

FSA INVESTIGATIONS

**(everything you wanted to know
but were too afraid to ask)**

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PART I

FSA INVESTIGATIONS

INTRODUCTION

"When the US sneezes, Europe catches a cold"

The increasing number of SEC investigations in the US appears to have set a trend and particularly here in the UK, the UK equivalent financial regulatory authority, the Financial Services Authority ("FSA"), has taken its lead from the US and become much more aggressive in investigating financial misconduct.

The increasing number of FSA investigations are a result of the following:

- **Public accountability** - note the questioning of the FSA by the Treasury Select Committee on the split trust matters, and shareholders of Cable & Wireless writing to the FSA to request the Regulator to investigate whether Cable & Wireless has infringed UK listing rules by failing to disclose a potential £1.5 billion tax liability (Financial Times, 12 December 2002).
- **Public awareness** through potential shareholder actions by outfits such as Class Law.
- **Prevention** is better than cure.
- Maintaining **public confidence** in the financial markets.
- London's **credibility** as a financial centre.

Consequently, the knock on affect of this aggressive stance by the FSA is a more comprehensive and invasive regulatory regime of financial markets, and a stronger response by the regulatory authorities to all breaches of financial misconduct. It has also resulted in an increasing awareness by a company and its officers of its own risk management culture, particularly that not only the company, but also its senior management could be held personally liable for any regulatory breaches. A recent survey of 50 FTSE companies indicated that 96% of those questioned were aware of regulatory issues. Finally, once it becomes known by the public that the FSA is investigating a particular company, there is the increased threat of litigation followed by the knock on effect on confidence in the company.

JURISDICTION

On 1 December 2001, the FSA assumed its powers and responsibilities under the Financial Services and Markets Act 2000 ("FSMA"). The FSA is now the single statutory regulator directly responsible for investment business, and supervision of banks, building societies, friendly societies, insurance companies and other financial institutions in the place of the former PIA, IMRO, SFA, Insurance Directorate, Building Societies Commission, the Friendly Societies' Commission and the Register of Friendly Societies. The FSA regulates approximately 10,000 institutions, including 7,500 investment firms, over 650 banks, 70 building societies, 1,000 insurance companies, friendly societies and Lloyd's markets. In addition, there are 180,000 approved individuals under its regulations.

The FSMA has introduced a new consolidated regime for investigations into matters of regulatory concern and for disciplinary and other enforcement action. This power affects not only the authorised persons, i.e. firms and their employees, but listed companies, their directors and officers and any other person who commits market abuse.

Principles for Business Instrument 2001

The FSMA also established the Principles for Businesses Instrument 2001. The Principles are a general statement of the fundamental obligations of firms under the FSA. The Principles derive their authority from the FSA's rule making powers as set out under the FSMA.

Contravention of a principle must:

"amount to a serious or persistent violation which has implications for confidence in the financial system, or for the fitness and propriety of the firm or for the adequacy of the firm's financial resources".

The Principles apply to market conduct of the firm's world-wide activities which might have a negative effect on confidence in the financial system operating here in the UK.

The Principles also give the FSA power to gather information and conduct an investigation, namely:

Principle 5 - a firm must observe proper standards of market conduct.

Principle 11 - a firm must deal with its regulators in an open and co-operative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

Statement of Principle and Code of Practice for Approved Persons

The Statement of Principle and Code of Practice for Approved Persons applies to approved persons as defined in the FSMA. Whereas the Principles set out the obligations for a firm to notify the FSA of any possible breaches or wrongdoing of market abuse, the Statement of Principle and Code of Practice for Approved Persons sets out similar obligations and standards for individuals.

The Statement of Principle sets the standard, and the Code of Practice determines whether or not an approved person's conduct complies with the standard.

Statement of Principle No. 4 provides:

"An approved person must deal with the FSA and with other regulators in an open and co-operative way and must disclose appropriately any information of which the FSA would reasonably expect notice".

The individual as an approved person has a duty to report promptly in accordance with either his firm's internal procedures (or if none exist directly to the FSA), information which it would be reasonable to assume would be of material significance to the FSA.

Financial Services and Markets Act 2000

This statute sets out a new regime, which is largely untested, for financial investigations. The FSA under the FSMA now has wider powers than any other single body had under a previous regime. Those who are now affected include the following:

(i) Authorised/Approved Persons

Approved/authorised persons who perform controlled functions for regulated firms can be fined or publicly censured for misconduct where an approved person has been involved in the firm's breach i.e has knowledge of the breach/misconduct or been involved with the breach/misconduct or itself contravened one of the statements of principle applicable to approved persons. The FSA can withdraw the approval of the approved person, if no longer considered fit and proper, impose a prohibition order from being involved in the financial services business and/or apply injunctions or restricted orders.

(ii) Listed Companies, Directors and Former Directors and Officers and Sponsors

The FSA in its guise as the United Kingdom Listing Authority ("UKLA") can fine or publicly censure an issuer for breaches of the Listing Rules. The ability to fine a listed company marks a significant change from the previous regime. It can also fine or publicly censure a director or former director, and accordingly all directors may therefore now incur liability. The FSA can publicly censure and suspend or cancel the listing of the company's securities.

The FSA will also be able to require companies to publish information to the market about their director's breach of the Companies Code or dealings. This is relevant to investors when making investment decisions. The FSA can also issue restitution orders and injunctions and shareholders may look to the UKLA to take action to secure compensation to avoid the need for costly and uncertain litigation.

(iii) Market Abusers

Any person who carries out market abuse can be subjected to criminal prosecution of insider dealing pursuant to Part 5 of the Criminal Justice Act 1993 and Section 397 of the FSMA. The FSA will act as the Prosecutor. The FSA can also fine and publicly censure any person for committing market abuse.

INVESTIGATION PROCEDURE

The FSA will now in many cases be able to investigate all the aspects of the alleged breach or misconduct and then take an overall view on which powers or combination of powers it is appropriate to use, and against whom.

The FSA has extensive powers to obtain information relating to rule breaches and other matters of concern from which it can decide what action, if any, it should take.

The nature of the investigation can appear in three guises:

A. Informal request for information

Pursuant to the Principles for Business and Statement of Principles for Approved Persons and Code of Practice, the firms and approved persons owe a general obligation of openness and co-operation with the regulators. Listed companies and sponsors will also owe similar obligations to the FSA in the FSA's capacity as the UKLA under the Listing Rules. The FSA's powers under this category are wide ranging. The fact finding investigations will mostly centre upon relevant documentation. The word "document" has a very wide definition and will include information recorded in any form. This will include meetings, access to premises, documents, taped telephone calls, electronic data.

B. Formal Enquiries

The FSA has statutory powers pursuant to the FSMA to require firms and certain persons to provide particular information or documentation. This is usually by way of written request, specifying the type of information and when and where it is to be provided. The FSA may also commission a report from a "skilled person" such as an accountant, actuary or person with technology skills.

C. Formal Investigations (ss 165 - 169 FSMA)

The FSA may appoint an investigator to conduct a formal investigation in a range of circumstances. Usually, the person under investigation will be notified of the investigation but the obligation to notify does not always apply, notably in the case of market abuse investigations. The investigator's powers extend to obtaining documents from third parties; demanding an explanation of documents; obtaining a warrant to enter and search premises and issuing proceedings for contempt of court if the requests/demands are not met. The investigation is ultimately controlled by the FSA. The investigation concludes with the presentation of a factual report to the FSA. The person under investigation will then receive a "Preliminary Findings Letter" giving the individual or the company an opportunity to comment on the factual findings of the investigation before it is concluded.

While some may regard these investigations as intrusive, most enforcement matters have been resolved by negotiation. The new procedure, although largely untested, aims to promote fair settlement while at the same time giving firms the opportunity of undergoing a full tribunal process.

NOTICE PROCEDURES

There are two enforcement procedures under the FSMA. The statutory provisions dealing with a particular enforcement action specify which procedure applies.

Warning/Decision Notice

This main procedure involves the FSA issuing a warning and/or decision notice. The warning and/or decision notice is issued once a problem is identified and the investigation (informal/formal) will result in the FSA staff recommending enforcement or not. If there is to be no enforcement action, then the FSA will most likely issue a private warning and the investigation process comes to an end. If an enforcement action is recommended then the Regulatory Decision Committee ("RDC") is notified. The RDC is an enforcement committee of senior individuals (not FSA employees), who report to the FSA board. The RDC is not involved in the investigation, and is therefore one step removed from the enforcement process. The RDC will consider the enforcement recommendation and decide whether to issue a warning notice. If it rejects the FSA's findings then again either a private warning will be issued to the company, or the investigation will end.

If the RDC agrees to issue a warning notice then this will be served upon the firm and/or any individual who has information which the FSA wishes to obtain. Those individuals are described as "prejudiced parties". Within 28 days, the firm upon whom the warning notice has been served, together with any other third parties, will be given access to the FSA's documents and can either enter into settlement discussions/mediation and/or make representations to the RDC. The RDC will then consider whether to issue a decision notice embodying any agreed terms or otherwise. If the RDC agrees not to issue a decision notice then it will file a notice of discontinuance. If, however a decision

notice is issued the firm will then have a further right of access to the FSA's documents, and a further 28 days to decide whether to refer the matter to the FSMA tribunal. If the decision notice is agreed with then the FSA will issue a final notice. Publicity at that stage is likely.

Supervisory Notice

A Supervisory Notice Procedure is harsher. Under this procedure, an issuance of a supervisory notice requires action to be taken as a matter of urgency and accordingly the entire decision making process will not be completed. The supervisory notice will specify when the action takes effect. There is no formal procedure for settlement discussions, mediation is not available and there is no right to access to the FSA's material. However, the person does have the right to refer the matter to the tribunal immediately on issue of the first supervisory notice. Third parties do not have any right to become involved in the process. In some urgent cases where the RDC members cannot be obtained, decisions instead will be taken by the FSA executive, i.e by senior FSA staff members.

Private Warning

In some cases, the FSA may decide that although a breach has taken place, it is not appropriate to exercise any of its formal powers and instead may issue a private warning, letting the person concerned know that they came close to formal action being taken.

UKLA

Where the FSA, in its capacity as the UKLA, seeks to take action against a listed company, its director or sponsor under the listing rules, a similar warning/decision notice procedure or, in some cases, supervisory notice procedure applies, although there are some differences, for example, decisions to suspend listing are taken by a body called the Listing Appeals Committee, rather than by the RDC.

THE FSMA TRIBUNAL

This is an independent body operated by the Lord Chancellor's Department. This is entirely separate and has no regulatory agenda. The Tribunal is able to consider any evidence whether or not the evidence is available to the FSA, and reach its own decision.

The Tribunal's procedures are outlined in the FSMA Rules 2001. However, the procedures are not prescribed in any detailed, leaving it largely to the appointed Tribunal to decide on the process appropriate for the case. The Tribunal members are drawn from legally qualified chairmen and lay members with relevant experience.

Under the Tribunal Rules, the individual/company being investigated by the FSA issues a "Reference Notice", referring the matter to the Tribunal. The FSA must then explain what the case is about by issuing a statement of case and the person concerned responds to that in its reply. Generally, the Tribunal will allow the parties to make submissions, will hear evidence from witnesses and experts and has powers to summons witnesses and to order the disclosure of documents.

Tribunal proceedings will normally be held in public and judgment pronounced publicly, in accordance with the requirements of the European Convention on Human Rights. This may be an important consideration for firms when considering whether or not to refer a particular case to the Tribunal. There is a right of appeal to the Court of Appeal, with permission, but only on points of law and from there to the House of Lords.

FSA POWERS

- A. Investigation powers - these enable the FSA or its investigators to obtain information from those who hold information that is relevant to any enquiry, in many cases even if the person holding the information is not itself the subject of the enquiry.

The FSA's investigatory powers are set out in the FSMA:

Section 167 into the business, ownership or control of an authorised person;

Section 168.1 in circumstances suggesting that a person has contravened the FSA's insurance business regulations or committed certain criminal offences relating to the provision of false or misleading information;

Section 168.2 in circumstances suggesting insider dealing, breach of the general prohibition against carrying on regulated business without permission, unlawful financial promotion or market abuse;

Section 168.4 in circumstances suggesting that a person may have contravened certain other regulations and other regulatory requirements including the FSA's Rules;

Section 169 at the request of an overseas regulator;

Section 97 in circumstances suggesting a breach of the listing rules by an issuer or applicant for listing or a director or former director;

- B. Enforcement powers - ranging from criminal prosecution, market abuse, fines, disciplinary action against firms and approved persons and a variety of other regulatory actions.

These can be exercised individually or in a combination, depending upon the situation. Different powers exist in relation to the following categories:

- (a) Firms

The FSA can impose a fine on or publicly censure a firm for regulatory breaches (Sections 205 and 206). Fines depend upon the breach, its effect, seriousness, disciplinary record and on a case by case basis. There is no limit on the level of fines, which the FSA may impose.

- (b) Variation of Permission - Previously Known as Intervention

The FSA may require firms to cease carrying on investment business. Limitations or restrictions or requirements may be imposed on the firm's commission. This can be achieved as a matter of urgency where urgent action is required to protect consumers.

- (c) Cancellation of Permission

Permission can be cancelled thereby preventing a firm carrying on any further regulated activities.

(d) Restitution Orders

The FSA can impose or apply to the Court for a restitution order, to require a firm to compensate investors who have suffered losses from its breach and/or disgorgement of profits made from the breach. It may not always be appropriate to use the FSA resources on issues of compensation, and this will depend upon factors including the investor's ability to pursue remedies through the civil courts or ombudsman scheme.

(e) Injunctions

The FSA may apply for injunctions to prevent firms from committing regulatory breaches, to require it to remedy those breaches (or mitigate their effect), and/or to freeze assets.

- C. A new regime for listed companies, allowing the FSA, in its capacity as the UKLA to take enforcement action against listed companies, their directors and sponsors and to refer particular aspects to other regulators, such as one of the UK exchanges or an overseas regulator.
- D. The new civil offence for market abuse, which applies to everyone, regardless of whether or not they are regulated under the FSMA.

ARE FSA INVESTIGATIONS CONFIDENTIAL?

ENF 2.13 provides:

"The FSA will not normally make public the fact that it is or is not investigating a particular matter, or any of the findings or conclusions of an investigation."

However, there appears to be no obligation on the person being investigated to keep the facts of the investigation confidential. A firm being investigated, however, may well be obliged to disclose the facts of an investigation in its accounts and in order to comply with the requirements of presenting a true and fair view.

Section 348 of FSMA addresses disclosure of confidential information, i.e. confidential information must not be disclosed by a "primary recipient" or by any person receiving the information directly or indirectly from a primary recipient, without the consent of the person from whom the primary recipient has obtained the information and if different, the person to whom it relates. A primary recipient includes the FSA and any person authorised to make a report.

This effects insurers requesting information from the Insured who are being investigated by the FSA. In order to make a decision as to whether coverage should be provided and comment on the costs of defending the directors and officers in relation to the investigations, Insurers will need to review the allegations, particularly for any wrongdoing or dishonesty. Normally the Insured will need to obtain written consent from the FSA that the documents which the FSA has released to the Insured under this particular section can actually be made available to Insurers.

DISCLOSURE OF DOCUMENTS

Legally privileged material, is generally speaking, protected from disclosure under Section 413 of FSMA. Section 413 states that a person may not be required to produce, disclose or permit the inspection of "protected items". Protected items are those which are subject to both legal and litigation privilege. No person can be required to produce a document in respect of which they owe a banking confidence, although in some

circumstances these are capable of being overridden. Care, however, should be taken under Section 413 because the statutory protection may not be as broad as that under common law, either in terms of the type of documents that are protected or in terms of the scope of the protection. There are a number of exceptions and the protection will not apply where the individuals themselves are under investigation or the person to whom the confidence is owed is also under investigation. It may also be possible to object to the production of a document where disclosure would lead to difficulties in another jurisdiction. There may be specific objections in particular circumstances, such as if the request is unreasonable or disproportionate or based on the ECHR right to respect for privacy. The FSMA however does not contain any mechanism for challenging a request to provide information, so the person concerned would either have to seek a judicial review of the FSA/investigator's decision to impose the requirement or would have to wait for action to be taken against him to enforce the requirement, and then defend that action on the grounds of the objection.

NATURE OF INVESTIGATIONS

As the FSA powers to take action against individuals overlap to a large extent with its powers against firms, the key question is in what circumstances the FSA will take action against an approved person rather than, or in addition to, the firm. This obviously will have an effect on the allocation of costs between a company and a director and officer under the D&O policy. The FSA's policy is that it primarily looks to the firm, rather than those who work for it, but it may take action against the individual where he is personally culpable, that is where he acted deliberately or fell below the standards expected.

Civil or criminal proceedings of the FSA which result in certain types of enforcement decisions by the FSA to apply to a Court for an injunction or restitution order; the use of insolvency powers under Part 24 of FSMA, or to institute a criminal prosecution, do not involve any specific procedures under the FSMA. The safeguards from the firm's perspective are found in the procedures for the relevant civil or criminal court concerned. The FSA has, however, stipulated that such decisions will normally be taken by the RDC Chairman. This does give some protection for firms in situations where the institution of such proceedings can cause significant costs.

EXAMPLES OF FSA RELATED INVESTIGATIONS

With Profit Funds

The FSA has recently been looking at ways insurers could invest in with-profits funds, Britain's biggest selling savings products. The FSA wants to ensure that the funds invested were invested in tradeable assets, and would avoid financing the firm's other businesses.

Insurance Policies

The FSA has informed insurance companies to spend £100 million improving the wording on customer documents and has squeezed in a warning to companies to get prepared for a terrorist emergency.

Travel Cover

Thousands of holiday makers could be left with inadequate travel cover as a result of the Government's decision against regulating the sale of policies through travel companies. Travel insurance sold by insurers or brokers will be regulated by the FSA from January 2005, but insurance bought with a package holiday will not. "*The result will be a lack of protection and confusion for consumers*" stated John Parker, the Head of General Insurance at the Association of British Insurers. This unwillingness to regulate sales of travel insurance by travel agents means that consumers may not have the correct level of protection they need while they are on holiday. Without proper regulation some travel agents may not ask the right questions when selling the cover. Travel insurance policies provide a fair proportion of the complaints investigated by the Financial Ombudsman Service. Travel insurance is full of complications because it covers so many different areas and no-one wants to spend all their time looking at all the exclusions that apply in different policies. One of the great areas concerns pre-existing medical conditions. Many people have bought cover, made a claim and then found that the insurer will not pay, saying that the policyholder's illness or condition excluded them from the scope of the cover.

Regulatory Failures

MPs are to be urged to look at strengthening the powers of the FSA to protect the interest of consumers, in a report by the Parliamentary and Health Service Ombudsman. The report raises concerns about the FSA's light touch approach which means that it rarely intervenes directly in a regulated company's affairs. The report is due to be published on 1 July 2003. The report comes months before the Penrose Report, a wide investigation sponsored by the Treasury which is expected in the autumn. The Ombudsman will reconsider whether there is a case for compensation if the Penrose Report finds evidence of regulatory failure before 1999. The report will dash the hopes of hundreds of thousands of policyholders by concluding that there is no case for government compensation over losses incurred on their investments in relation to the demise of Equitable Life, the mutual insurer. This will outrage policyholders and MPs, who have been critical of the narrow scope of her enquiry.

Life Insurance

The FSA is pressing ahead to implement its' far reaching plans to improve the governance of life insurance firms. These include making use of discussion in with-profits funds more transparent and making directors and senior management of life insurers explicitly responsible for all decisions of their business, including those taken on actuarial advice.

Banks/Building Societies

Banks and Building Societies are buttoning down the hatches in preparation of a down turn in the housing market. Building Societies in high risk areas have been bolstering their financial strength over the past year, and some banks have been increasingly cautious about lending to borrowers with small deposits in property hotspots. The FSA is involved in an exercise aimed at establishing how well banks and building societies could withstand the effects of a down turn. In the wake of the FSA investigations, Norwich and Peterborough and National Counties Building Societies which are both heavily exposed to high risk areas, have substantially bolstered their financial strength. (Mortgage regulation: A Guide to FSA's Consultation and Draft Conduct of Business Rules).

Football

Manchester United under investigation by the Regulator – Manchester United Plc is being investigated over the way it released news of the possible sale of its' mid-fielder, David Beckham (16 June 2003). The FSA is examining whether the Club should have made it public through the stock exchange because this information could have affected the share price. Manchester United's share price rose after the announcement of the deal was made at 3.32pm on Tuesday through the Association. It closed at 158p, up 7p on the day. The £30 million bid for Beckham is substantial even for a club as wealthy as Manchester United. The transfer of the England Captain, who cost them nothing after joining at age 15, will also reduce the Club's annual wage bill by £4.6 million. Investors appear to have gained good business even if many of the Club's supporters regret Beckham's imminent departure. The FSA is making preliminary enquiries into the announcement which, if it deserves further action, can call for a full investigation. In turn, this may result in disciplinary action and/or a substantial fine. The FSA contacted the Club to seek an explanation for the unusual way the Club handled news of transfer developments. Manchester United, has been asked to provide a written explanation of its' actions. The suggestion that the Club has deliberately acted improperly or that any directors have lost out financially from the announcement is denied. The FSA is responsible for ensuring quoted companies such as United, inform the stock market properly about events that can influence their share price. To prevent insider trading manipulation, all investors are supposed to receive price sensitive information at the same time. City analysts believe that player transfers are a grey area when it comes to price sensitive issues and the FSA will want to know the reasons behind United's actions.

The same exercise may be undertaken in respect of the Chelsea Football Club takeover by the Russian billionaire. However, at this stage there is only the rumour of an FSA investigation.

Somerfield Plc

The UK Financial Watchdog is set to look into trading in Somerfields' shares made ahead of the news of a takeover approach. The FSA is looking into high trading volumes and the purchase of 100,000 shares in the company by its Executive Chairman, John Von Spreckelson. The FSA is also looking at sudden share price movements in 3 other major companies listed on the stock exchange, including mobile phone group - MM02, security specialist – Chubb & Amey.

Investment Banking

The FSA has recently introduced a whole new set of regulations to clamp down on conflicts of interest within investment banking. Following the lead set in the US, it wants to make sure analysts' share recommendations are objective. Analysts will have to produce a 3 year historical chart for every stock they cover, highlighting where ratings or

price targets change to show their track record. They must show the firm's global spread of recommendations. For all the good intentions, there is little evidence that the torrent of rules is making investors feel more confident or producing a healthier market. Sales of the products known as individual savings accounts, through which most British investors buy equities, fell 28% to 4.8 billion last year according to the Investment Management Association.

Property

FSA investigations into real estate funds have been booming as equities fall. It is worrying that investors may not be sufficiently aware of the risks and the rules governing the sector which might be outdated.

Independent Financial Advisors

FSA confirm action will be taken against IFA's with inadequate PII cover.

Spread Betting

The FSA has fined Paul Davidson £750,000 in respect of a spread-bet surrounding the flotation on AIM of the pharmaceutical company Cyprotex. It is thought that the FSA has concluded that the bet constituted market abuse. Davidson is the majority shareholder in Cyprotex. Last year, he placed a bet with spread-betting firm, City Index, on which he would gain £175,000 for every 1p the share price would rise. The company was then floated, as a result of the bet. Davidson's holding was worth £9.5million. City Index entered into a contract for difference with Dresdner Kleinwort Wasserstein to protect itself against losses. The FSA has also warned broker Nigel Howe (who was broker to the float) and former director of City Index Ashley Tatham, that they will be fined £350,000 and £100,000 respectively.

PART II
AN OVERVIEW OF THE FUTURE REGULATION
OF UK LIMITED COMPANIES

BACKGROUND

The key focus today of governments and regulators across the world is on corporate governance and the extensive changes to the regulation of companies in response to concerns about the lack of investor confidence in the financial markets and financial services industry. This lack of confidence has resulted in many investors turning away from investments in equities into fixed income investments such as bonds and gilts.

The objectives of the changes are to make companies more transparent and accountable to their shareholders and to remove the image of the “fat cat” director, as well as to ensure that frauds on the scale of Enron and WorldCom are never repeated.

Due to the increased globalisation of business, regulators and governments are aware of the need to harmonise laws and regulations across jurisdictions to stimulate and attract business and prevent unfair competition. There is a concern, particularly in the UK, that if the UK has tighter regulations than some of its competitors, businesses may turn away from the UK to invest in countries whose regulatory regimes are less stringent.

As a result, UK listed companies will be affected not only by changes enacted by the UK government and regulators, such as the Financial Services Authority, but also by the European Union and the United States.

UK

UK REVIEW OF COMPANY LAW

In the UK, a review of company law and, in particular the Companies Act 1985 (“the Act”), commenced in 1998. The Companies Act 1985 was, in particular, seen by some commentators as being outdated and not wholly relevant to today’s business needs. The aims of the review were to simplify company law and outline directors’ duties.

A white paper on these changes was produced in July 2002, but it is likely to go through extensive revisions before being scheduled to become law in either 2004 or 2005.

The review has shown a preference for the use of codes of practice rather than further legislation as it is considered that these should be flexible to operate and easier to update as circumstances change. However, the new Act will contain provisions in respect of directors’ duties and directors’ accountability which will complement the new codes of practice.

The proposed Act will include a statement of directors’ duties;

Directors will owe a duty to the company for the benefit of its shareholders.

That duty will be to “*exercise the care, skill and diligence which would be exercised by a reasonably diligent person with both:*

1. *the knowledge, skill and experience which may reasonably be expected of a director in his position; and*
2. *any additional knowledge, skill and experience which he has.”*

(paragraph 4 of Schedule 2 to the Companies Bill)

Added to the general duty which a director owes to his company, he will also have to take into account the interests of other groups and the effect his decision and actions will have upon them. These groups will include employees, customers, suppliers, local communities, as well as the environment. The director will also have to ensure there is fairness between the shareholders, i.e. he cannot favour the interest of one set of shareholders, such as large institutional investors, over another group, such as smaller investors.

It is clear from the proposed Act that there will be no distinction between executive directors and non-executive directors, so keeping the unity of the board.

Possible consequences of the proposed Act may be:

There will be no defence in any action that a director lacks the knowledge or experience.

A potential tension between one of the main focuses of the new Act and a key recommendation of the Higgs Report. Broadly, the Higgs Report outlined that directors should be drawn from a wide pool of executive and non-executive directors. A concern would be that the proposed standard of duty to be exercised by directors may deter less experienced people from seeking to become, or remain, as directors.

There is a concern that the fact that the directors must have regard to other interested parties, may, in effect, give rise to a further duty, or perhaps a weapon for single issue groups, although that is not the intention of the Act in the explanatory notes.

It will therefore remain to be seen how directors will reconcile potentially conflicting interests. One example of this would be the reconciliation which would be required between the needs of a local community for increased employment with the requirement from environmental lobbyists to limit the impact of any business expansion on the local environment.

The review proposed an Operating Financial Review, a report produced by the company which should include factors, such as:

- Business development
- Corporate governance
- Shareholder relationships
- Environment

The Confederation of British Industry has already indicated its opposition to such a requirement, although the FSA's Director of Listing is in favour of its being mandatory for listed companies.

UK LISTING AUTHORITY (UKLA)

In 2000, a major change to the financial services industry took place with the establishment of one regulator, the FSA. As part of its role as regulator, on 1 May 2000, it took over responsibility for the listing rules to become the UK's Listing Authority.

As such, the FSA, along with **market participants**, is undertaking a review of the listing rules with the aim of simplifying and modernising the rules. A discussion paper was published in July 2002 and consultation is underway. The new rules and guidance are expected to be published by early-mid 2005.

The review is concentrating on:

Corporate Governance
Corporate Communication
Shareholders' rights and obligations
Financial Information
Sponsors

The FSA's Director of Listing has made it clear that he is keen to maintain a strong enforcement regime, with strong powers to censure, such as the power to disqualify directors for significant breaches of the listing rules.

The FSA is already investigating many cases involving breaches of the listing rules and predicts there will be more in the future.

The Director of Listing wants to ensure that listed companies disclose as much information as possible to their investors, and the industry as a whole, including forward-looking information. In fact, on his appointment, the Director reminded all UK listed companies of their obligations under the listing rules to publish material and price sensitive information in a timely manner.

The FSA proposes that shareholders' should have stronger rights, including the protection that shareholders' approval must be given for a company to delist.

The FSA is considering the issue of financial information. The frequency and quality of that information, as well as the independence of auditors.

Further, the FSA wants to ensure the directors and companies remain responsible for the information they produce. They should not be allowed to hide behind others. To achieve this, the FSA proposes to abolish sponsors in respect of share issues, so that directors cannot hide behind sponsors for breaches of the rules governing prospectuses.

The FSA are well aware that any changes in the UK will be influenced by events in Europe, principally the review which is being carried out by the European Union into company law and corporate governance.

EUROPEAN UNION

CORPORATE GOVERNANCE IN THE EUROPEAN UNION

The European Union set up a group comprising of company law experts led by Professor Japp Winter to review company law in the European Union and how it should be modernised. The Winter Group, as it became known, published its report in November 2002. The European Commission then published its Action Plan on company law and corporate governance in European Union on 21 May 2003.

The Commission decided not to follow the approach of the USA and introduce legislation, along the lines of the Sarbanes Oxley Act, owing to concerns that such a change would result in a restrictive regulatory environment. It also opposed the idea of a European Union code, preferring that there should be co-ordination by Member States to ensure harmonisation between their codes.

The aims of the review were:

- I. to strengthen shareholder democracy
- II. to protect third parties such as creditors and employees
- III. to foster efficiency and competitiveness in European business

This is to be achieved by:

1. Listed companies to include a "Corporate Governance Statement" in their annual reports;
2. Listed companies should make use of electronic means of communication;
3. The rights of shareholders should be strengthened by the exercise of voting rights, including voting rights which can be exercised by electronic means, and the ability to question directors;
4. Institutional investors should disclose investing and voting policies and disclose how they voted to beneficial holders (at their request);
5. Board members should be nominated by majority of independent persons, as should the audit and remuneration committees;
6. Directors should disclose the company's remuneration policy; and
7. Shareholders should have to approve share option schemes.

The Commission has also proposed a wrongful trading rule.

The CBI is broadly in favour of many of the European Commission's proposals which are similar to existing UK law. It is concerned, however, that the proposals should not adversely affect UK business and that there should not be too much new regulation which could harm business profitability and flexibility.

As part of the European Union's efforts to achieve some kind of harmonisation between member states, three new Directives have been proposed: the Transparency Directive, the Prospectus Directive and the Market Abuse Directive.

The proposed Directives will be implemented after they have gone through four levels of consultation:

- Level 1: The European Council and Parliament adopts a broad framework of principles in the proposed Directive;
- Level 2: The European Commission is then responsible for drafting the implementing measures advised by the Committee of European Securities Regulators ("CESR");
- Level 3: Co-operation through CESR between the regulators of member states to improve the implementation process; and
- Level 4: Enforcement of the law by the Commission.

This is known as the "Lamfalussy Process".

TRANSPARENCY DIRECTIVE

The Directive is currently being debated by the European Council and Parliament at Level 1 of the Lamfalussy Process.

The objective is to improve dissemination of information to investors.

The Directive aims to improve financial reporting:

- | | | |
|-----------------------|---|--|
| Annual reports | - | audited financial statement in accordance with International Accounting Standards; |
| | - | The inclusion of a management report; |
| | - | Liability for false information. |
| | | |
| Half yearly reports:- | - | short financial statement; |
| | - | do not have to be audited; |
| | - | liability for false information. |
| | | |
| Quarterly reports | - | net turnover; |
| | - | profit/loss; |
| | - | optional trend statement; |
| | - | do not have to be audited; |
| | - | liability for false information. |

The introduction of quarterly reporting has proved a very controversial and unpopular proposal in the UK.

The concerns expressed by bodies, such as the CBI and ABI include:

1. More regular reporting will increase costs for businesses. Although the quarterly reports will not have to be audited, companies will either want the reports to be audited or will involve the auditors in preparing the reports.
2. Management time will be diverted from running the company to preparing reports.
3. Quarterly reports will lead to short termism, as directors will only look as far as the next report and will not concentrate on the long term strategy of the company.
4. It will prevent the free flow of information throughout the year, as companies will save the information up until the reports. This is a particular concern in respect of price sensitive information.
5. It will possibly create a new civil liability, and the UK already has sufficient rules in place to prevent market abuse and manipulation.

The ABI is concerned that *“The focus of management would be on meeting quarterly expectations. This would take away from the focus on generating long-term performance”*.

However, groups such as investors, analysts and fund managers have expressed support for increased reporting. The FSA also is not opposed to the new measure, as long as it does not replace the timely publication of material or price sensitive information.

Many in the European Union do not really understand the opposition in the UK, as many European countries such as Italy already have quarterly reporting to a higher standard as that proposed.

The Commission believes that quarterly reporting will enhance corporate governance and prevent market abuse, as companies will have to introduce efficient systems and publish information to a wider audience. Also, many companies, including those in the UK, already publish quarterly information.

The Commission rejects the concern that a new civil liability will be introduced as the countries will be able to build on their current civil liability regime.

The Directive deals with the language in which the reports are published. This will be the language customarily used in international finance, e.g. English and the language of the country in which the company is quoted.

Other measures are to encourage the increased use of electronic means of communication, such as the company's web site.

PROSPECTUS DIRECTIVE

The EU Prospectus Directive has reached Level 2 of the Lamfalussy Procedure (advice by CESR to the Commission in respect of the implementing measures). The deadline for responses to the consultation paper published by CESR has just passed.

The intention behind the Directive is both to replace the current EU Listing Directive and EU Prospectus Directive and to "harmonise" the rules for certain prospectuses throughout the European market

The Directive should make it easier for companies who wish to offer shares in other member states of the European Union to do so without having to issue different prospectuses according to different rules. It is also anticipated that the Directive should lead to more uniformity in disclosure standards throughout the European Union.

However, the provisions of the proposed Directive are extremely complex, and concerns have been expressed over certain mechanical aspects of the Directive which could lead to non-EU issuers being disadvantaged as against EU issuers. Difficulties also exist in respect of the way in which the proposed Directive seeks to treat issues of securities which have equity characteristics, such as hybrid instruments and convertible bonds.

MARKET ABUSE DIRECTIVE

This Directive has completed the Lamfalussy Procedure and the Directive has to be implemented into member state's national law by 13 October 2004.

The aim of the Directive is to create a regime to tackle market abuse and manipulation throughout the European Union, and to update existing legislation in respect of insider dealing.

It is possible that the rules brought in under the Financial Services and Markets Act 2000 will have to be changed.

The Directive:

1. prohibits insider dealing and market manipulation;
2. obliges companies to publish inside information;
3. requires companies to maintain a list of people with access to inside information;
4. compels companies to publish share dealings by those with "managerial responsibilities";
5. Regulators, such as the FSA, should put into place structures to prevent and identify market manipulation;
6. Requires professional advisers to report suspicious transactions; and

7. Regulates investment research to ensure that there is a fair presentation and interests are disclosed.

Currently, the European Commission is drafting secondary legislation needed to implement the Directive. There are several issues which still have to be resolved and further consultation is underway by CESR. Those issues include:

1. Whether there will be a defence to market abuse where companies have used "accepted market practices".
2. Who should be included on the lists of persons with access to inside information. Theoretically, such lists may have to include everyone from a secretary to the managing director.
3. Who will have a duty to disclose their share dealings.
4. Whether those who report suspicious transactions should have immunity in respect of any action against them for a breach of the duty of confidentiality.

The CBI supports measures to prevent market abuse, however, they are concerned by over-regulation, which may place an extra burden on companies, such as the maintenance of lists of those with access to inside information.

COMMITTEE OF EUROPEAN SECURITIES REGULATORS (CESR)

This Committee is made up of representatives from the securities regulator of each member state, plus Norway and Ireland. The FSA is the UK representative.

CESR was established to improve co-ordination between the regulators and to advise the European Commission.

In March 2003, CESR published the Enforcement of Standards of Financial Information ("the Standards")

The Standards were drafted after consultation, including informal consultation with the Securities and Exchange Commission. They are to be implemented in member states on a "best endeavours" basis, which means that although the representatives do not necessarily have the powers to introduce the Standards into legislation, each member state is expected to do its best to implement it into the national law.

The Standards include 21 Principles with several aims:

1. to protect investors and restore investor confidence;
2. to encourage harmonisation and consistent enforcement throughout Europe, to prevent companies choosing jurisdictions with laxer regimes over those with tight regulation; and
3. to make access to US markets easier.

Member states are expected to establish an independent body to enforce standards of financial information, such as the use of International Accounting Standards in documents such as accounts, and prospectuses.

One controversial issue has been the subject of pre-clearance. Countries such as France support the idea of pre-clearance, whereby a company can run issues pass the appropriate body to obtain approval. In the UK, this approach is anathema as there is a

concern that the principles become more akin to rules. The FSA is against a pre-clearance process as unnecessary and inappropriate. However, it does give a measure of protection to companies in their accounts.

CESR decided, however, that pre-clearance should not be covered by the Principles. The body in the UK which will be responsible for enforcing financial reporting standards is the Financial Reporting Review Panel ("FRRP"). To comply with the Principles, the FRRP will need to consider some adjustments in its operation:

1. it will be expected to be pro-active in enforcing the Principles and investigating breaches. Up to now, the FRRP has been a reactive body, whose source of information is normally by way of "tip off";
2. the Principles will cover interim accounts and reports, as well as annual; and
3. there will have to be co-ordination throughout Europe, although it is not clear how this will be done.

The FRRP is currently consulting with the FSA, the DTI and the Treasury and expects to publish a paper later in the year. The focus of the FRRP will be on companies listed in the FTSE, because most of the public's money, whether by pension funds or privately, is invested in these companies.

Implementation of International Accounting Standards (International Financial Reporting Standards)

One of the biggest changes to affect UK companies will be the introduction of the International Accounting Standards or International Financial Reporting Standards ("IFRS").

Pursuant to a European Union Regulation, approved on 7 June 2002, final consolidated accounts for the year 2005 must be prepared in accordance with IFRS, although it is not yet clear whether this will also apply to interim accounts. This applies to all companies listed in the European Union.

To comply, companies must prepare comparative accounts for one year before implementation, two years if listed in the US. This means that UK companies will have to start preparing to use IFRS in 2004, if not this year.

The Institute of Chartered Accountants has recently expressed its concern that two thirds of accountants are not aware of the timetable in respect of the implementation of IFRS.

Even more concerning, it appears that many UK companies are not prepared for the implementation of the new accounting standards. Recent research by PricewaterhouseCoopers has highlighted the problem. According to Nick Rea, a director of valuation and strategy at PWC, *"The sheer magnitude of the task is putting some people off getting started. There is such a broad range of issues that they do not know where to begin"*.

The problem for companies is exacerbated by the lack of detail and uncertainty as to what the final standards will be. Only 18 out of 42 standards have been finalised.

In June 2003, the first full reporting standard was published. IFRS1 deals with how companies should implement the transition to IFRS. IFRS1 has been *"designed to ease the transition for all concerned"* (IASB Chairman).

The CBI support the introduction of IFRS which should encourage the global harmonisation of accounting standards and hope that the USA will recognise the IFRS. However, it is concerned that the standards are not finalised which will hinder companies in their preparation for the Standards. The IASB Chairman has indicated that the IFRS standard in relation to pension accounting will follow FRS17, which it opposes.

The Securities and Exchanges Commission is looking at whether from 2005, the requirement for reconciliation to US GAAP will be reduced or removed, but at this stage, it seems unlikely that a decision will be made for some time.

USA

THE SARBANES OXLEY ACT

Last year, in response to the major US corporate scandals, the US government rushed through the Sarbanes Oxley Act (the "Act"). Little consideration was given to the effect on non-US companies. Further, much of the Act was left to the Securities and Commission Commission to make the rules in order to police the Act.

The Act applies to all companies who are listed in the US or have attempted to list, i.e. any company who has ever filed a return to the SEC.

The aim was to protect US investors and it is therefore unlikely that non-US companies will be granted much exemption from the requirements of the Act

The most important measures are:

1. Accounts must be certified by the Chief Executive Officer and Chief Financial Officer. There is a criminal penalty if the accounts contain false or misleading information;
2. The requirement for an efficient internal control reporting system. Non-US companies are able to use the existing framework required by their home country. The SEC has been impressed by the Turnbull report;
3. To ensure auditors' independence, auditors are prohibited from providing many other services to the company. Further, all auditors must register with the Public Accounting and Oversight Board, even if they reside and work in the UK;
4. There must be an independent audit committee. There are some exemptions to address European laws and practices;
5. In respect of all financial information which has not been prepared in accordance with US accounting practices, there must be reconciliations in all instances including all public communications and press releases. There is only a limited exemption: for example, press releases by a non-us company which is made outside US and not derived from US GAAP measure;
5. Prohibition on loans to directors, save in certain very limited circumstances. An exemption has been given to US banks, but strangely not to non-US banks; and
6. Attorney reporting. Lawyers are required to report breaches of the rules, in the first instance to the Chief Legal Officer.

Many of the measures under the Act are not controversial and in line with many of the changes which are in place or are proposed in the European Union, such as auditor

independence, certifying accounts. However, some of the requirements are not popular in the European Union and the SEC has been reluctant to allow many exemptions.

Neither the European Union nor the UK have been able to secure an exemption from the requirement of auditors to register with the SEC. There are concerns that this requirement could cause human rights and data protection issues.

Limited exemptions have been secured in respect of the attorney reporting requirements which will not cover non-US lawyers who do not hold themselves out as practising US securities law and do not work on SEC matters save with a US lawyer. Also lawyers are not expected to breach their local bar rules. However, of course, there may be similar provisions under the proposed market abuse directive.

UK companies can gain a small degree of comfort by the knowledge that the SEC will be targeting US companies first, which may take some time.

CONCLUSION

Many bodies and individuals in the market are in favour of harmonisation of rules and regulations, but, at least in the case of UK, not if they are detrimental to the interests of UK listed companies. There is a feeling that European Union provisions may be more applicable to the continental capital markets than the UK market and a concern that the UK will apply the rules and regulations more strictly than other European countries.

As most of the changes are still in consultation and will not be implemented for several years, it is too early to tell whether they represent a real change to the way that companies are governed in the UK. However, directors and companies will probably try to find ways to accommodate the new changes with a view to continuing their current businesses activities without undue disruption.

It is possible that the most substantive change to future regulation of UK listed companies may devolve from the enhanced powers that regulators may soon enjoy under this series of proposals. In particular, in an environment of enhanced consumer concern over the regulation of listed companies, regulators may well feel emboldened to use, and be seen to use, the new powers which they have been granted which, in turn, will prompt new challenges for the companies being subject to such regulations.