBA has welcomed the willingness of US agencies and the AIG to work with the industry in identifying practical issues that will arise. The FSA plans to work in cooperation with the US regulators and not to duplicate work. Regulators hope that disruptions to operations can be minimised during the transitional phases of implementation, and firms are anxious to ensure that regulators' interpretations of the revised Accord avoid both any potential for conflicting requirements and the creation and maintenance of multiple systems for the transitional phase and beyond. In the UK, firms will be able to adopt foundation or advanced approaches irrespective of their home country regime, and a UK group will be able to include US entities within its application for a waiver from the standardised approach to credit risk.

The US Banking Agencies released the first of a sequence of Notices of Proposed Rulemaking (NPR) on Basel implementation in September 2006. LIBA has been involved in a joint association initiative in responding with the IIF and ISDA. The key message has been to encourage consistency of approach among regulators on a global basis, but not to seek changes to the Basel 2 text or to the Trading Book Review agreement (although there are certain areas of concern that the industry wishes to highlight for future attention).

It is worth noting that many firms are very concerned that there should not be a major divergence between the implementation of the Market Risk changes and the rest of the package in the US.

## EU prudential developments

### *Committee of European Banking Supervisors*

In 2006, CEBS saw the thrust of its work as having shifted from “design to delivery” of the CRD in particular. During the coming year CEBS sees a continuing role in assessing market and supervisory practices and providing feedback. Initiatives on supervisory disclosure and work on the Commission’s CRD Transposition Group support this aim. Moreover, CEBS has been open to industry dialogue, in which LIBA has been involved, on emerging supervisory debates including the role of proportionality in regulation generally and the implementation of the CRD in particular.

The chair of CEBS has summarised the Committee’s objectives as focusing on avoidance of potential divergences and gold-plating in the implementation of the CRD; delivering a cost-efficient prudential regime; and harmonising approaches to supervising cross-border groups. Broadly these objectives are welcome and CEBS retains its consensual character. Nevertheless it will be necessary to remain close to the Committee, particularly with respect to its work on international groups, and its responses to calls for advice from the Commission, not least as these initiatives will have implications for investment firms as well as banks.

Other aspects of CEBS’ work in which LIBA has been involved included the Committee’s work on calls for advice from the Commission and the three further consultations issued during the last year, namely: the revised consultation on the implementation of the Internal Ratings Based Approach and Advanced Measurement Approaches, the Pillar 2 treatment of Interest Rate Risk in the Banking Book and Concentration Risk, and Stress Testing. Further to industry comment the consultation on Concentration Risk was revisited in order to take full account of the market practices survey on the treatment of large exposures.

LIBA has continued its close liaison and collaboration with other associations to ensure well informed and timely industry responses.

### *CRD Transposition Group*

The CRD Transposition Group set up by the Commission at the end of 2005, comprised of Finance Ministries and Regulators, has also been a source of implementation guidance. This Group, while not providing binding regulations, has produced answers in respect to a number of questions raised by firms, regulators and other interested parties. These answers form a persuasive body of guidance for regulators across Europe. One issue in which LIBA played a particularly active role in pursuing Members’ interests was the determination of appropriate add-ons to be used to calculate counterparty risk exposure for credit derivatives during the 2007 transitional year. A very successful outcome was achieved, whereby firms can continue to use the existing domestically set add-ons until they move across to the revised approaches to credit risk and the more advanced approaches to calculation (such as the internal models method) become available.

### *Large Exposures review*

The existing large exposures regime was largely unchanged by the review of capital requirements. Hence, the CRD provided for a review with a report and proposals to be presented to the European Parliament by the end of 2007. This review started in earnest with the Commission’s Call for Advice issued in

December 2005. This first call for advice on large exposures comprised two main elements: a review of existing supervisory practice to determine the extent of convergence across Europe; and a review of industry risk management practice in concentration risk.

LIBA, together with the BBA and ISDA have been working jointly on this review providing early comment on the industry view of the objectives of a large exposures regime and developing principles under which policy outcomes can be assessed. A major part of our work during 2006 was the production of the report “Managing concentration risk: a review of industry practice”. This was submitted to CEBS, the Commission, the FSA and the Treasury, and resulted in an invitation to present our findings to the European Banking Committee (EBC) Working Group, comprised of Finance Ministries, which is guiding the review. In particular, we concluded that management of concentration risk is an integral part of the management of credit risk more generally, and that firms’ internal management of concentration risk bears little or no relation to the existing regulatory regime. There is diversity in the detail of risk management but certain core themes emerged in relation to setting risk appetite, establishing limits, monitoring and reporting, and taking action where necessary.

Further to this early work the EBC decided to conduct the review over a longer period than that originally envisaged by the CRD. In January 2007, the Commission issued a further call for advice, comprised of two stages. Part One, reporting at the end of September 2007, covers the purpose and effectiveness of the existing large exposures regime, together with an initial view on metrics. Part Two, reporting end-February 2008, considers the more detailed issues that would need to be addressed to develop a revised regime. To assist CEBS with its work the joint industry group has so far submitted a discussion paper on the purpose of single name regulatory limits and capital charges, and we also participated in the EBC round table on the review. We expect to continue to contribute actively to the debate over the coming year.

A review of composition of capital – Own Funds – is provided for by the CRD. In preparation for this report, the Commission has issued several calls for technical advice from CEBS. These mandates covered a review of implementation of existing own funds provisions together with a survey of capital instruments developed by firms and, latterly, a quantitative analysis of the types of capital held by credit institutions. It is unclear whether the Commission report will recommend legislative changes, but LIBA and other industry voices have insisted that, whatever the outcome, parallelism with Basel remains essential. For its part the Basel Committee has set up a working group to conduct a stocktake on capital by the end of 2007.

*Own Funds  
Review*

LIBA worked with the BBA to produce a joint response to the market participants questionnaire produced by CEBS on current practice, and LIBA was invited to attend a constructive industry meeting in May with the CEBS working group where we emphasised the need for consistency of approach with Basel.

A particular question hangs over the treatment of innovative hybrid Tier 1 instruments. The Basel Committee is prepared to accept such instruments as part

of Tier 1 to a strictly limited extent, but current EU legislation has never been amended to permit this within the EU. It is unclear whether greater EU consistency can be achieved through convergence of supervisory approach, or whether amendments to the CRD will be required.

### *Liquidity*

The supervision of liquidity is the only aspect of prudential regulation that has not been harmonised and this topic has received increasing attention. It is far from clear that EU regulators are ready to support a harmonisation initiative, not least as it would touch on difficult areas including the Lender of Last Resort role. Nevertheless, some work is now being undertaken at an international level on liquidity regulation, and it will be important to ensure that the profiles of investment banks are fully taken into account in any policy development.

In March 2007 the Commission issued a call for advice on the assessment of the current arrangements on liquidity risk: a stocktake of current practices is to be submitted by mid-2007 and an issues paper by September. As with the definition of capital, CEBS will complement the work on liquidity issues being conducted from a financial stability perspective by the Banking Supervision Committee (BSC) of the European System of Central Banks (ESCB). CEBS will also liaise closely with the parallel work stream on liquidity supervision that the Basel Committee has initiated: the Basel Working Group is also focusing on a stocktake at this stage.

### *Commodities Review*

Both the CRD and the MiFID were finalised with provisions that called for an early review of certain exclusions created for commodities firms. The Commission is therefore undertaking fact-finding exercises for the Commodities Review which includes an assessment of whether these exclusions for commodities derivative business and commodities firms should continue or be amended. The Commission has launched a call for evidence as well as calling for studies from both CEBS and CESR. The Commission received a report on the prudential treatment of commodities business at the beginning of 2007, and CEBS is now focusing on the prudential risks arising from the conduct of commodities business and from the activities of firms carrying on that business.

LIBA attended the first CEBS' Expert Group meeting and we are responding to the Commission's call for evidence. The issues are wide-ranging, and include the appropriate scope of application of the CRD and MiFID with respect to commodities activities. It is important to note, though, that the Commission is not definitively committed to introducing further legislation at this stage.

### *Financial sector mergers and acquisitions directive*

Certain cases involving attempted takeovers of banks in one Member State by banks based in a different State raised questions about the supervisors' approach to changes of control. In response, the Commission proposed a directive to amend the appropriate provisions in all the relevant financial services directives to clarify the criteria and procedures that should be followed when deciding whether a proposed acquisition of a financial services firm should be approved. In principle, LIBA supported measures designed to prevent protectionist objections to cross-border takeovers: however, the Commission's proposal applied to all acquisitions above a certain size in any kind of financial services firm and, although the Commission had consulted upon the policy that they should

pursue, a consultation paper on draft text was not published. As a result, there were a number of areas in which amendments were needed – not least as regards establishing a realistic timetable for supervisors to consider whether to approve an acquisition and clarification of the kinds of acquisition that should not be covered by the Directive’s requirements because they do not involve the exercise of control or influence (for example market making or underwriting positions). Within the Council of Ministers, securing adoption of the Directive was seen as a priority, so that it was not possible to give sufficient attention to a number of the detailed drafting issues that had to be resolved. We – working with the Financial Services and Markets City Legislation Liaison Group (the other work of which is covered in the Compliance section below) – therefore briefed MEPs on the changes that Members believed were needed. Although at the time of writing a final text has not yet been published, the signs are that a number of the amendments that we had sought have been agreed. (This should enable the Treasury to bring forward the amendments to the Financial Services and Markets Act provisions on controller notifications that were consulted upon in March 2006.)

### **European contract law developments and other cross-border issues**

In December 2005 the Commission brought forward a proposal for a “Rome I Regulation” on the applicable law applying to cross-border contracts. The Regulation would replace the existing “Rome Convention”. The Commission’s proposal raises several legal problems which could deter financial market participants from choosing to use the contract law of EU countries, and there was inadequate consultation on the implications of the changes to the Convention that were envisaged. As a result, following representations from LIBA and other wholesale market representatives, the UK decided to exercise its right not to opt in to the proposed Regulation, while continuing to participate in the negotiations. We continue to monitor the extent to which the changes made to the proposals in the negotiations resolve the defects in the Commission’s draft.

*Contract law*

We have also continued to follow the CBI’s and Law Society work on the European Commission’s examination of a possible voluntary frame of reference for EU contract law, with a view to not disturbing the existing and well-functioning contractual relations on which financial instruments are based

We have continued to participate in groups which have been working on ways to facilitate cross-border transfers of personal data given the “adequate safeguard” requirements in the 1995 Directive. In addition, the Article 29 Working Party – representing European data protection commissioners – produced a paper in November about information disclosed by SWIFT to the US authorities in the wake of 9/11 (Opinion 10 2006), and LIBA’s committee is considering the implications of the Working Party’s recommendations for Members’ business whilst not necessarily accepting its conclusion that the disclosures were made in breach of EU law.

*Data protection*

## SECURITIES TRADING, PRIME BROKERAGE AND FIXED INCOME MARKETS

*Overview* The year was one of notable achievements, with the Committee pursuing its goal of more efficient markets, chiefly through its work on exchange relationships, exchange consolidation and clearing and settlement.

In the markets, Euronext and the New York Stock Exchange agreed a merger, and Deutsche Börse Group proposed various consolidation initiatives – none of which came to fruition. The London Stock Exchange was the subject of bids by Macquarie and NASDAQ, neither of which succeeded. Borsa Italiana had a record year and at the time of writing continues to plan a flotation.

We continued our work on the application of competition policy to market infrastructure. Building on the analysis we published in 2005 – and deepening our relationships with like-minded associations – we published a paper in February 2006 on calls for consolidation in clearing and settlement which concluded that public and private stakeholders must work together and that the European Commission was adopting the right approach.

We developed our position further in July in our response to the Commission's working paper on clearing and settlement, again in conjunction with fellow associations. We commended DG Competition for the approach it has taken to this work. We noted that the wholesale market in which LIBA Members operate is sufficiently competitive. This is demonstrated by the low barriers to entry and the combination of falling prices and technical innovation.

We also noted that the central market infrastructure in Europe – broadly defined to include trading, clearing and settlement of bonds, equities and their derivatives – is more or less fragmented, expensive and uncompetitive. It needs to be integrated and to become cheaper, which will lead to the benefits of competition being spread more widely.

There are a number of features creating obstacles to progress. These include:

- The lack of measures open to the authorities and market users and the less developed state of competition policy, law and practice at the European level;
- The exchanges' obligations to their owners;
- The extent to which market participants are held back from taking collective action by a lack of incentives, the need to overcome practical difficulties and by a fear of retaliation by exchanges with a degree of regulatory control.

*Progress so far* Nevertheless, the industry as a whole has made progress. Projects undertaken in the last five years include the creation of LCH.Clearnet, the series of mergers enlarging the Euroclear group, the acquisition of Cedel by Deutsche Börse, the Express II project in Italy and the "Nordic Single" project. We believe we can do more, with the guidance and leadership of the Commission. In particular, increasing the transparency of fees charged by central market infrastructure and

monitoring the progress made towards the public policy objectives will require sustained commitment. If and where the programme we have outlined stalls, more targeted intervention may be justified.

In October 2006, as noted above, ICSA published the “Principles for the Governance of Market Infrastructures” which drew on the work we had done with European colleagues.

In November 2006, the central market infrastructures signed a Code of Conduct in which they committed themselves to price transparency measures in January 2007, to set access and interoperability requirements by 30 June 2007, and to establish unbundling and accounting separation by 31 December 2007. In conjunction with other associations in the securities sector, we are engaged with the Commission, the authorities and market infrastructure providers in developing these commitments and in monitoring implementation of the Code.

In parallel, we pursued our discussions about fees and costs. While there was a welcome recognition that this was a dialogue which should continue, the focus of exchange management on the consolidation agenda made it difficult to pursue. Nevertheless, in late-2006 there were announcements of reductions from virt-x and x-clear and in early 2007 the London Stock Exchange published a phased programme of tariff changes for 2007/08 which it said were ‘designed to drive SETS growth’.

We continued our programme of constructive engagement with infrastructure operators, including the major operators of derivatives trading platforms. Although progress was slow in the early part of the year, in September LCH.Clearnet announced changes to its fee structures for derivatives clearing fees for Euronext.liffe – the aim being to simplify, standardise and reduce fees. This was a welcome development and we believe that LIBA’s statements on fees policy have influenced LCH.Clearnet’s thinking. Towards the end of the year, we welcomed reductions in cash equity clearing costs from LCH.Clearnet in relation to the London, Euronext and virt-x markets, and look forward to further progress. Deutsche Borse extended its Automated Trading Programme to clearing fees and announced a cut in the “headline fee” of 4%.

In November 2006, seven investment banks announced that they were working on “Turquoise”, an initiative to develop an integrated pan-European trading platform. The intention is to provide arrangements under which equities can be traded more cost-effectively, obtaining significant liquidity with greater efficiency for the equity markets.

*Turquoise*

Looking at public policy issues more broadly, we worked on a public statement, in the form of an article in the Financial Times by our Chairman in June, identifying the issues of concern to market participants arising from the possibility of international exchange combinations, including the extent to which US regulatory agencies could become more involved in the detail of UK and European arrangements. We also provided comments to the authorities, and we were pleased with the decisive step taken by the Government in the shape of the Investment Exchanges and Clearing Houses Act.

*Wider public policy issues*

In addition, the Securities Trading Committee contributed to LIBA's work on MiFID, discussed above. This ends the legislative phase of the ambitious securities market reform in Europe but, as already noted, we shall continue to be engaged in implementation – not only in the UK but in other Member States as well.

Looking into 2007, we can see evidence of the progress we have made and identify some areas for further work. These include market-specific developments at the London Stock Exchange, Euronext and Deutsche Börse, and the November 2006 Code of Conduct. This initiative by market infrastructure providers, containing timed commitments in relation to tariff transparency, access and interoperability and unbundling and accounting separation, promises much.

#### *Target2- Securities*

In a Press statement on 7 July, the European Central Bank (ECB) announced that it was considering work on "Target 2 for Securities" (T2S). Many of the details of T2S remain to be developed but market participants will want to understand the proposals in much more detail before they can be satisfied that the potential for improving the European clearing and settlement landscape which the T2S proposal might bring about has a realistic chance of being achieved. Following a discussion about T2S by the Council of Finance Ministers (ECOFIN) in February 2007, ECOFIN concluded that T2S would have a profound impact on the settlement infrastructure and invited the ECB to proceed step by step, examine carefully the results of its consultations, and report back regularly to ECOFIN and others. The ECB subsequently announced that it has concluded that it is feasible to implement T2S and has therefore decided to go ahead with the next phase of the project, namely the definition of user requirements on the basis of a dialogue with the market. The scope of the project will be determined by taking into account the results of a public consultation. The Governing Council will then decide on the subsequent development phase. This decision is expected by early 2008. The ECB also announced that it would publish a paper on the governance of the T2S project.

#### *Settlement Committee*

Members of the Settlement Committee made a major contribution to the development of LIBA's work in relation to exchange consolidation and the structure of European securities markets. In particular, we have focused on two aspects of clearing and settlement reform: harmonisation of market practices, with the attendant cost-saving potential, and consolidation of providers, with the aim of promoting competition between trading platforms. We also considered detailed issues which arose in relation to the roll-out of the Euroclear single settlement engine (SSE).

### **Work by other committees**

#### *Prime Brokerage*

The Prime Brokerage Committee has continued to act as the industry's point of contact with the FSA in relation to the twice-yearly survey of hedge funds as counterparties. This is a voluntary survey, and an increasing number of firms provide data on a global basis. We continue to discuss improvements and extensions to the survey, respecting its voluntary nature. The Chairman of the Committee has served on the European Commission's Expert Group on Hedge

Funds and has provided assistance to IOSCO in relation to its proposals for hedge fund valuations.

Towards the end of 2006 LIBA oversaw the formation of the City Fixed Income Markets Group (CFIMG) – a senior-level cross-market oversight body to encourage a timely response to market and regulatory fixed income market issues. ISDA, the International Capital Market Association (ICMA) and the Securities Industry and Financial Markets Association (SIFMA) had accepted their invitation to join the CFIMG along with LIBA, the Investment Management Association (IMA) and the Association of British Insurers (ABI); the BBA and the National Association of Pension Funds joined early in 2007.

*Fixed income*

The European debate on non-equity market transparency continued to dominate the fixed income agenda in 2006. The focus of this debate is the European Commission's review – as MiFID requires – of the possible extension of the Directive's pre and post-trade transparency obligations to fixed income and derivative markets.

*Bond market transparency*

Our efforts focused on bond market liquidity and transparency, with participants making the overall point that because markets work well in Europe, regulators should respond cautiously to any calls for mandated transparency.

Discussions with the Commission in 2005 on the lack of original research on European bond markets led LIBA – along with the ABI, ICMA, IMA and also the Corporation of London – to commission joint independent research into the markets. In 2006, the European Primary Dealers' Association and the European High Yield Association joined the commissioning consortium. The purpose of the research was to provide high quality and objective material to support evidence-based regulatory policy formation.

The research, published in May, entailed two independent studies. One concentrated on the corporate investment grade bond market; the second covered sovereign debt. The Centre for Economic and Policy Research (CEPR) was commissioned to undertake both studies.

The study on the corporate bond markets concluded that:

*Research findings*

- Euro-denominated bonds have tighter spreads than either sterling bonds or domestic US dollar bonds their US counterparts.
- Competition is a key driver of liquidity, and this is where public policy should focus.
- To impose pre-trade transparency via regulation would be risky, as it would require significant changes to the microstructure of the market.
- Greater post-trade transparency would benefit some market participants but should be designed and implemented carefully and be market-led if possible.

The study on the government bond markets concluded that:

- The secondary market microstructure is heavily influenced by the relationships between issuers and primary dealers.
- Where transparency is high, trade size tends to be low. Where primary dealer obligations are greatest or where syndication is used heavily, this provides better liquidity and low spreads, but less good execution quality for large trades. Effective spreads in the US Treasury market are lower than on MTS, except for the long benchmark.
- The differing levels of transparency seem appropriate for all major market participants.
- The study suggests that regulatory imposition of greater transparency could adversely affect liquidity in the government bond markets.

Both studies concluded that imposing change through regulation would be risky. Ideally, the market itself could lead such changes.

Following the publication of the research, LIBA along with the other commissioning associations worked together to ensure the research was profiled to regulators and other decision makers.

#### *European Commission's Call for Evidence*

The Commission issued a Call for Evidence on the question of transparency in non-equity markets. LIBA drafted a high-level response on behalf of our Members and twelve other European associations. This response drew heavily on the CEPR research and the FSA's June policy statement on transparency, both of which support the industry's view that fixed income markets work well and there is no market failure open to transparency as a solution. However, both CEPR and the FSA thought it was possible that the market might benefit from a little more formal post-trade transparency, but that this should be carefully investigated, ideally by the industry, to determine whether or not a significant benefit would emerge. The response to the Commission set out respondents' intention to investigate this matter further.

The Commission published its Feedback Statement on the responses it received to the Call for Evidence in November. The Statement is a reasonably balanced exposition of the responses and highlights the point that overwhelming opinion (including most buy-side) is against regulatory intervention. A minority view supports regulatory intervention on transparency. However, those advocating regulation have yet to produce evidence to support their case.

#### *Future work*

The Commission's timetable for the review of non-equity market transparency has been extended with the final report now expected early in 2008 rather than the end of October 2007:

Complications with data meant that the bond market research commissioned from CEPR did not, as originally envisaged, cover high yield corporate debt and, towards the end of the year, the buy-side and sell-side associations associated with the original research (ABI, IMA, ICMA, the Bond Market Association (TBMA) and LIBA) commissioned further independent research on the high yield corporate debt market.

## CORPORATE FINANCE

2006 proved to be another busy year for the Corporate Finance Committee, including extensive work on the implementation of Directives – not least the Takeover and Transparency Directives – and continuing work on Takeover Panel proposals, as well as responding to consultations on the listing and AIM regimes and addressing issues in the legislation enacted as the Companies Act 2006.

*Overview*

The Corporate Finance Committee also considered Level 3 implementing measures for the Market Abuse Directive proposed by CESR, proposals made by the Financial Reporting Council (FRC) and by the European Commission to deal with the risks of collapse of one or more of the Big Four audit firms, and concerns arising in the context of the US/UK extradition treaty which relaxes protections for UK citizens and residents. In addition, the Committee led LIBA's response to the FSA's Discussion Paper dealing with private equity.

### Takeovers

The Takeover Directive will be implemented by the relevant part of the Companies Act 2006 when it becomes law in early April 2007. As a practical matter, the Takeover Panel and its Code Committee have indicated that there will be no substantive changes in their activities or in the principles which underpin the Takeover Code. The Directive is a minimum harmonisation measure, which also allows each Member State substantial discretion whether to implement some provisions (for example, provisions allowing a breakthrough against defensive shareholding structures). The other important discretionary measure would require a target company's board to refrain from hostile corporate actions vis-à-vis a bid unless hostile actions are approved by shareholders. In a recent Commission report on the implementation of the Directive, it was found that only eighteen Member States will have some form of Board neutrality requirement and that five Member States will or are likely to introduce the option of a reciprocity qualification – under which breakthrough and board neutrality provisions of target companies may be predicated on the offeror company's reciprocal position – which was not present before the Directive.

*Takeover  
Directive*

The UK has not introduced the breakthrough provisions of the Directive nor any reciprocity provision and it has maintained the Takeover Code's requirement for Board neutrality. The UK has introduced one super-equivalent provision, however, such that parties responsible for bid documentation which does not meet the requirements of the Takeover Code will be guilty of a criminal offence. Language which would have expressly extended this criminal liability to agents of issuers was withdrawn during the Parliamentary process, but the Act refers to the liability that would attach to "a person making the bid" – which may include a corporate adviser making a bid on the offeror's behalf. LIBA made representations about the need to make clear in the statute that investment banks making bids on behalf of the bidder would not be considered "a person making the bid" for the purposes of the criminal liability provisions. In the event, the wording was maintained, but the Attorney General entered statements into the Hansard record which he said would accomplish the clarification we had sought.

Nevertheless, many investment banks have decided not to continue making bids on behalf of an offeror so as to avoid any issues of liability.

#### *Takeover Code*

We have maintained our strong relationship with the Takeover Panel, and have taken forward the constructive dialogue on consultation procedures that was referred to in last year's report. The Corporate Finance Committee considered the public consultation papers referred to below.

**PCP 2005/3: Dealings in Derivatives and Options, Detailed Proposals re Control Issues.** In response to comments by LIBA and others, the Code Committee established the new status of "recognised intermediary" (RI), providing an exemption from the disclosure requirements concerning derivatives referenced to relevant shares. The Code Committee accepted LIBA's suggestion that a pragmatic approach be taken on assigning and maintaining the RI status of a trading desk. LIBA had advised against the eventual decision of the Code Committee to adopt the "broad approach" to the treatment of long derivatives positions (but not short) to determine whether a mandatory bid has been triggered – this was on the grounds that a more proportionate approach would be to consider short positions and other factors. In a subsequent review of the impact of the new rules, LIBA Members indicated that the new disclosure rules have yielded transparency advantages while being very costly to implement. Members remained concerned about the new treatment of derivatives, which are to be aggregated with any holding of physical shares in determining whether a mandatory bid obligation has been triggered.

**PCP 2005/4: Proposed Abolition of the Rules covering Substantial Acquisitions of Shares (SARs):** LIBA agreed with all of the Code Committee's proposals.

**PCP 2006/1 – Miscellaneous Code Amendments:** after reviewing all proposals, LIBA had no objections to make.

### **Transparency Directive**

The Directive has been implemented through the Companies Act 2006 and through the FSA's final rules following Consultation Paper 06/04. The Directive is a minimum harmonisation measure, which allows Member States to impose more onerous provisions. The FSA – with one exception – has chosen not to impose super-equivalent provisions except to preserve existing rules where that makes practical sense. LIBA has supported that general policy. The following recommendations by LIBA were adopted by the FSA in final rules:

#### *LIBA priorities*

- The market maker exemption from disclosure requirements related to major shareholders was set at the maximum of 10% of outstanding shares. The definition of market maker is pragmatically set in the directive: the proposal to require all market makers to establish separate accounts for all shares held in that capacity was changed to permit them to demonstrate the number of shares held as a market maker in other ways. This will avoid very considerable cost and complexity.
- The FSA has also established an exemption from reporting requirements on significant shareholdings up to 5% for other trading desks.

- LIBA's recommendation that borrowers of shares who on-lend them promptly need not disclose either transaction even where a defined reporting level is crossed was adopted by the FSA. The FSA also determined that a loan of securities would not be disclosable under the disclosure regime.
- The FSA decided not to delete existing listing rules which require annual reports to contain details of directors' waivers of emoluments, statements regarding the beneficial and non-beneficial interests of directors, and details of issuers' purchases of own shares.

The FSA also requested views on whether significant holdings of cash-settled derivatives such as CFDs referenced to shares should be subject to a disclosure requirement such as exists for significant shareholders (at 3% and at each 1% increment). Given the principles of better regulation, which require proportionate measures, LIBA opposes such a measure (which does not, incidentally, exist in any other jurisdiction). First, LIBA considers that any market failure which would require such a measure – for example, inefficient pricing, takeovers by stealth or weakened market confidence – has not been demonstrated. Second, the suggested measure would not fare well in any cost-benefit analysis. The FSA has undertaken to do additional investigation into the issues raised by stakeholders in their responses.

### **Company Law Reform**

The Companies Act 2006 (the Act) received Royal Assent in November and stands as one of the lengthiest statutes ever enacted (with 1,300 sections). Parts of the Act are to be brought into operation on various dates in 2007. The Act will permit directors to register service addresses in lieu of residential addresses at Companies' House. Directors will be required to have regard to the interests of stakeholders including employee interests and the environment in making decisions. There will be issuer liability on a recklessness standard to shareholders and to investors who rely on the periodic financial information mandated by the Transparency Directive which is misleading or inaccurate. Auditors will be liable to issuers and shareholders with respect to their reports but they will be allowed to limit their liabilities by agreement with a company subject to shareholders' approval with the proviso that the agreed limitation must be reasonable in all the circumstances. The Government has been given various powers to implement the Act's provisions through secondary legislation and has appointed LSE Professor Paul Davies to undertake a review of issuer liability to shareholders/investors and to make recommendations concerning changes to the liability regime. LIBA has been working with the CBI in its efforts to contribute to this debate.

The issue of auditor liability limitation agreements has been considered by our Corporate Finance Committee – both in the context of the Act and in the context of an European Commission public consultation on measures to decrease the risk that one of the "Big Four" audit firms could be driven from the market by catastrophic liability (upon which also see the Accounting section below). LIBA has argued that a material risk of a Big Four firm's collapse due to catastrophic

*Auditor liability*

litigation losses has not been demonstrated but that it would be appropriate to implement a proportionate liability scheme. This would be fairer to shareholders and to the issuer (and to other parties such as corporate advisers who may share joint and several liability with auditors in certain cases). The Act's provisions are described by some as approximating proportionate liability but ultimately that will be settled by the UK courts. The Commission has not yet published its recommendations on this matter.

LIBA has also argued that another method of reducing potential liabilities of audit firms would be to find ways to improve the control and governance process of multinational audit firm networks. This process is being initiated internationally through cooperative efforts of public audit regulators including the FRC.

### **Listing matters**

In addition to the changes in the Prospectus, Listing and Disclosure Rules mentioned in the section on the Transparency Directive implementation, our Corporate Finance Committee also responded to a range of other consultation papers relevant to Members' business.

#### *AIM rules*

The LSE consulted on AIM rules for nominated advisers (NOMADs) and AIM rules for companies. We responded by voicing serious concern that the proposed rules would engender greater risks of liabilities and litigation for NOMADs as well as creating new responsibilities for NOMADs which seemed to shift Exchange responsibilities onto them.

LIBA indicated particular concern about the proposed representation to be made on the front page of every admission document for an AIM applicant which could have created the inaccurate impression that the representations made by a NOMAD (as to its assessment that the applicant is an appropriate candidate for listing) is being made to every investor. In fact, the representation is being made to the Exchange and only to the Exchange, which alone has the power to decide whether it is appropriate to list a particular company. The final rules did change the front page wording, but the issue of NOMAD liability remains an important concern.

We also voiced concerns that the proposed rules would require NOMADs to monitor the trading of the shares of an AIM client wherever it occurs but, unfortunately, this requirement remains in the final rules. Monitoring trading has traditionally been an Exchange function, and the new rule may be seen as a partial transfer of its traditional responsibility. Ultimately, though, the Exchange must remain primarily responsible for monitoring trading. (This is not to say that NOMADs should not assist the Exchange in its efforts to monitor trading.)

LIBA is also concerned that the new rules may be seen by some to put a NOMAD in the position of approving some of the statements and activities of the Board of Directors of an AIM company. This goes beyond offering advice to a Board when requested to do so and it ignores the fact that AIM companies are not required by the new rules to seek advice or guidance in any specific contexts after admission. LIBA has reiterated that a NOMAD may rely on the

representations of the Board and its professional advisers in the absence of contrary knowledge gained through due diligence efforts. Members are concerned that the risks in investing in AIM companies should not be indirectly transferred to NOMADs who perform their tasks professionally. Rather, the risks should be disclosed to investors to enable them to make informed risk/reward assessments when deciding whether to invest.

With respect to the FSA's CP 06/21 on Investment Entities, we agreed with the proposals intended to attract various types of funds to the UK which have hitherto been listed in other Member States (hedge funds, private equity funds, and certain others). The FSA intended to reduce regulatory burdens for such funds under a full disclosure regime and, at the time of writing, the results of the consultation are still awaited.

*Investment  
entities  
consultation*

### **Private Equity**

In November the FSA published a Discussion Paper which invited responses to its analysis of the private equity sector including market practices and risks inherent in the sector, and its conclusion that the sector is proportionately regulated in the UK – with a regulatory structure that is adequately resourced – but with some proposals for future work. LIBA's response to the DP confirmed the FSA's assessment that the current regulatory approach to the sector is proportionate and adequate; and we strongly endorsed the view that private equity is an extremely important factor in the UK and in global markets by using capital in productive ways to create strong, competitive companies.

*Response to  
FSA's DP 06/6*

We also endorsed the proposal to undertake periodic surveys of the sector, provided that there be closer coordination with private equity firms to ensure clarity and a practical scope. LIBA also focused on the chain of information running from a borrower of leveraged debt to the holder of securitised debt who may not be privy to any discussions with the borrower in distressed circumstances, and we suggested that means be found to assure adequate disclosure by the borrower.

Although LIBA found the DP's discussion of types of risks in the sector to be conceptually accurate, there is a concern that some readers might conclude from the DP that the private equity sector exists in a regulatory vacuum. We suggested that the FSA make clear in its response to the consultation that the activities of private equity firms – for example, takeovers, IPOs, secondary offerings and Class 1 transactions – are subject to strong regulation. Each of these activities must meet regulatory requirements, which protect shareholders, potential investors, and, in the case of takeovers, employees. We pointed out that a better understanding of the regulatory position would assist an informed consideration of both the benefits and the potential risks posed by private equity to investors and to the market and economy more generally.

## COMPLIANCE, BANKING AND UK PRUDENTIAL REGULATION

*Overview* Other sections of this report cover LIBA's work on a range of issues stemming from the EU and other international fora – not least on proposals for implementing EU directives – as well as our intensive work with the regulators on reforming the capital adequacy regime which applies to banks and investment firms. Domestically, we considered the FSA's discussion paper on private equity, together with proposals to make important changes to the Takeover Code (as outlined in the Corporate Finance section above), as well as further work on the reform of the Companies Act and related legislation.

More generally, we have continued to maintain an overview of the FSA's relationship with LIBA Members, for example in our dialogue about enforcement and service standards issues. We have also responded to consultation papers in all cases where these have covered changes to the FSA's rules that are relevant to our Members' business. At the same time, we have had further discussions with the Treasury about the need for amendments to parts of the Financial Services and Markets Act (FSMA).

Firms have continued to draw to our attention issues arising from their day-to-day relationships with the FSA and, where a matter appears to have general implications for Members, we have pursued the issues further. Overall, we had expected that the new organisation structure at the FSA which took effect in 2004 would help foster a clearer focus on wholesale market issues – and our experience tends very much to confirm that our optimism was justified. For example, Members welcomed the ARROW II modifications to the FSA's risk-assessment framework announced in August, which had been discussed in detail with firms beforehand (including at meetings hosted by our Banking Committee), and also the FSA's increased focus on relationship management.

### *City Liaison Group*

As in previous years, much of our work on the FSMA and related secondary legislation – including changes necessitated by MiFID – has been taken forward through the Financial Services and Markets Legislation City Liaison Group (CLG), to which LIBA continues to act as the Secretary. The other members are the ABI, BBA, ICMA, IMA, ISDA, the Futures and Options Association (FOA), Clifford Chance LLP, Freshfields Bruckhaus Deringer and Linklaters. We are very grateful to all members of the Group for the help that they have given.

### **FSA initiatives – major submissions**

### *Principles-based regulation*

A major exercise for us has been to analyse the implications for our Members of the FSA's project to move to more principles-based regulation (MPBR), and to seek assurances from the FSA about the safeguards that are needed if the shift in the regulator's approach is to deliver the benefits sought.

LIBA submitted, and in September discussed with senior FSA officials, a paper setting out Members' interim thoughts on MPBR. Members were briefed about key aspects of the FSA's thinking at that stage and a major conference is to be held in April 2007 at which the FSA is expected to spell out its plans more clearly. We have stressed that although MPBR could have significant advantages for firms, it would be wrong to assume that replacing detailed requirements with

more generally drafted provisions will necessarily decrease the regulatory burden or promote innovation: we believe that the FSA shares this view. Overall, the new framework must allow firms to plan their compliance arrangements and controls with confidence that they will meet the regulator's requirements; at the same time, when establishing requirements, the FSA needs to ensure that the consultation safeguards in the legislation designed to confirm that new measures are both necessary and proportionate should not be bypassed. Accordingly, our work has focused on the changes to the FSA's approach to enforcement within MPBR – as discussed further below – and on the way in which the FSA will clarify its expectations. An important element will be the FSA's willingness to share its views on requirements with the industry and, in particular, the extent to which it will be prepared to respond to firms seeking confirmation that their arrangements for complying with the Principles are likely to be acceptable, given their business model.

In November we set up a working group to consider DP06/5 which set out the FSA's thinking on the role of industry guidance in a more principles-based regulatory structure. The paper included a number of proposals that we had sought in the past and, although there were some issues where further clarification was needed, we were able to support the FSA's general approach. In particular, the paper:

*Industry  
Guidance*

- recognised that industry guidance is not new, but already exists in different parts of the regulatory system;
- made clear that industry guidance would supplement rules not replace them;
- set out a standard process for the FSA to recognise industry guidance;
- made clear the standards that would be applied in recognising such guidance; and
- confirmed that the FSA would not take action against a firm which has complied with recognised guidance covering the issue concerned. (However, the rights of third parties to take action would not be affected, and we are discussing the implications of this with the FSA.)

Given the CLG's work on the Enforcement Process Review in 2005, the FSA approached us at an early stage of their work on reviewing the Enforcement and Decision making manuals The CLG – supplemented by Allen & Overy, Barlow Lyde & Gilbert, Herbert Smith, Norton Rose, Simmons & Simmons, Shearman & Sterling and Slaughter and May – submitted a paper highlighting the areas where it was felt that changes should be made, and these ideas were discussed in detail with the FSA in a meeting in September. Key issues were whether the "post-Strachan" system of checks and balances is sufficient to ensure that firms do not feel under unfair pressure to settle early (given the incentive to do so that is provided by the new system of fine discounts), and the extent to which there were questions about whether "early settled" cases should establish precedents on the meaning of rules. More generally, the Group stressed the need

*Enforcement  
issues*

for the FSA to use the exercise to clarify its position on the use of its enforcement powers and the status of trade association guidance within MPBR. On the former, we have been seeking clarification about the application of the important safeguard on predictability that the FSA has been stressing (“in order for consequences legitimately to be attached to the breach of a principle, it must be possible to predict, at the time of the action concerned, whether or not it would be in breach of a principle...”). We believe that firms’ concerns about how MPBR might apply to their business where requirements are unclear would be significantly reduced if the FSA would confirm formally that firms taking reasonably conscientious steps to analyse what a Principle entails for their business, and to implement systems and controls accordingly, will not be brought into enforcement if, in the event, the FSA has a different view on what the Principle required. In this context the Group also reminded the FSA about the earlier suggestion that it should recognise the “reasonably conscientious firms” approach (under which, if a firm in a given situation took the steps which could be expected of any reasonably conscientious firm in the same situation, it should be treated as having met the standards expected): in this case, if the FSA consider that prevailing standards are inadequate, then it should say so and give firms sufficient time to respond before taking enforcement action.

A related issue is the status of “soft communications” such as speeches, “Dear CEO” letters and newsletters in the MPBR regime. The Group suggested that the FSA would need to consult on the contents of such material where it might be relied upon in determining the standards expected and would be relevant, therefore, to the FSA’s assessment of firms.

The FSA has now published its proposals for a new Decision Procedure and Penalties manual and Enforcement Guide to replace the current manuals (CP 07/2), to which the CLG will respond in due course.

#### *TCF developments*

The FSA’s work on Treating Customers Fairly has provided a precursor to how the MPBR regime might work. Given the retail focus, LIBA has largely kept a watching brief on developments although, at Members’ behest, we have questioned the suggestions that have come from some quarters that somehow firms whose business is purely wholesale should be considering how TCF might apply to their business. In addition, in September, the FSA published a Discussion Paper on the responsibilities of providers and distributors for the fair treatment of customers. We worked jointly with the European Securitisation Forum (ESF), ICMA, ISDA and SIFMA in responding to this. Our main concern was that the proposed Statement of Responsibilities focused unduly on packaged products and did not reflect adequately the range of different arrangements that can arise in the retail structured product market. Our impression at this stage is that the FSA has accepted that more work needs to be done on this aspect.

#### **Reviews of the FSMA regime and associated legislation**

We submitted evidence to both the Davidson and National Audit Office reviews. The former focused on the extent to which the UK “gold-plates” EU measures when it implements them, and we drew attention to a number of areas where

we felt that this issue had arisen. The Review concluded that the incidence of gold-plating should not be exaggerated, but made some helpful recommendations on new procedures to reduce the likelihood of super-equivalent measures in the future, and there were also specific proposals on areas in financial services regulation where changes to requirements are needed (including the provisions on “close links” reporting, as we had proposed). The National Audit Office were appointed by the Treasury to conduct a review of five aspects of the FSA’s work and, at the time of writing, their report has still to be published. One of the issues that we explored with them in some detail was the importance of the FSA’s work in influencing the development of international and EU regulatory policy.

In addition, towards the end of the year, the new House of Lords Select Committee on Regulators announced that it was conducting an inquiry into the UK’s major economic regulators, including the FSA. The main theme of our response was the importance of distinguishing between wholesale and retail regulation – and we highlighted the extent to which there were a number of factors that might make it harder for the FSA to maintain the distinction in the future.

The CLG has also led the work on responding to the Treasury’s consideration of the way the FSMA and related secondary legislation should be amended in the light of the issues raised in the review of the new framework two years after “N2” (the “N2 + 2” review). The scope for making changes to the primary legislation through the fast track Regulatory Reform Order (RRO) procedure is limited, but in a consultation paper published towards the end of 2005 the Treasury was able to bring forward proposals for nine changes to the FSMA. The great majority of the proposals were welcome, but the CLG concluded that three of the measures – which would have removed the obligation to consult on a range of Handbook changes in the future – were too sweeping. We proposed the inclusion of an additional “notice of intended rulemaking” procedure as a halfway house. In the event, the Treasury decided that it did not need to proceed with a number of its proposals – a follow-up consultation was published in May summarising its views at that stage – and we now await the new legislation. The CLG’s work on the need to amend the requirements on disclosing changes in controllers of financial services firms and such firms’ “close links” bore fruit, with the Treasury proposing wide-ranging proposals – which closely followed the Group’s recommendations – in a consultation paper in March. However, work on changing the UK rules was then deferred in the light of the European Commission’s decision to bring forward a Directive on mergers and acquisitions in the financial sector (upon which also see the section on International Developments above).

*Amendments to  
the legislation*

We also commented through the CLG on the changes to the FSMA and secondary legislation necessitated by MiFID. A number of the amendments to the Regulated Activities Order, in particular, were technically complicated but the analysis of the implications for firms was assisted by the helpful assistance provided by the Treasury team.

## Other issues

### *“Costs of Regulation” project*

The costs of regulation project was a joint FSA/Practitioner Panel exercise, and Deloitte undertook the work. The results were published at the end of June. Despite the title, the exercise was limited in scope – focusing on *direct* incremental FSA-driven compliance costs for firms’ activities in three markets (corporate finance, fund management for institutional clients, and investment/pension advice to retail customers). The indirect costs of regulation (for example, barriers to trade and opportunity costs) were not covered and neither was FSA Guidance, only FSA Rules. The costs arising from compliance activity that a firm would undertake anyway – either at the behest of a non-FSA regulator, or as a matter of business practice – were also excluded. The FSA has said that it may use the results of the project to help set the agenda for possible deregulatory opportunities. In addition, a report by Oxera for the FSA on a framework for assessing the benefits of financial regulation was published in September, and the FSA has also posted on the website an internal guide designed to help its staff undertake market failure and cost-benefit analysis when they formulate any policy initiative that could have material market-wide impacts.

### *FSCS financing*

The FSA maintained the Industry Advisory Group to consider the modifications to the current Financial Services Compensation Scheme (FSCS) financing rules proposed in March 2006 in DP 06/1. We have been a leading member of this group, and have stressed in the discussions the importance of maintaining arrangements that ensure that firms’ business with wholesale clients (which would not be compensatable) is not taken into account when compensation levies are calculated. In practice, the current separate contribution groups for trading and corporate finance business largely achieve this result. We also noted that it was essential to give due weight to the provisions in the FSMA that limit cross-subsidies and stress the importance of maintaining the UK’s international competitiveness. The FSA is expected to publish a consultation paper on proposals for changes to the current rules in March 2007 and we fear that, in spite of the earlier debate, this will suggest that wholesale business should provide some kind of safety net to provide compensation payments when the resources of the other contribution groups have been exhausted. The implications of such a proposal would need to be exceptionally carefully scrutinised given that it seems that EU firms with branches here cannot be required to join the UK scheme. (We also responded to the later consultation, in May, about the funding of the Financial Ombudsman Service’s compulsory jurisdiction: the proposals in the Discussion Paper were much less controversial as far as LIBA Members were concerned given that the Ombudsman’s levies exclude wholesale business.)

### *FSA’s fees*

As regards the FSA’s finances, aspects of the way firms’ periodic fees are calculated continue to give rise to difficulties as a result of a double-counting problem. This arises because some of the fee-blocks use a headcount of approved persons and proprietary traders to measure a firm’s size, which can mislead when the individuals involved undertake activities in more than one fee-block, or work for more than one firm within a group. We stressed the need to address this problem when the FSA consulted on its budget for 2006–2007, and we also

welcomed the maintenance of the arrangements under which the costs of the FSA's financial capability budget are not allocated to the "wholesale" fee-blocks. We will need to review the FSA's thinking on these aspects carefully when we consider the proposals for the 2007–2008 budget. In addition, we reminded the FSA that the need to review the current arrangements for transaction reporting fees was agreed during the discussions in 2004 on the plans to develop the transaction monitoring systems.

We responded with the IMA to the Home Office's consultation on the investigation of protected information under the Regulation of Investigatory Powers Act. We welcomed the Government's commitment to protecting the confidentiality of investors' information and assets, and made a range of recommendations to ensure that those protections were comprehensive.

*Regulation of  
Investigatory  
Powers Act*

Other work has included submissions on the follow-up Home Office consultation on the Reform of the Prevention and Corruption Acts – where we coordinated the CLG contribution – and LIBA's response to the FSA's Integrated Regulatory Reporting consultation paper published in May. On the latter, the Compliance Committee focused on the non-financial reporting aspects and we were pleased that the FSA concluded that it should not proceed with a number of the proposals about which we had raised concerns: LIBA's work on other aspects of this CP and also on the Approved Persons regime is covered in the sections on UK Prudential Developments and Personnel below.

*Other work*

### **Financial Crime**

Financial crime issues continue to be a matter of concern to the authorities worldwide. We have focused on our work with the Joint Money Laundering Steering Group (JMLSG) and implementing the new risk-based approach to anti-money laundering.

In addition, LIBA – as a member of ICSA – has been closely involved with consultative work on behalf of the Financial Action Task Force (FATF). This work is ongoing and its significance relates to FATF's desire to engage more widely with the private sector generally in developing its future strategy, policies and recommendations (something LIBA has encouraged). This new association demonstrates how important it is becoming for all parties affected by organised financial crime to be coordinated in their ways of tackling the problem. FATF is to be congratulated on its initiative in this regard and its leadership is welcomed.

LIBA has also worked closely with other trade associations, the JMLSG, the Treasury and the FSA in the work on implementing the EU Third Money Laundering Directive: in particular developing the Money Laundering Regulations 2007 and the revision to the JMLSG Guidance that will be needed. This work is ongoing but the Treasury published in January 2007 draft Money Laundering Regulations for consultation and the JMLSG will be publishing its revised Guidance for consultation during the summer of 2007.

*EU measures*

In addition, LIBA, alongside the BBA which has taken the leading role, has been liaising with the Treasury regarding implementation of the EU Regulation on

information on the payer accompanying transfers of funds. Draft guidance has been developed by the BBA and was published on its and the JMLSG websites in early 2007 (the EU Regulation came into effect in January, but transition provisions have been put in place which expire at the same date – 15 December 2007 – that the Third Money Laundering Directive has to be implemented).

*Fraud* Fraud remains a matter of concern for the regulatory authorities, and the possibility of establishing a specialist group will be explored further in 2007 as some LIBA Members have now expressed an interest in engaging with other trade associations' members on this subject.

### **Internal Audit**

The Internal Audit Committee has continued to focus on matters relating to corporate governance, risk and the management of conflicts covering both UK and international developments.

In addition to its review of relevant FSA material, the Committee followed the developments surrounding the implementation of MiFID and the role of internal audit in this, as well as maintaining its interest in relation to the implementation of the CRD and in papers issued by the Basel Committee. As noted earlier, the FSA's new ARROW process was also a topic of discussion during the year.

Finally, the Committee has maintained its interest in financial crime issues – money laundering (Third Money Laundering Directive and the Wire Transfers Regulation as well as the JMLSG's new Guidance) and fraud, the FSA's Handbook Review programme, the development of the FSA's Approved Persons and Training and Competence regimes and the Financial Reporting Council's work in relation to corporate governance standards.

### **UK Prudential Developments**

The main focus of domestic prudential regulation has continued to be on the implementation of the revised capital requirements framework set out in the CRD.

#### *FSA consultations on CRD implementation*

In February 2006 the FSA issued its third major consultation on implementation – CP06/3 – Strengthening Capital Standards 2. This consultation built on the progress made in CP05/3 and provided, for the first time, a full set of Handbook text implementing the CRD. LIBA collaborated with other trade associations in developing a comprehensive response. As well as commenting on the detailed policy implementation issues, this response also articulated industry concerns as regards the clarity and usability of the Handbook, how the requirements might fit within a principles-based approach to regulation and the FSA's approach to granting waivers for the use of the advanced approaches. The Policy Statement (PS06/6) addressed many of the issues and the FSA has continued to address questions of navigability and understanding through the development of the online Handbook, additional explanatory material sitting outside the Handbook – such as FAQs – and an articulation of its approach to waivers.

In addition, policy implementation discussions have continued throughout the year with a view to enhancing the common understanding of the requirements through the various standing groups in which we have participated – namely those on credit risk, credit risk mitigation, securitisation, Pillar 2, trading book, and capital and groups (and in the various expert groups set up to support this process). Some of these groups, such as those considering the trading book and capital and groups, focused their work almost entirely on the major consultation on CRD implementation. Other groups, however, have had extended debates on certain issues both before and after the consultation – matters of particular note on the implementation of the credit risk requirements have been Loss Given Default, Exposure at Default and Procyclicality, whilst in the trading book area discussion has focused more on default risk (model validation principles), and Effective Expected Positive Exposure. Securitisation discussions have continued on the meaning of the significant risk transfer requirement, the treatment of derivatives with securitisation vehicle counterparties, liquidity facilities and integrated regulatory reporting. Discussions on securitisation are continuing in 2007 on issues such as substitution and replenishment of assets, early amortisation features, regulatory calls and sub-participation. In addition, the FSA has also started to give feedback through the credit risk standing group on the initial findings with respect to firms' implementation of the CRD.

Towards the end of 2006 an issue arose in relation to the calculation of eligible regulatory Tier 3 capital for investment firms. This required swift action to ensure that a pragmatic and sensible approach was put in place in time for the January 2007 implementation date. The FSA responded promptly and constructively to our representations.

Pillar 2 has become a key priority for many firms, particularly with respect to the cross-border dimension, home-host relationships and the application of Pillar 2 at group consolidated level. The CRD requirements create particular problems for firms with non-EU parents. LIBA has successfully raised the profile of the issue with the FSA, which is supportive of firms' concerns and who have pressed the case with Basel and EU peers. Another major issue has been the recognition of risk diversification within firms' Pillar 2 models. The FSA has now indicated that it is willing to be persuaded on this point and, potentially, will take account of the benefits of diversification once more experience has been gained over the next few years.

For most of the year the progress on implementation has also been reviewed by the High Level Basel/CRD Implementation Advisory Group, chaired by the Managing Director, Wholesale and Institutional Markets at the FSA. As the focus of implementation has moved on from establishing the Handbook to practical implementation matters, this Group has now been stood down, although it can be re-established if firms identify a need for it.

Additionally, the FSA has also consulted on its proposals, now finalised, for CRD reporting (CP06/11 – Integrated Regulatory Reporting). As far as practicable this package represents a harmonised set of reports for banks and investment firms affected by the CRD and a slimline version of the possible reporting

*Pillar 2 issues*

*Integrated  
Regulatory  
Reporting*

requirements envisaged by the CEBS guidelines. In particular, the FSA has taken a very pragmatic approach to the reporting required during 2007, scaling down to the minimum necessary to supplement the existing reporting package. In parallel, the FSA has also been developing its technology for Mandatory Electronic Reporting. LIBA has participated in the discussions on both aspects.

#### *Future issues*

Looking forward into 2007, we expect implementation discussions to continue through the standing groups, but predominantly through the individual discussions firms will be having with their supervisors on their progress. However, there are two domestic policy projects of note: first, the capital treatments of firms that are members of financial groups, and secondly, the review of prudential filters. In respect of the former, the FSA will be reviewing its policies on deducting investments in subsidiaries and associates and of setting capital requirements at a solo (as well as group) level, considering the interaction between solo and group capital regimes to assess the impact of the current policy, and establishing the drivers of capital allocation in practice. We are expecting the FSA to publish its findings in Q3 2007. The review of prudential filters, foreshadowed in PS05/5 (“Implications of changing the accounting framework – Feedback on CP04/17 and made text”), will seek to consider the continued appropriateness of the adjustments to the accounting numbers for regulatory purposes. We expect a consultation in Q4 2007.

## **ACCOUNTING**

### **International Financial Reporting Standards**

The EU’s IAS Regulation came into full effect in January 2005. This – with minor transitional exemptions – requires companies listed in the EU to prepare their consolidated financial statements under International Financial Reporting Standards (IFRS) and, to the extent they have not yet been replaced by IFRS, under updated International Accounting Standards (IAS). With most EU-listed companies having now produced their first set of IAS/IFRS accounts, the short-term focus of the International Accounting Standards Board (IASB), and of the relevant European and UK standard-setting and regulatory bodies, has shifted to implementation-related issues, such as the best way to ensure the consistent application of IAS/IFRS across the EU. A secondary, longer-term, IASB focus has been the development, together with the US Financial Accounting Standards Board (FASB), of a joint conceptual framework to provide a common basis for IAS/IFRS and US GAAP to assist their convergence towards the goal of a single unified set of standards.

#### *Accounting Committee priorities*

This change of emphasis has been reflected in the LIBA Accounting Committee’s work, which has tended to divide into practical issues – typically arising either from day-to-day application of IAS/IFRS or from IASB Exposure Drafts proposing relatively small changes – and broader issues of principle arising from IASB Discussion Papers on longer-term matters. The Committee has in recent months been assisted in its work on the practical issues by a new LIBA/ISDA International Financial Instruments Technical Accounting Group (InFITAG), while

the more conceptual papers have been examined in some detail in the regular meetings of LIBA's informal IAS Working Group.

Amongst the practical issues studied during the year have been the presentation of information on operating segments and accounting for business combinations, for share-based payments, and for financial instruments puttable at fair value. Of particular satisfaction was the reversal, following strong LIBA representations, of a decision by the International Financial Reporting Interpretations Committee (IFRIC) that IAS 39 required short sale contracts to be recognised and accounted for as derivatives, which would have created major administrative problems for many Members. The main focus on the conceptual side was on issues around the valuation of financial instruments and other assets and liabilities and, more broadly, on papers emanating from the first stages of the FASB/IASB work on a conceptual framework.

### **Other accounting and audit developments**

Following our success in persuading (with ICMA) the European Parliament to amend the Statutory Audit Directive to remove the potentially onerous requirement to have an Audit Committee from SPVs used for securitisations, LIBA was invited to join the European Commission's Auditors Liability Forum, which has been assisting the Commission to review the EU legal framework for auditor liability, and to examine the case (strongly promoted by the big audit firms) for an EU-wide limitation of liability. A key LIBA concern in this context has been to ensure that the introduction of any such limitation does not produce a consequential increase in the liability of investment banks or other financial advisers. (The Corporate Finance section of this report covers other aspects of this debate.)

*Work on auditor liability*

A separate audit-related issue of concern to our Members, and for rather different reasons to the Financial Reporting Council, arises from the Statutory Audit Directive provisions for the regulation and oversight of third country audit firms. We believe these provisions could, if implemented too hastily, provide a serious deterrent to some overseas companies considering a London listing, and we have strongly supported the suggestion in the Commission's consultation paper that the problems could be resolved through an extended transitional period.

*Third country auditors*

We have also continued to participate in the ICAEW's high-level Audit Quality Forum which has been considering a number of audit issues in the UK, and to maintain a largely watching brief on a number of other developments in accounting and reporting, including issues arising in relation to the implementation of the Prospectus and Transparency Directives (see Corporate Finance above).

## TAXATION

### **Her Majesty's Revenue & Customs**

It is now a little over two years since the merger of HM Customs and the Inland Revenue into Her Majesty's Revenue & Customs (HMRC) and the concomitant transfer of the higher-level policy making functions to the Treasury. The new policy structure has bedded down well, with earlier concerns over unclear demarcation of responsibility largely assuaged, and we continue to have excellent relationships with policy makers in both departments.

The benefits of integration at the operational level are – so far – less evident. It seems clear, as evidenced for example by the very sensible conclusions of the November “Varney Report”, that HMRC has a genuine desire to improve their service to large businesses. But there is an understandable tension between this aim and the equally laudable statement in the March 2006 Budget that the HMRC budget “will fall (over the 2008-11 period) by five per cent per year in real terms”. The Large Business Service (LBS) established at the time of the merger generally works well for Corporation Tax, but the fact that most of the senior LBS officers come from an Inland Revenue background can sometimes make it more difficult for them to deal as effectively with Members' VAT issues. A recent issue over the correct tax treatment of late night taxis raised a concern over the LBS role in PAYE matters, although it appears that constructive efforts are being made to resolve this point. We look forward to continuing to work with officials to ensure that the improved service promised by the Varney Report can be delivered fully.

#### *HMRC and Large Businesses*

Following their 2005 paper on “Modernising Powers, Deterrents and Safeguards”, HMRC has published a number of more detailed consultation documents on specific aspects of this wide-ranging subject. So far their approach appears generally unexceptionable, but we shall continue to scrutinise such proposals with great care, and to respond on any issues of potential concern.

### **Anti-avoidance reporting regime**

While the March 2006 Budget Statement and the December Pre-Budget Report (PBR) contained some further anti-avoidance measures directed at the financial services industry, the volume of such measures was substantially lower than in the previous two years. This suggests that HMRC feels the reporting systems are now working reasonably well, a view with which we would broadly concur, and which reflects the effectiveness of the consultation process as each new batch of measures has been brought in.

### **Other UK tax issues**

Perhaps the most significant current issue for LIBA Members on the direct tax front is the Treasury's fundamental review of the taxation of foreign income; the principal drivers for this are concerns over the potential impact of a series of European Court of Justice cases and the need to maintain UK competitiveness in

#### *Taxation of foreign income*

the context of increased globalisation, with the added aim of reducing compliance costs. The review is being conducted informally with periodic discussions with selected industry participants, but the real test will not come until the Treasury starts to narrow down the options to what it sees as the right regime for the future, and publishes specific proposals for the way forward.

At a more technical level, we have for some time been discussing with the Treasury and HMRC possible changes (now included in the 2007 Finance Bill) to the system of intermediary relief for SDRT/Stamp Duty to remove possible tax obstacles that could prevent some Members from taking full advantage of the provisions of MiFID. The Bill also contains provisions for updating the regime for the taxation of sale and repurchase agreements (“repos”) – another area where HMRC has been responsive to LIBA’s comments.

*Finance Bill*

We are disappointed, however, that yet another year has passed without any progress towards the reduction or abolition of Stamp Duty and SDRT on securities transactions. As LIBA and many others have stressed, these taxes are levied at a significantly higher level than corresponding taxes in other jurisdictions and thus create, amongst other problems, a major disincentive for the largest multinational corporations to remain registered in the UK. We continue to believe that market pressures and competition will increasingly erode the revenue from these taxes, and that attempting to preserve them risks irreversible damage to the UK securities industry; we hope that the Treasury will come to recognise the case for the abolition of these taxes.

*Stamp Duty*

2006 has seen a number of developments on the VAT front. A major, and continuing, topic is the European Commission’s review of the Financial Services Exemption for VAT. The relevant parts of the Sixth VAT Directive are badly out of date and present considerable difficulties in today’s financial markets, and in principle we fully support the Commission’s efforts to update this part of the legislation. The need for unanimity means it will not be easy to effect any changes but we are keeping in close contact with the Treasury and HMRC as this exercise progresses.

*VAT developments*

Other VAT issues which we have been discussing with HMRC include the reviews of the Terminal Markets Order (TMO) and the Staff Hire Concession, together with possible clarification of the treatment of investment research services supplied under commission-sharing agreements.

Finally, we again used our annual tax submission to underline the importance of the fiscal legislative process working – and being seen to work – in an equitable and sensible manner. We restated the principles which we believe should be followed if this is to be achieved: cost-benefit analysis of the effects of prospective changes, full consultation wherever possible, confining new anti-avoidance measures to specific targets, avoiding sudden legal changes but ensuring that legislation keeps up to date with changes in the traditional divisions between different types of firm, and ensuring that adequate notice is given of the date when new measures are to take effect.

*Fiscal legislative process*

## EU “Savings Tax” Directive

The European “Savings Tax” Directive, which came into effect at the end of June 2005, requires the Commission to report every three years on the Directive’s operation and to put forward any amendments that it thinks necessary “to better ensure effective taxation of savings income and to remove undesirable distortions of competition”. To prepare for its first such report the Commission has convened an Expert Group of representatives of EU trade associations, on which LIBA is representing EFSA, with a remit to examine the operation of the Directive and to give advice on possible changes.

LIBA also continues to provide the Secretariat for the “City Group”, an informal grouping of UK trade associations and major market operators which coordinates UK industry views on the Directive: this Group will provide a useful vehicle for ensuring that UK market views and experience are properly reflected in the work of the Commission’s Expert Group.

## PERSONNEL

*Overview* The Personnel Committee is LIBA’s forum for discussion of personnel practice and employment law, together with related matters including the implications for firms of changes to the FSA’s Approved Persons and Training and Competence regimes and the work of the Financial Services Skills Council (FSSC).

The Committee has noted a number of issues during the year the most significant including: age discrimination; disability discrimination; continued discussion in the EU concerning the Working Time Directive; the Government’s consultations on proposed changes to the work permit system and new legal rights for working mothers and fathers.

*Approved Persons regime* The FSA proposed in CP 05/10 to disapply the Approved Persons regime for those individuals dealing only with non-private customers. Our Members strongly disagreed with this, seeing the “Central Register” as a cornerstone in delivering compliance in the wholesale sector. We are now pleased to report that the strong representations we made, alongside other associations and the awarding bodies, has resulted in the FSA maintaining the registration process for all Approved Persons (although this will be kept under review: see CP 06/15 “Reforming the Approved Person regime – Including feedback on CP 05/10”, published in August 2006).

*Training and competence* The Training and Competence regime will no longer apply to wholesale firms and our Training and Competence Working Party, reporting to the Compliance and Personnel Committees, has been working alongside other trade associations and relevant interested parties to consider the implications. This has involved meetings and discussions with the FSA, FSSC, some awarding bodies and the major training providers to the wholesale sector. LIBA set out in a draft “concept paper” a proposed framework around which all parties might begin to develop proposals. This work is ongoing and will take some time to develop into an acceptable way forward that will meet both the regulator’s and firms’ needs. This

is an important issue for the industry to address and Members are committing significant time to this effort so as to ensure that the wholesale sector has a clear and agreed way forward.

LIBA is also developing its involvement with the ICAEW's Corporate Finance Faculty and its new Corporate Finance qualification (the first UK candidates will be taking examinations during 2007). The progress of this qualification will be monitored and discussed with Members.

## **ADMINISTRATION, CONTINGENCY PLANNING AND BUSINESS CONTINUITY**

The Administration Committee's work has covered a wide range of topics including building administration, space planning, cleaning services, environmental audits, ecology initiatives, catering, archiving and records management, off-shoring, outsourcing support services and print services.

*Overview*

In addition, the Committee has been involved in LIBA's work on business continuity and disaster recovery issues. A number of Members took part in the Tripartite Authorities – the Treasury, Bank of England and FSA – Resilience Benchmarking Project which was designed with the assistance of Members to assess the resilience and recovery capability of the UK financial services sector in the event of major operational disruption that could be caused by, for example, a terrorist attack or natural disaster. The Benchmarking exercise required participants to answer more than a thousand questions on their business continuity arrangements. The output from the exercise – the FSA's "Business Continuity Management Practice Guide" (published in November) – reflects the collective business continuity planning and crisis management expertise of the UK's most significant firms and financial infrastructure providers, and has been praised for its useful and practical approach. (All participants in the Benchmarking exercise received a bespoke report enabling comparisons to be made within their sector and overall.)

*Business continuity*

As in previous years LIBA Members played a significant part in the preparation of and participation in the 2006 Market-wide Exercise. This was the largest of its kind in the world, involving well over 3,000 people: no other country has undertaken such a thorough test of its financial sector's resilience to pandemic influenza. The exercise ran for six weeks, simulating twenty-two weeks of a pandemic. The two main objectives were: first, to provide each participant with the opportunity to test its plans for responding to a flu pandemic, and second, to assess whether there were any sector-wide issues which might need to be addressed in order to strengthen the capability of the financial sector. The exercise has been seen as a major success, with the feedback from participants indicating the extent to which the exercise was a genuine challenge. Many organisations are now re-evaluating long-standing business continuity strategies and policies in areas such as human resources, third party dependencies, outsourced ancillary services, suppliers, operational priorities and communications. The FSA is running workshops and seminars in 2007 to enable a wider audience to benefit from the exercise.

LIBA is a member of the Tripartite Authorities' Financial Sector discussion group on pandemics, bringing together the financial sector and trade associations. The work of this group has been important in giving focus to the issues of concern that would arise from the absence of staff over a prolonged period. The group assisted in the preparations of the Market-wide exercise. It has also published on the Financial Sector Continuity website ([www.fsc.gov.uk](http://www.fsc.gov.uk)) a useful document "List of business issues in a pandemic".

The Committee will maintain its interest in the issues arising from pandemics and business continuity, and we are starting to explore whether a BCM working group should be established for Members that are not involved in other bodies (such as the Securities Industry Business Continuity Management Group).

## COMMITTEES OF THE ASSOCIATION

The Association has four committees representing Members' interests in Corporate Finance, Securities Trading, Prime Brokerage and Compliance. In addition, there are ten specialist committees (listed below) and working parties are appointed to deal with particular issues when the need arises.

The work of all the committees is coordinated by the Chairman's Committee.

### COMMITTEES

The Members of the main committees at March 2007 were as follows:

#### Corporate Finance

Mr A. Defriez ( <i>Chairman</i> )	- UBS Investment Bank
Mrs P. Adomakoh	- N.M. Rothschild & Sons Limited
Mr Z. Brech	- Credit Suisse
Mr S. Dingemans	- Goldman Sachs International
Mr J. Grace	- Investec Investment Banking
Mr M. Jarman	- Lazard
Mr J. Manson	- Morgan Stanley & Co Limited
Mr C. Smith	- JPMorgan Cazenove
Mr K.J. Smith	- Merrill Lynch International
Mr H. Somerset	- Dresdner Kleinwort
Mr S. Upcraft	- Lehman Brothers
Mr C. Wilkinson	- Deutsche Bank AG London
Mr G.T. Willett	- ABN AMRO Corporate Finance Limited

#### Securities Trading

Dr R.D.F. Barnes ( <i>Chairman</i> )	- UBS Investment Bank
Ms N. Beattie	- Merrill Lynch International
Mr J.C. Birch	- Goldman Sachs International
Mr J. Brown	- JPMorgan Cazenove
Mr D. Crookston	- JPMorgan Securities Limited
Mr T. Eckert	- Dresdner Kleinwort
Mr F. Evangelista	- BNP Paribas Arbitrage
Mr M. Halliday	- Credit Suisse
Mr R.J. Kyle	- Citigroup
Mr P. Randall	- Instinet Europe Limited
Mr P. Reeves	- Deutsche Bank AG London
Mr D. Russell	- Morgan Stanley & Co International plc
Ms A. Samson	- Lehman Brothers
Mr P. Wale	- Lehman Brothers
Mr J. White	- HSBC Bank plc
Mr A.C.D. Yarrow	- Dresdner Kleinwort

## Prime Brokerage

Mr S. Aganga ( <i>Chairman</i> )	– Goldman Sachs International
Mr A. Angelone	– JPMorgan Securities Limited
Mr B.J. Bisesi	– Lehman Brothers
Mr M. Brian	– Barclays Capital
Mr G. Burkhardt	– Lehman Brothers
Mr W. Douglas	– Goldman Sachs International
Mr S. Foster	– Credit Suisse Securities (Europe) Limited
Mr J. Hitchon	– Deutsche Bank AG London
Mr P. Lambert	– Bear, Stearns International Limited
Ms K. Lee	– UBS Investment Bank
Mr P. Mahon	– Bear, Stearns International Limited
Mr T.J. Minkey	– Bear, Stearns International Limited
Ms K. Mulhall	– Morgan Stanley & Co plc
Mr R. Munro	– UBS Investment Bank
Mr J. Phillips	– Barclays Capital
Mr T. Platt	– Merrill Lynch
Mr N. Roe	– Citi
Mr S. Vora	– Citigroup Global Markets Limited

## Compliance

Mr R.J. Levy ( <i>Chairman</i> )	– Goldman Sachs International
Mr J.T. Brown	– JPMorgan Securities Limited
Ms C. Curtis	– Lehman Brothers
Mrs S. Docx	– BNP Paribas London Branch
Mr D. Gordon	– Nomura International plc
Mr M. Hart	– ABN AMRO Bank N.V.
Dr P.L. Heatlie	– Merrill Lynch
Mr G. Lewis	– CIBC World Markets
Mr R. Murdin	– ING Bank NV London Branch
Mr A. Procter	– Deutsche Bank AG London
Mr C. Ross-Stewart	– UBS AG
Mr J. Westcott	– N.M. Rothschild & Sons Limited
Mr A. Whitehouse	– Calyon

## SPECIALIST COMMITTEES

Accounting  
Administration  
Banking  
Financial Regulation  
Fixed Income Markets  
Internal Audit  
Personnel  
Settlement  
Taxation  
VAT

## MEMBERS OF THE ASSOCIATION

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Ambrian Partners Limited  
Arbuthnot Latham & Co., Limited  
Arbuthnot Securities Limited  
Arden Partners plc  
Banc of America Securities Limited  
Barclays Capital  
Bayerische Hypo -und Vereinsbank AG  
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Bear, Stearns International Limited  
BNP Paribas  
Brewin Dolphin Securities  
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CIBC World Markets  
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Jefferies International Limited  
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