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31 May 2006

Davidson Review
Better Regulation Executive
Cabinet Office
22 Whitehall
London
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Dear Lord Davidson

DAVIDSON REVIEW: IMPLEMENTATION OF EU LEGISLATION
RESPONSE TO CALL FOR EVIDENCE
FMLC ISSUE 122

The role of the Financial Markets Law Committee ("FMLC") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.[1]

Following the Call for Evidence made by the Davidson Review on 3 March 2006, the FMLC resolved to respond, addressing issues that particularly concern its remit. Therefore, this response is limited to issues that relate to legal uncertainty arising in the wholesale financial markets from the implementation of EU directives in this area.

In this letter, the FMLC makes a number of general comments concerning the implementation of EU legislation in the UK[2]; an appendix to this letter then sets out a number of particular examples that seek to explain some of the issues that have arisen in relation to UK implementation.

The FMLC welcomes the UK government's recognition that goldplating of EU directives leads to unnecessary burdens on business in the UK and broadly supports an approach that seeks to reduce the impact of EU legislation on financial markets beyond the extent necessary to comply with the UK's obligations under European law. The FMLC recognises, however, that

1 The members of the FMLC can be found on the website, www.fmlc.org. Please note that, in light of their official responsibilities, Clive Maxwell and Sally Dewar took no part in the FMLC's consideration of this issue.

2 As will be seen from the comments below, this response is mainly concerned with the uncertainties that can arise from copy out of EU legislation. Therefore, it is particularly relevant to question 1(c) of the questions set out in the Annex to the Call for Evidence dated 3 March 2006.

there may be times when it is justified on specific policy grounds to impose more extensive regulation than required by EU legislation. As the FMLC's remit is limited to issues of legal uncertainty, it does not offer any comment on the policy issues this approach raises.

One response to criticisms of goldplating is to implement directives by way of "copy out", where the UK regulations simply reproduce the language used in the directive, thus transposing the wording directly into UK law. This method of implementing directives may have initial attractions, as by following the precise terms of the directive to be implemented it would be expected that no additional requirements would be imposed and at the same time the UK's obligations to fully implement EU law would be discharged.

The FMLC has serious concerns relating to copy out from the perspective of legal certainty. It is widely recognised that the texts of EU directives often contain provisions that are vague, ambiguous, meaningless in the particular national context or open-ended. Occasionally, the wording of an EU directive may have been agreed by the Member States, even though they were aware that different Member States had different views of what the text meant. These features of the texts of EU directives reflect the nature of EU legislation, which is the product of political negotiations between Member States to produce an agreed text that contains sufficient flexibility for individual Member States to transpose the directive into national law taking into account the different legal traditions and features of each particular Member State.

In light of the characteristics of EU legislation, simple and indiscriminate copy out is likely to lead to UK regulations that are unclear, do not provide sufficient detail or rely on concepts that are not well understood by English law. Such UK regulations can only lead to legal uncertainty and legislation that places its own burdens on business. In the financial markets context, when confronted by this legal uncertainty, market participants may either avoid certain types of business, price the consequences of the uncertainty into the cost of the transaction in some way, adopt inefficient structures to avoid the uncertainty or rely more than would otherwise be the case on legal advice.

Not all copy out of the provisions of EU directives is wrong and in certain circumstances transposing directly the text of a directive may be a legitimate way of implementing its requirements into UK law without imposing any additional burdens on UK business. Central to this issue is a question of judgment in choosing how to implement the particular provisions of a directive and assessing when additional clarification or further elaboration of the directive's provisions is necessary in order to ensure that the UK regulations are clear and understandable and do not create any legal uncertainty.

Therefore, in order to promote legal certainty, it is important to adopt an intelligent approach to the transposition of EU directives into UK law. Where the EU directive is vague, ambiguous or open ended, the FMLC considers that it will be necessary to adopt clear provisions in the UK legislation implementing the directive that clarify the legal position and set out sensible limits to the scope of the directive's provisions. It is also necessary to ensure that the UK legislation relies on clear and well understood concepts and features from UK law, so that the general provisions of the directive, drafted so as to allow Member States the flexibility to adopt national legislation that reflects their own legal environment and concepts, are implemented into UK law in a way that has clear meaning to a UK lawyer.

In the appendix to this letter, a number of examples of copy out and non-copy out are highlighted. As can be seen from the implementation of a number of directives in the UK, including the Financial Collateral Directive, the Investment Services Directive, the Market Abuse Directive and the Prospectus Directive, straight copy out in all circumstances can lead to uncertain legislation, which is detrimental to the financial markets. However, as further examples show, an intelligent approach to implementing the relevant directives has led to superior legislation that is certain in scope and intended effect and does not lead to unwanted consequences.

Yours sincerely

Harry Woolf

Lord Woolf

Financial Markets Law Committee

Davidson Review – Response to Call for Evidence

Appendix

1. The Financial Collateral Directive

The Financial Collateral Directive[3] ("FCD") has been implemented in the UK by the Financial Collateral Arrangements (No 2) Regulations 2003 ("the FCA Regulations").[4] The implementation of the FCD into UK law demonstrates both how copy out can lead to an undesirable result and also provides examples of sensible non-copy out.

Example of copy out producing an undesirable result

Article 4 of the FCD provides that Member States shall ensure that on the occurrence of an enforcement event, the collateral taker shall be able to realise financial collateral provided under, and subject to the terms agreed in, a security financial collateral arrangement by appropriation of any financial instruments, and that appropriation is only possible if the parties have agreed on the valuation of the financial instruments. Article 4(6) provides that Article 4 shall be without prejudice to any requirements under national law to the effect that the valuation of financial collateral must be conducted "in a commercially reasonable manner".

There is no requirement, as such, under English law that the valuation of collateral be conducted in a "commercially reasonable manner". The English courts generally take the view that, outside a consumer context, effect should be given to the terms of the contract. Notwithstanding this, Regulation 18(1) of the FCA Regulations provides that the collateral-taker must value the financial collateral "in accordance with the terms of the arrangement and *in any event* in a commercially reasonable manner" (emphasis added). There is no reason why the FCA Regulations needed to incorporate a concept which has not been used in other legislation and is not a concept known to English law, particularly if it overrides the express provisions of the security document and thus undermines the freedom of commercial parties to enter into contracts on the terms that they choose.

Therefore, the copy out of the provisions of the FCD relating to the valuation of financial collateral being subject to a requirement that it is conducted in a commercially reasonable manner into the FCA Regulations leads to uncertainty, as this provision introduces a new concept into UK law. Moreover, as the concept of collateral valuation being conducted in a commercially reasonable manner is unknown to UK law, its incorporation into the FCA Regulations was unnecessary.

Example of non-copy out implementation

Article 2 of the FCD defines "security financial collateral arrangement" in terms of the provision of financial collateral by way of security where the "full ownership" of the financial collateral remains with the collateral provider when the security right is established. However, there is no definition of "security" or explanation of what is meant by "full ownership" in the FCD. Regulation 3 of the FCA Regulations sensibly enumerates the different types of security that can exist under English law (pledge, mortgage, fixed or floating charge or lien) and disregards the word "full" by construing the FCD purposively – a restrictive interpretation would not include any form of security or would not include a mortgage.

Similarly, Article 2(1)(j) of the FCD defines the meaning of "winding-up proceedings" and Article 2(1)(k) of the FCD defines the meaning of "reorganisation measures" for the purposes of the FCD. However, both these definitions in the FCD are very general in scope and leave open the question what specific proceedings or measures are covered at the national level in

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3 Directive 2002/47/EC (OJ L 168, 27.6.2002)
4 SI 2003/3226

each Member State. When implementing the FCD, the definitions included in the FCA Regulations (see Regulation 3) identify the particular proceedings of the relevant description which exist under English law. Therefore, the necessary clarification has been provided, in order for the UK legislation to be clear and certain as to the insolvency proceedings covered.[5]

2. The Investment Services Directive

The Investment Services Directive[6] ("ISD") has been implemented in the UK by the Financial Services and Markets Act 2000 ("FSMA") and also by regulations and other forms of legislation made under the FSMA. The implementation of the ISD provides a number of examples of implementation that has gone further than necessary, but also an example of sensible elaboration of the terms of the ISD.

Examples of implementation going further than necessary

Article 9 of the ISD provides that a person who proposes to acquire, directly or indirectly, a qualifying holding[7] in an investment firm must first inform the competent authorities, telling them the size of the intended holding. Similarly, there is a requirement to inform the competent authorities if it is proposed that the qualifying holding is to be increased so that the proportion of voting rights or capital held reaches or exceeds 20, 33 or 50% or so that the investment firm would become a subsidiary.

These requirements are implemented by Part XII of the FSMA. The result of the FSMA provisions is broadly that anybody who proposes to purchase shares in an investment firm may have to notify the FSA where, when aggregated with the rest of the acquirer's group, the holding of the group crosses the relevant threshold. The requirement of the FSMA to notify exists regardless of whether there is a proposal to take control of the investment firm. This requirement is notwithstanding the aim of the ISD, which is to ensure that regulators in Member States assess the suitability of the controllers of investment firms, meaning persons taking stakes for controlling or strategic purposes. Therefore, the UK requirements are unnecessarily burdensome and this super-equivalence places significant compliance costs on firms for no particular benefit.[8]

Article 3 of the ISD[9] provides that, where close links exist between an investment firm and another person, authorisation shall only be granted by a competent authority where those close links do not prevent the effective exercise of the authority's supervisory functions. Further, the investment firm is required to provide the competent authority with information to monitor compliance with this condition on a continuous basis.

These requirements are implemented through provisions of the FSMA (including Schedule 6, paragraph 3) and the FSA Handbook (SUP 11.9 and 16.5.4). The requirements in the FSMA and the FSA Handbook are very wide, covering the reporting of all close links and changes to close links. However, the requirements of the ISD for the FSA to monitor close links to ensure that the threshold conditions are satisfied does not necessarily mean that all close links and changes to close links need to be reported. The FMLC understands that the reporting requirements in the FSA Handbook lead to an unnecessarily large amount of information being reported to the FSA.

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5 This approach is to be contrasted with that taken in the Transfer of Undertakings (Protection of Employment) Regulations 2006 (SI 2006/246) ("TUPE Regulations"), which implement Directive 2001/23/EC (OJ L 82, 22.3.2001). In the TUPE Regulations, Regulation 8(6) and Regulation 8(7) copy out provisions of the relevant directive that seek to identify certain different types of insolvency proceedings. However, no attempt has been made to clarify the actual insolvency proceedings recognised by UK law that are covered, thus leading to uncertainty as to the operation of the TUPE Regulations.

6 Directive 93/22/EEC (OJ L 141, 11.6.1993)

7 Defined as any direct or indirect holding in an investment firm which represents 10% or more of the capital or of the voting rights or which makes it possible to exercise a significant influence over management of the investment firm in which that holding subsists.

8 The FMLC notes that this issue has already been taken up by market bodies with HM Treasury, who have recently published a consultation paper on the subject, entitled "Reducing reporting requirements: a consultation on reform of the controllers regime in Part XII of the FSMA" (March 2006).

9 As amended by Directive 95/26/EC (OJ L 168, 18.7.1995)

Example of sensible elaboration

The ISD sets out the categories of investment services and financial instruments that are to be covered by the provisions of the directive in the Annex to the ISD. The descriptions of the services and instruments are very general and seek only to identify at a very high level the activities that are to come within the ISD regime.

The key legislative provision that implements this aspect of the ISD in the UK is the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 ("RAO").[10] The RAO sensibly provides detailed descriptions of those investment services and financial instruments that are covered by the regulatory regime and thus provides the necessary certainty for market participants to know what areas come within the regulatory perimeter.

3. The Market Abuse Directive

The Market Abuse Directive[11] (MAD) has been implemented in the UK by amendments to section 118 of the FSMA. However, prior to the implementation of MAD, the UK had a pre-existing market abuse regime. The implementation of MAD did not entirely replace this pre-existing regime and certain provisions in section 118 of the FSMA retain the old rules on market abuse alongside the new rules implementing the provisions of MAD (see subsections 4 and 8).[12]

At the time of implementing MAD, the UK government indicated that it wanted to retain certain aspects of the old market abuse rules, as they covered a wider scope of behaviour than that caught by the provisions of MAD. However, the result is that the market abuse regime in the UK is more complicated than needed to be the case. The key provisions of MAD have largely been copied out into the FSMA and left alongside the previous provisions that the UK government wished to retain. The resulting scheme for market abuse set out in the FSMA is unwieldy and includes a degree of overlap between the retained provisions and the new provisions taken from MAD. A more judicious approach to the drafting of the implementing provisions, adapting the legislation so that the new and old provisions were worked into a single, clear regime, would have been more certain and easily understood by market participants and their advisors.

Further, there are significant cross-border issues for market participants, who will need to address the implications of a wider market abuse regime in the UK than that that would apply to operations elsewhere in Europe, such as by adopting modified systems and controls in the UK compared with their other European operations.

4. The Prospectus Directive

The implementation of the Prospectus Directive[13] ("PD") provides two examples that highlight issues relating to the implementation of EU legislation into UK law.

Example of implementation going further than necessary

The PD sets out a regime relating to when a prospectus must be produced by an issuer in connection with an offer of securities to the public and the content of such a prospectus. A key part of this regime is the trigger for when a prospectus is needed – i.e. when there is an offer of securities to the public. Whereas the PD refers to an "offer of securities to the public" meaning "a communication to ***persons*** in any form ..." (see Article 2(1)(d)), the implementing provisions in the FSMA refer to "a communication to ***any person*** ..." (see section 102B(1) of the FSMA). The FMLC understands that in other jurisdictions, the wording of the implementing legislation tracks more closely the precise wording of the PD.

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10 SI 2001/544

11 Directive 2003/6/EC (OJ L 96, 12.4.2003)

12 It is relevant to note that the UK has applied a sunset provision to the retained provisions together with a review of their operation: see section 118(9) of the FSMA.

13 Directive 2003/71/EC (OJ L 345, 31.12.2003)

The result of this differential implementation in the UK compared to other Member States is that, while in the UK an offer to a single person triggers the need for a prospectus, a more flexible approach is taken in other Member States (for example Germany), who only require a prospectus when a number of persons are the subject of the offer. This differential implementation puts issuers subject to the UK rules under a more onerous regime.

Example of implementation that clarifies the operation of the legislation

One issue that arises in relation to the PD is the breadth of the meaning of an offer to the public. This wide meaning has the potential to catch a number of activities that would not ordinarily be considered by market participants or regulators as an offer to the public. An example of the UK implementing legislation providing helpful clarification of the scope of the rule relates to the position of regulated markets and multilateral trading facilities, whose normal activities of providing prices of securities as part of the trading process could potentially be caught by the very wide meaning of offer to the public. The UK implementing legislation specifically excludes communications in connection with trading on a regulated market or a multilateral trading facility, thus clarifying that the relevant activities are not within the meaning of an offer to the public (see section 102B(5) of the FSMA).