**Important**: The following English text is a translation of extracts from the French version of the 2004 Annual Report. Only the original French text has any legal value. The AMF expressly disclaims all liability for any inaccuracies in the translation.

# CHAPTER II: INTERNATIONAL COOPERATION AND REGULATION

The AMF is heir to a long tradition of stock market regulation, with clear-cut principles governing investor protection and transparency. As such, it has always played an important role in international organisations. That role is especially important today, because financial markets are closely integrated and require international standards that are precise, cogent and properly transposed into law.

The AMF's involvement in international and European regulation was provided for, along with its other missions, in the Financial Security Act of 1 August 2003. Accordingly, in 2004, the regulator played an active role in the work of international bodies such as the International Organisation of Securities Commissions (IOSCO), the Committee of European Securities Regulators (CESR), the Joint Forum, the Financial Stability Forum (FSF) and the institute of French-speaking regulators (IFREFI).

At European level, 2004 was marked by an acceleration in "CESR Level 2" work, aimed at finalising the arrangements for the transposition of European directives, and by the "Himalaya" report, which reviewed CESR's progress and explored ways in which the organisation could be developed.

Internationally, the discussions prompted by the recent crises that rocked financial markets and undermined investor confidence continued apace. Significant progress was achieved in the field of credit rating agencies, with IOSCO releasing a code of conduct for these firms. Headway was also made in terms of corporate governance: thanks to the creation of an IOSCO-led task force responsible for drawing conclusions from the recent spate of fraudulent bankruptcies.

Among the many discussions held on market supervision and integrity in 2004, IOSCO, the Joint Forum and the FSF agreed to step up cooperation on offshore financial centres and money laundering.

## I – WORK BY INTERNATIONAL ORGANISATIONS

### A – Credit rating agencies

Initiatives concerning the supervision of credit rating agencies (CRAs) have multiplied in recent years, both in Europe and internationally. The AMF pursued its commitment to this subject in 2004, taking part in the work of task forces set up through CESR and IOSCO and drafting its first annual report on CRAs.

#### 1- CESR technical advice to the European Commission

In light of the findings of an own-initiative report from its Committee on Economic and Monetary Affairs concerning CRAs[1], the European Parliament adopted on 10 February 2004 a resolution calling on the European Commission to weigh up the need for a European system for registering these agencies and to consider how such a system might affect Europe's financial markets.

On 27 July 2004, the European Commission asked CESR to submit technical advice on possible measures concerning CRAs before 1 April 2005. The Commission is due to report back to Parliament by 31 July 2005 on whether to introduce European legislation or to adopt other solutions.

The Commission's mandate to CESR encompasses several issues. These include conflicts of interest, fair presentation of ratings, relations between issuing companies and CRAs, competition, access to CRA status, use of ratings in European law and private agreements, and registration of CRAs at European level. The mandate was submitted for public consultation in August 2004[2].

Responding to its mandate, CESR set up a task force [3] headed by the Swedish regulator in the person of its director general, Ingrid Bonde. One member of the European Commission and one member of the Committee of European Banking Supervisors (CEBS) are also present as observers. Furthermore, CESR is in contact with representatives of the US Securities and Exchange Commission.

CESR released its first paper on 30 November 2004 and submitted it for consultation until 1 February 2005. A public hearing was organised on 14 January 2005.

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[1] Report by Giorgos Katiforis on the role and methods of credit rating agencies, ref. A5-0040/2004
[2] CESR website at www.cesr-eu.org, Ref. CESR/04/394
[3] The countries taking part in the group are Belgium, Italy, Portugal, Netherlands, France, the UK, Germany and Spain.

CESR's consultation paper[4] results from the task force's initial efforts. It takes into consideration the responses to the questionnaire sent to CESR members, asking them to describe the credit rating industry in Europe and analyse the reactions of the market participants who responded to the consultation on the mandate in August 2004 and attended two seminars in October 2004. The paper also refers to work done by IOSCO and the SEC and also to the project to amend the directive on capital requirements for credit institutions and investment firms[5].

Referring to the six topics in the mandate, the document takes stock of the current situation, expands on possible approaches for addressing potential problems, and puts forward several options for implementing these solutions. The options cover a range of possibilities, including a Europe-wide registration scheme that could be handled by a European authority, a self-regulation system, solutions involving the IOSCO code of conduct, and a recognition procedure that could be included in the reform of banking supervisory rules on capital requirements. Submitting its advice to the Commission, CESR expressed a preference for the self-regulation option, by a majority of its 25 members. A significant minority of members were in favour of a system of registration and periodic monitoring.

### 2 – IOSCO Code of Conduct Fundamentals for Credit Rating Agencies

In 2003, under France's presidency of the G7, IOSCO responded to a request from the FSF, among others, to work closely with CRAs on a set of guidelines for the rating industry. Published in October 2003, these guidelines have four main themes: quality and integrity of the rating process, methods for rating disclosure, prevention of conflicts of interest, and the handling of non-public information by agencies.

In February 2004, IOSCO announced that it would go a step further and prepare a code of conduct, thus providing CRAs with a methodology to help them implement those principles. On 23 December, it published the "Code of Conduct Fundamentals for Credit Rating Agencies". [6]

The code contains a series of concrete measures that CRAs are urged to incorporate into their own codes of conduct. Agencies are also advised to introduce supervisory mechanisms for monitoring enforcement of the measures. At the same time, the code provides flexibility by allowing CRAs to omit some of the measures from their codes, provided they explain how they respect the spirit and intent of those measures despite departing from the letter. Furthermore, the principle of flexible regulation is maintained because IOSCO does not intend to require CRAs to transpose either its principles or its code. The decision on whether to favour self-regulation or take regulatory measures is left to individual appreciation, depending on the legal and regulatory environment.

## B – Corporate governance: learning from financial fraud

The Technical Committee of IOSCO voted in 2004 to set up a Chairs' Task Force co-chaired by SEC Commissioner Roel Campos and by Lamberto Cardia, chair of the Italian regulator, to organise IOSCO's response to the problems revealed by financial fraud at major corporate groups such as Parmalat.

The group has a four-fold remit:

- identify issues raised by the Parmalat scandal, especially bond market transparency (disclosures, placement, transparency in secondary markets), the role of unregulated entities, particularly in offshore financial centres, the impact of complex group structures, and regulators' actual powers of sanction;

- review existing standards, notably those applicable to auditors, and the arrangements for cooperation among regulators;

- suggest appropriate regulatory responses to improve methods for risk identification and measurement;

- take action to increase international pressure on uncooperative jurisdictions.

The aim of IOSCO's work is not only to review the methods currently in force with a view to making them more effective but also to identify what initiatives should be taken, having regard to the existing body of regulation and the work of the standing committees.

Furthermore, it has been possible to address some issues more directly, especially that of uncooperative jurisdictions, a subject often avoided because of reluctance in certain quarters.

The Task Force will publish its report in first-quarter 2005.

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[4] CESR website www.cesr-eu.org, Ref. CESR/04/612b
[5] Directive 98/31/EC of the European Parliament and of the Council of 22 June 1998 amending Council Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions.
[6] Available on the IOSCO website at www.iosco.org

## C – Offshore financial centres[7]

Encouraged by the FSF, IOSCO's Technical Committee decided to establish an overall procedure for dealing with uncooperative jurisdictions. The decision follows on from the initial findings of the analysis of the Parmalat affair, released to a special meeting of the Presidents' Committee in February 2004, and questions raised by membership requests from such jurisdictions.

IOSCO began by examining the problems encountered by the enforcement officers of the regulatory authorities represented on Standing Committee 4. A summary of these difficulties was presented to the Technical Committee meeting held during IOSCO's annual conference in Amman in May 2004.

A report outlining the means available to IOSCO to encourage members to implement its principles was then presented, with a view to establishing an overall procedure.

Among other things, the report proposes that the main criterion to be satisfied by all IOSCO members should be the endorsement of the Multilateral Memorandum of Understanding (MOU). If this approach were to be adopted, then assistance and verification programmes would need to be implemented. That is why the majority of the organisation's members, especially the Emerging Markets Committee, would have to sign up to the approach. The Regional Committees, which provide support for declared applicants to the MOU, would also have to be involved. The procedure will be approved in full at the 2005 annual conference in Colombo.

IOSCO is also concentrating on the extent to which jurisdictions are actually able to cooperate together and it has engaged them in dialogue on this issue. The ability to cooperate is measured in particular by the number and quality of market oversight teams, the instruments available to them, and the independence from market operators exercising the role of first-level supervisors in several jurisdictions as self-regulatory organisations.

IOSCO is not the only body to become involved in this area. Its action is part of a series of initiatives by several international organisations, including the Financial Action Task Force on Money Laundering (FATF), which, since the attacks of 11 September 2001, has extended activities to include the prevention of terrorist financing, and two other international regulators: the Basel Committee on Banking Supervision (BCBS) and the International Association of Insurance Supervisors (IAIS). Work on customer identification standards is one of several initiatives taken in parallel by these international bodies. The Joint Forum, which comprises members of the BCBS, the IAIS and IOSCO, published a record of these initiatives in autumn 2004[8]. This is important insofar as the fight against uncooperative jurisdictions, and, in particular, cooperation with offshore financial centres (OFCs), is not a matter solely for securities regulators; it demands coordinated joint action by all the bodies concerned.

These bodies work increasingly closely with the FSF, whose role as an instigator and coordinator deserves to be highlighted. The issue of OFCs and uncooperative jurisdictions has been one of the Forum's main concerns since it began work in 1999. While recognising the existence and expediency of OFCs, the Forum has stressed from the outset – including in its first report – that they must comply with international standards, especially as regards proper supervision of the financial sector, and cooperate with their correspondents.

In 2000, the Forum made a critical analysis of the objective situation of OFCs in terms of cooperation. It published a list divided into three groups: well regulated and cooperative centres (Group I), centres whose situation is unsatisfactory (Group II) and those deemed to fall well short of the necessary standards (Group III). At the same time, it called on the International Monetary Fund (IMF) to assess the progress of countries in Groups II and III. It also asked the countries in question to publish the findings of the IMF's assessments.

In a report published in April 2004, the FSF took note of the progress made by OFCs in certain fields and announced that it intended to pursue its action. Accordingly, in a press release issued after its September 2004 meeting, it acknowledged the efforts made by IOSCO and other international regulators and encouraged IOSCO to continue assessing the level of OFC cooperation. In this way, the Forum gave impetus and consistency to this action. At its meeting in Tokyo in March 2005, the FSF adopted a proactive approach to ensure that international financial institutions and regulators oversee the progress made by OFCs.

[7] Offshore centres are jurisdictions which, for reasons of taxation and regulatory flexibility, are used by legal entities or which receive the results of transactions executed in so-called onshore financial centres.
[8] "Initiatives by the BCBS, IAIS and IOSCO to combat money laundering and the financing of terrorism" – 25 October 2004.

# D – Market supervision

## 1 – CESR-Pol

In 2004, European regulators devoted much of their attention to the Market Abuse Directive (MAD) and its implementing directives and regulation[9], which were due to be transposed into national law by 12 October 2004. CESR-Pol[10] is still highly active in this regard.

The main purpose of CESR-Pol, which now meets four times a year, is to facilitate the sharing of information among its members in order to improve the efficiency of surveillance and enforcement activities. It enables authorities to amass the data they need to conduct their enquiries more effectively and to coordinate their efforts during international investigations.

In 2004, based on a CESR mandate to draft and propose so-called Level 3 measures[11] to prepare and facilitate implementation of MAD, CESR-Pol issued a paper to provide regulatory information and advice for the financial services industry. Titled "Level 3 – Preliminary guidance and information on the common operation of the Directive", the paper addressed the issue of accepted market practices. It provided an indicative provisional list, together with a description, of the practices accepted thus far by some member regulators. It also gave a non-exhaustive and descriptive list of practices that might constitute market manipulation, together with factors that investment services providers could construe as evidence of possible infringements that should be notified to the authorities. Lastly, it established a common format to be used by investment firms and credit institutions to report suspicious transactions. CESR published the paper on 28 October and submitted it for comment for three months.

In midyear, CESR-Pol unveiled a programme of short-term and medium-term actions and measures on cooperation and promotion procedures for a common approach to market abuse. The initial results of this programme are expected in 2005.

CESR-Pol works regularly on ways to tackle problems of cooperation and information exchange with third-country jurisdictions. It liased with IOSCO, which is also active in this sphere, in order to avoid overlapping efforts.

## 2 – The IOSCO MOU and the Screening Group

IOSCO adopted a multilateral memorandum of understanding (MOU) on cooperation and exchange of information among its member regulators at its annual conference in Istanbul in May 2002. [12] The aim was to facilitate the detection, investigation and sanction of securities violations.

This keynote agreement combined in a single document the principles for cooperation that IOSCO had adopted through a series of previous resolutions. The organisation is pursuing the ambitious goal of having the majority of its members sign up to the MOU in the near future.

Regulators wishing to become signatories must apply to do so by answering a questionnaire intended to assess their legal ability to comply with the agreement's provisions. The document comprises nine questions covering the scope of the agencies' investigative powers, the type of information and evidence they can obtain, the possibilities for passing these data on to their foreign counterparts, the manner in which foreign regulators may use these data, and the rules of confidentiality.

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[9]- Commission Directive 2003/125/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest
- Commission Directive 2003/124/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the definition and public disclosure of inside information and the definition of market manipulation .
- Commission Regulation (EC) No 2273/2003 of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards exemptions for buy-back programmes and stabilisation of financial instruments .
- Commission Directive 2004/72/EC of 29 April 2004 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers' transactions and the notification of suspicious transactions

[10] This permanent CESR working group was formed in 1999 following the signature of a multilateral memorandum of understanding on the exchange of information and surveillance of securities activities, under the auspices of the Federation of European Securities Commissions (FESCO). It comprises the enforcement and supervision officers of CESR's 27 member-commissions. The head of investigations and market supervision of the AMF has had a seat on CESR-Pol since the committee was first established.

[11] The Lamfalussy Process is named for Baron Alexandre Lamfalussy, chair of the Committee of Wise Men set up under the French presidency of the EU in 1999. The aim of the process is to foster consistency and harmonisation in financial regulation in Europe by creating a second level of measures through directives ("comitology"). The Committee of European Securities Regulators (CESR) helps to draft these measures. The Lamfalussy Process also includes a third level, consisting of procedures and implementing measures voted by CESR members, and a fourth level, which consists in assessing the consistency of transposition procedures.

[12] Full title: "Multilateral Memorandum of Understanding Concerning Consultation and the Exchange of Information"

Shortly after the MOU was adopted, IOSCO set up a Screening Group composed of 26 commissions, six of which from the emerging markets group. The role of the Screening Group, which meets three times a year, is to analyse the responses to the questionnaire, to examine specific points in greater depth with the applicants, and to make recommendations to the three IOSCO officials responsible for accepting or rejecting applications, namely the Chairmen of the Technical Committee, the Executive Committee and the Emerging Markets Committee. (Applicants whose appeals are rejected can lodge an appeal with the Executive Committee.)

The Commission des Opérations de Bourse, which was among the first agencies to be assessed and accepted as an MOU signatory in October 2002, and the AMF as its successor, has been a member of the Screening Group since its inception.

At 31 December 2004, 26 commissions had been accepted as MOU signatories, and several applications were still under consideration. Four other commissions are on a separate list of applicants that do not yet fulfil all the conditions to become signatories but that have committed themselves to seeking the legal capacity needed to sign in the near future by eliminating specific barriers from their regulatory frameworks.

The signatories to the MOU together form the Monitoring Group, which has a dual function: to discuss general issues related to the implementation of the agreement, such as interpretations and amendments, and to make recommendations to the three chairmen regarding the expulsion of signatories that fail to meet their obligations under the MOU. Naturally, the AMF is a member of the Monitoring Group.

## E – Money laundering prevention

The proposed European Commission directive aimed at preventing use of the financial system for money laundering or terrorist financing was forwarded to the Council of the European Union and the European Parliament on 11 October 2004[13].

The draft directive seeks to strengthen resources for anti-money laundering and combating the financing of terrorism (AML/CFT) in the European Union (EU). It follows on from two directives adopted in 1991 and 2001. The first directive drew heavily on the recommendations of the FATF; it defined money laundering as a series of offences related to drug trafficking and was binding solely on the financial sector. The second directive extended this initial scope to cover the proceeds from a much wider range of criminal activities as well as some non-financial activities and professions. The European Commission presented this new draft directive, which is based largely on the FATF's Forty Recommendations as revised in June 2003 and which, in certain areas, is actually more stringent.

The definition of money laundering in the new directive not only covers concealment of the proceeds of serious offences; it encompasses CFT and places AML obligations on new constituencies. In addition, customer identification requirements are far more detailed, although enforcement depends on the actual level of risk. Accordingly, entities and persons subject to the directive should focus their efforts on high-risk situations; they are not required to implement customer identification procedures if risks are limited.

## F – CESR report on supervisory tools for EU securities markets

When the Lamfalussy Process was launched in Stockholm in 2000, it was agreed at the time that the operation and effectiveness of this mechanism would be reviewed at the end of 2004. An initial report on European financial integration was drafted by a working group of the Financial Stability Committee, chaired by Germany's finance minister, Jörg Asmunssen, and was approved by the Ecofin Council in June 2004. The report stressed that priority should be given to implementation of the measures stemming from the Financial Services Action Plan (FSAP).

The assessment process per se actually got underway with the publication of three reports:

- the third report of the Inter-institutional Monitoring Group on the Lamfalussy Process[14], published on 17 November 2004;

- the European Commission report, put out to public consultation;

[13] Directive 2001/97/EC of the European Parliament and the Council of 4 December 2001 amending Council Directive 91/308/EEC on prevention of the use of the financial system for money laundering - Declaration of the Commission.

[14] The Inter-institutional Monitoring Group consists of prominent personalities appointed by the European Council, Parliament and Commission.

- CESR's report ("the Himalaya report"), issued for consultation, which assesses the work of the Committee and outlines a series of proposals for the future[15].

The Ecofin meeting of 16 November 2004 acknowledged the benefits of Lamfalussy. It placed particular emphasis on the need to maintain the specific objectives of all four levels of the process and the respective roles of the various parties. It also insisted on the importance of Level 3, the need for closer convergence of practices, and full transposition of Community measures.

The CESR report contains a brief initial section on European financial integration, which emphasises the need to adapt the regulatory framework in several areas, especially those relating to settlement and fund management. It also points to the delay in integrating the retail market, which is still more fragmented than the market for professionals. The second part of the report addresses the obstacles to integration and the means that CESR might use to tackle them. The third part deals with the question of cooperation among authorities when supervising entities operating in several EU countries.

The areas of uncertainty facing CESR member-regulators are summarised in three questions:

- How convergent is the approach to supervision pursued by European regulators? (The report underscores the varying degrees of importance given to different aspects of regulation: systemic risk, economic regulation, investor protection, market operation.)

- Is there enough mutual reliance between European regulators for the fair application of directives and the effective supervision of the financial system? (The report notes that regulators have a diversity of powers and raises questions about the quality of regulation, which is key to effective cooperation.)

- Is there enough coordination of decisions by European regulators, for example in the event of serious market disruption or when dealing with financial innovation?

The report responds to these questions in two ways. It outlines initiatives that CESR might take, in particular by developing the potential of the network of securities regulators, and it proposes amendments that would bring about institutional changes were they to be implemented.

## 1- Developing the network of securities regulators

The report makes the following proposals for achieving greater supervisory convergence:

- Establish which authority is responsible for coordinating supervision, on a case by case basis. This could be done through a memorandum of understanding covering relations between the home and host supervisors, especially in the case of large corporate groups operating across Europe.

- Introduce a joint investigative process, with a more active role for the Chair of CESR-Pol.

- Develop joint databases, especially for the reporting requirements provided for in MiFID or the database of issuers provided for in the Transparency Directive.

Regarding regulatory convergence, the report suggests developing:

- mechanisms for obtaining information and, where appropriate, for discussing ways of dealing with financial innovation;

- a mediation mechanism within CESR, along the lines of the one provided for in MAD, to encourage European regulators to implement directives in a harmonised manner;

- mechanisms for harmonised transposition of Community rules, in particular a greater role for CESR's internal committee on monitoring transposition and the implementation of a peer review process.

The report proposes that regulators' actions should be enshrined in a clearly defined mission statement that would foster a common understanding of and approaches to regulation. Among other things, this could lead to the definition of overarching general principles for regulatory objectives.

The report's proposals on strengthening the network were put out to public consultation through a CESR paper on Level 3 implementation. For CESR, the aim is to develop resources for taking joint, coordinated action. This is particularly important at a time when the FSAP directives are being transposed and implemented. Most of the work done by CESR since its inception in 2001 has focused on its role in advising the European Commission on

[15] "Which supervisory tools for the EU securities markets? Preliminary Progress Report (Himalaya Report)". CESR reference 04-333f, downloadable from www.cesr-eu.org.

the preparation of Level 2 technical measures. The actual implementation of directives, and especially coordinated supervision at European level, is of cardinal importance. CESR must therefore become the established head of a network with the authority and resources to unite and coordinate the activities of European regulators.

## 2- Individual decisions by CESR

In addition to discussing measures to strengthen the network, the report observes that CESR might be empowered in some cases to take decisions that would be valid for all its members. This would mean that CESR would have to become a European agency, along the lines of the European Aviation Safety Agency. The report specifies that this capability should be recognised if the decisions in question meet several criteria:

- efficiency;

- subsidiarity (the benefit of having a single EU decision rather than one subject to mutual recognition or 25 coordinated decisions);

- whether the regulator is the competent authority, having regard to the percentage of business that an entity conducts outside its jurisdiction;

- the level of European integration of the activity involved.

The report proposes several areas in which this possibility could be envisaged:
- credit rating agencies;
- European bond issues;
- standard UCITS;
- implementation of accounting standards;
- Europe-wide trading and post-trading infrastructures.

## 3 – Coordination of multi-jurisdictional market participants

A separate section of the report deals with the special question of market participants operating in more than one jurisdiction in Europe. Theoretically, the issue is addressed by the directives, which clearly state that the home regulator is the competent authority in most cases (vetting of prospectuses, with an exception for bond issues; approval of market intermediaries and infrastructures specified in MiFID). In practice, however, the situation is more complex – witness the example of Euronext – and special arrangements need to be put in place. Going forward, such situations could become more prevalent.

The directives provide a partial answer to the problem. For example, the Prospectus Directive gives regulators the power to delegate to each other, while MiFID requires them to jointly organise the opening of remote access to a market.

In its response to this issue, CESR devoted considerable attention to developing stronger mechanisms for cooperation and coordination.

The report concludes with two institutional proposals:

- foster the convergence of regulatory powers, working on the principle that cooperation and mutual trust among regulators will be facilitated if they have similar powers and jurisdiction;

- extend the possibilities for regulators to delegate. The report suggests that the mechanism provided for in the Prospectus Directive could be applied to other directives. Naturally, this would mean amending Level 1 texts. Such a solution has practical benefits in terms of efficiency and resource allocation. It would require an analysis of how a transfer of powers might affect the responsibility of national regulators, as well as the consequences of creating lead regulators.

# G – The Joint Forum and the Financial Stability Forum

## 1 – The Joint Forum

The Joint Forum and the Financial Stability Forum share the same remit, albeit at different levels and with different viewpoints, namely to address cross-cutting issues and to take a systematic view of concerns in different sectors.

The Joint Forum comprises representatives from IOSCO (securities), the IAIS (insurance) and the Basel Committee (banking). The bulk of its work in 2004 was concerned with credit risk transfer and hedge funds, and it framed high-level principles on both subjects. Regarding credit risk transfer, it sought to alert financial institutions to the need to fully understand these products and their legal environment and to implement the appropriate tools for closer supervision of counterparties and risks.

The Joint Forum's principles for hedge funds call on banks, which work closely with these vehicles, to gain a better understanding of them.

## 2- The Financial Stability Forum

The Financial Stability Forum (FSF) is composed of finance ministry representatives, central bank governors, and the chairs of the securities, banking and insurance regulators in the G7/G8, along with representatives of international financial institutions and regulatory groupings. Its main task is to monitor the global economic situation, with emphasis on assessing the risks to financial stability.

The FSF has taken a special interest in questions related to reforming the International Federation of Accountants (IFAC), implementing the Public Interest Oversight Board, and coordinating the authorities responsible for auditor supervision. It also initiated a debate on offshore financial centres in an effort to review the action taken in this area and implement a procedure for helping OFCs with their efforts to improve transparency and international cooperation. This discussion drew heavily on the work done by IOSCO on OFCs. The FSF was due to finalise its own work in time for its meeting in Tokyo in March.

The FSF is also paying close attention to efforts to analyse recent scandals, especially the work done by IOSCO in this area.

# H – Clearing and settlement in the European Union

## 1 – CPSS-IOSCO recommendations for central counterparties [16]

A joint task force composed of representatives of IOSCO and the CPSS[17], together with a number of "external" participants (India, Czech Republic, IMF, World Bank), published a paper in November 2001 entitled "Recommendations for Securities Settlement Systems". The paper was approved by the two parent organisations. Of the 19 recommendations aimed at promoting secure and efficient systems, only one dealt specifically with central counterparties (or clearing houses). It called for an assessment of the costs and benefits of setting up a central counterparty (CCP) in countries that did not yet have one and, where such a mechanism did exist, asked that CCPs rigorously control the risks they assume.

CCPs are playing an increasingly important role in securities settlement procedures and pose a threat to payment systems and settlement systems should they default. Accordingly, in February 2003 the CPSS and the IOSCO Technical Committee asked the same task force to draw up recommendations concerning the main risks faced by clearing houses acting as CCPs.

One year on, the CPSS/IOSCO task force submitted a draft set of recommendations for public consultation between March and June 2004. Several items were subsequently amended in the light of responses to the consultation. The final text was approved by the IOSCO Technical Committee on 25 October 2004, then by the CPSS on 27 October and finally by the council of central bank governors on 8 November.

The report sets out fifteen recommendations. Each is accompanied by an explanatory text and an assessment methodology which, through a series of questions, make it possible to gauge the extent to which it has been implemented. The recommendations cover the main types of risk facing CCPs and place particular emphasis on

[16] Committee on Payment and Settlement Systems / International Organisation of Securities Commissions. IOSCO report released in November 2004 and available on the websites of IOSCO at www.iosco.org and the Bank for International Settlements at www.bis.org.

[17] The Committee on Payment and Settlement Systems (CPSS), which comprises the G8 central banks, is one of the committees set up under the auspices of the Basel Committee.

the need for adequate financial resources. This is important because, while a CCP can substantially reduce the individual exposures of market participants, it nonetheless assumes all the risks and responsibilities connected with managing those exposures. Accordingly, the existence and efficiency of the risk control procedures put in place by a CCP, as well as the appropriate financial resources, are vital to the market infrastructure on which it operates.

Several of the report's recommendations draw heavily on those in the previous IOSCO/CPSS report on securities settlement systems. They relate to the management and control of operational risk, settlement currency, and the efficiency, transparency, regulation and supervision of CCPs.

However, the report lays greater emphasis on the requirements for becoming a CCP participant and on the CCP's arrangements for monitoring its participants (Recommendation 2), on the measurement and monitoring of CCPs' credit risk exposures (Recommendation 3), on margin requirements (Recommendation 4), and on financial resources (Recommendation 5). Recommendation 5 is crucial: it states that a CCP must maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions. To help CCPs satisfy this requirement and to prevent malfunctions and possible consequences for non-defaulting participants, the report says that CCPs must have mechanisms to limit their risk exposure so that, if a participant defaults, non-defaulting participants are not exposed to losses that they are unable to anticipate.

For futures markets and markets in which contracts have long durations or are inherently leveraged, a management method based on margin calls – the conditions for which are spelled out in the report – is considered vital for effectively limiting CCPs' credit risk.

The recommendations and the assessment methodology will be used by regulators and also by the IMF in its financial system assessment programmes. They will provide a framework for self-assessment by CCPs.

## 2- ESCB/ECSR report on settlement standards for Europe

CESR and the governors of the European System of Central Banks (ESCB) finally approved a report titled "Standards for Securities Clearing and Settlement Systems in Europe" in October 2004, after three years of work, two public consultations and several meetings with the industry[18]. The standards expand on and clarify the recommendations made to EU member states in 2001 in a CPSS/IOSCO report on securities settlement systems. The overarching aim is to improve the safety, soundness and efficiency of post-trade activities in Europe.

It should be stressed that the purpose of the standards is not to establish the future framework for settlement activities. Instead, based on an assessment of the current position, they seek to develop the most effective possible measures for dealing with the risks engendered by these activities, which are vital to the security and orderly operation of all financial markets and payment systems. The legal infrastructure for clearing and settlement in Europe will be established in accordance with the framework directive proposed by the European Commission in a communication in spring 2004. In this respect, the introduction to the ESCB/ECSR report states that the standards will not pre-empt any subsequent decisions regarding the regulation of these activities at European level and that, if a directive were to be adopted, the relevance and validity of the standards would be reassessed.

In addition to the introduction, which sets forth the purpose of the discussions and places them in the context of other European initiatives, the report contains nineteen standards that borrow extensively from the architecture of the CPSS/IOSCO report.

Two topics in particular, both of which are closely related to the functional approach used for the report, were debated during the preparation and adoption of the standards. The first topic, reflected in Standard 6 (Central securities depositories*)* and Standard 9 (Credit and liquidity risk control), covers the potential scope of activity of a central securities depository (CSD) and the possibility for these organisations to carry on a banking business simultaneously, on condition that the associated risks are properly managed. Without taking a position on the substance of the debate, the ESCB/ECSR report notes that Clearstream and Euroclear, among others, engage in a banking activity; and it sets out measures in Standard 9 that are deemed appropriate for dealing with the resultant risk situation.

The second focal point of debate concerned the enforcement of certain standards, especially Standard 9 (Credit and liquidity risk control) and Standard 7 (Delivery versus payment), not only at CSDs (including ICSDs[19]) but also at custodians. In view of the amount of assets under safekeeping and the flows they process during settlement, custodians play a crucial role and would therefore be a particular source of risk for the entire system. The report acknowledges that the Basel II Capital Accord will serve as a basis for regulating "significant custodians", while

[18] AMF 2003 Annual Report, page 45.

[19] International Central Securities Depositaries

noting that additional safeguards might have to be introduced to tackle specific settlement-related risks that are not explicitly covered by Basel II.

This issue, along with the definition of significant custodian, will be addressed in further discussions among regulators, central banks and banking supervisors in 2005 while preparing methods for assessing the standards. This methodology, to be based on that of CPSS/IOSCO, should provide an opportunity to spell out and explain the contents of the standards, which will not come into force until they have been finalised.

It was decided to set up six sub-working groups that together will conduct an in-depth examination of the standards.

## 3 – Response to the European Commission communication of 28 April 2004 on clearing and settlement in the European Union

The European Commission published on 28 April 2004 a Communication titled "Clearing and settlement in the European Union – The way forward". This document built on previous work, especially the two Giovannini reports on barriers to the efficient delivery of securities clearing and settlement services in Europe. The Commission invited comments from all interested parties, including national regulators and supervisory authorities, before 30 July 2004.

Noting that cross-border clearing and settlement processes are inefficient and costly, the European Commission proposes a number of practical initiatives for addressing this problem. The most important of these is the preparation of a framework directive [20] based on three principles: freedom of choice and access, a common regulatory and supervisory framework, and appropriate governance arrangements.

- Freedom of choice and access: The European Commission is impartial on the choice between vertical and horizontal integration procedures, which it leaves to market forces, and it believes that markets should organise themselves. One of the approaches suggested by the Commission to ensure that market mechanisms are not hampered by competitive distortions is that all participants – banks, investment services providers, CSDs, clearing houses, and so on – that fulfil the same functions should be subject to the same regulations. This is the so-called functional approach, usually contrasted with the institutional (or infrastructure) approach.

In addition to this functional approach to post-trade activities, the European Commission recalled its insistence on the right to choose and gain access to any branch of the activity. This means that an intermediary with its registered office in Europe must be able to access any settlement system and any clearing house in Europe. Also, markets must be free to choose the clearing house and the settlement system or systems with which they want to work. And CSDs must be entitled to compete with intermediaries providing settlement services, and vice versa.

- Common regulatory and supervisory framework: On this point, the European Commission is in favour of establishing a common framework for cross-border cooperation among national supervisory authorities (for the oversight of groupings resulting from mergers or cross-border links). It is also in favour of capital requirements that would be explicitly linked not only to the functions exercised but to the associated level of risk (i.e. the functional approach). It is expected that the directive will establish high-level principles for risk management and investor protection.

- Governance: The European Commission does not wish to decide between two models of governance, one based on user-owned and user-directed entities, the other on for-profit entities.

According to the Communication, the Commission plans to spell out the main aspects of governance applicable to relations between interested parties where conflicts or interest might arise. The Communication addresses the issue of groups that simultaneously provide intermediary and infrastructure services, as well as the risks of competitive distortions arising from the coexistence of different functions within the same groups.

The AMF offered to assist the Treasury Department (*Trésor*) with its deliberations in order to prepare a coordinated response from the French authorities, with emphasis on the following points:

[20] In addition to the directive, a European Commission communication suggested setting up an advisory and monitoring group on clearing and settlement, responsible for coordinating market-led provisions with those introduced by regulatory and supervisory authorities. The group, of which CESR is a member, is chaired by the Commission. Furthermore, working with ad hoc expert groups, the Commission plans to address a large number of legal issues – already identified in other forums – that need to be taken into account when harmonising securities laws across different jurisdictions. These issues include the choice of laws, the nature of investors' rights vis-à-vis book entries with custodians, methods of transferring such rights, and laws governing corporate actions and the location of securities. Tax-related issues will also be taken into account, but these do not fall directly within the jurisdiction of the AMF.

- The Commission must clarify its concepts so that strict limits can be placed on exposure to banking risks. The AMF noted that the use of concepts such as "clearing system" and "settlement system" was unsatisfactory and it offered to seek an agreement on precise definitions for these functions to ensure that different participants are not grouped together under the same function – especially in the highly technical field of clearing and settlement. At the same time, other definitions need to be established, particularly for the functions of CSD, securities settlement system operator, settlement agent, custodian, clearing house, central counterparty and clearer. These definitions correspond to specific functions, which must be identified as such in a future framework directive.

Looking beyond this initial project, it is vital that the definitions adopted by the European Commission should make a clear-cut distinction between participants whose main function is to incur banking-related risks, particularly custodians, settlement agents, clearing houses, central counterparties and clearers; and participants whose role is to avoid such risks, notably for prudential reasons. The latter group includes CSDs and settlement system operators. Precise and effective limits must be put in place to ensure that an entity is not able to perform risk-exposed functions while simultaneously acting as a CSD or settlement system operator.

- The future directive should establish high-level principles that foster competition among all participants. It must also contain provisions to prevent anti-competitive practices and to facilitate enforcement of these measures. In particular, the directive should reiterate that a distinction must be made within the same group between entities fulfilling functions and offering services related to banking and those performing the functions of CSD or settlement system manager. Furthermore, the relevant supervisors and overseers must have the power to refer to the competition authorities any practice, especially a pricing practice, that may hinder free access or infringe competition rules.

- A precise framework for the supervision of all participants is needed. A distinction should be drawn between banking participants, which must be supervised under existing prudential rules (especially custodians, clearing houses and clearers) and those that manage systems (CSDs, settlement system operators). The method for coordinating supervision of the latter group will have to be set forth in the future directive.

# II – THE FINANCIAL SERVICES ACTION PLAN

## A – Schedule for transposing European directives

This section sets out the timetable for transposing the directives adopted by the European Parliament and the Council under the Financial Services Action Plan (FSAP) of the European Commission.

| Adopted directives and regulations | Deadlines for transposing directives in Member States[21] | State of implementation in France[22] |
|---|---|---|
| **MARKET ABUSE**<br>Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse)<br><br>Commission directives and regulations (technical implementing measures for Directive 2003/6/EC):<br>➢ Commission Directive 2004/72/EC of 29 April 2004 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers' transactions and the notification of suspicious transactions<br>➢ Commission Directive of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the definition and public disclosure of inside information and the definition of market manipulation<br>➢ Commission Directive 2003/125/EC of 22 | 12 October 2004 | - Financial Security Act of 1 August 2003.<br><br>- The following elements will underpin the legal framework governing market abuse:<br>* an omnibus bill, presented to the Cabinet on 24 March 2005, to bring French law into line with Community legislation in the field of financial markets;<br>* the Economic Confidence and Modernisation Bill, presented to the Cabinet on 13 April 2005.<br><br>- the General |

[21] European regulations take effect immediately.

[22] At this writing, i.e. 20 April 2005.

| | | |
|---|---|---|
| December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest<br>➢ Commission Regulation (EC) No 2273/2003 of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards exemptions for buy-back programmes and stabilisation of financial instruments | | Regulation of the AMF, approved by a decree published in the Official Journal on 24 November 2004.<br><br>- The texts are due to be transposed into the AMF General Regulation once the bill has been passed. |
| **PROSPECTUSES**<br>Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC<br><br>**Technical implementing measures adopted by the Commission:**<br>➢ Commission Regulation (EC) 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements | 1 July 2005 | - The legal framework for prospectuses will be supplemented by the Economic Confidence and Modernisation Bill, presented to the Cabinet on 13 April 2005.<br><br>- The texts are due to be transposed into the AMF General Regulation once the bill has been passed. |
| **Markets in Financial Instruments Directive**<br>Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC | 30 April 2006[23] | - Draft legislation pending<br><br>- The texts are due to be transposed into the AMF General Regulation once the bill has been passed. |
| **Takeovers**<br>Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids. | 21 May 2006 | - The legal framework and the AMF General Regulation will be amended before May 2006. |
| **TRANSPARENCY**<br>Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC | 20 January 2007 | - The provisions of this directive have been incorporated into the Economic Confidence and Modernisation Bill, presented to the Cabinet on 13 April 2005.<br><br>- The text is due to be transposed into the |

[23] The Parliament and the Council are due to decide during the second quarter 2005 to push back the implementation timetable:
- Member States must adopt the necessary legal and regulatory measures by 30 October 2006;
- investment services providers and market operators must bring their organisational structures into line with the new provisions by 30 April 2007.

| | | |
|---|---|---|
| | | AMF General Regulation before January 2007. |

## B – The Takeover Directive

The directive on takeover bids was adopted by the European Council and the Parliament after fourteen years of negotiation. It was published in the Official Journal of the European Union (OJEU) on 30 April 2004 and came into force on 21 May 2004. The transposition deadline is 21 May 2006.

The basic principles are broadly similar to those underpinning French takeover legislation [24], but the directive is special in that two of its key provisions – Article 9 on defence mechanisms and Article 11 on breakthrough rules – are non-compulsory, with optional arrangements being provided for in Article 12.

Under Article 12, Member States may exempt listed companies operating on their territory from enforcing two principles: that only general meetings of shareholders are empowered to authorise defence mechanisms during the offer period (Article 9) and that restrictions on the transfer of securities and voting rights, as well as multiple voting rights, should be frozen during the offer period or following the outcome of the bid (Article 11).

Accordingly, Member States must allow their companies to apply these principles voluntarily, on condition that they have been authorised to do so by an extraordinary general meeting of shareholders. That authorisation must be renewed every eighteen months.

Regardless of whether they decide to enforce the principles posited in these two articles, Member States can authorise their companies not to apply them in the event of a bid from a company (or one of its subsidiaries) that does not apply them either. This can be done by introducing a reciprocity clause into the Member State's legislation.

With a view to transposing the text into French law, the finance minister commissioned Jean-François Lepetit, former chairman of the COB and the CMF, to set up a working group with a mandate to analyse the options available to Member States under the directive, as well as the ensuing consequences.

The group comprised Jean-Louis Beffa, Chairman and Chief Executive of Saint-Gobain, Gérard de la Martinière, chairman of the French insurance federation (FFSA), and Dominique Schmidt, a law professor and member of the Paris and Strasbourg bars. It met for the first time in December 2004.

The working group is due to submit its report to the minister by the end of first-half 2005.

## C – Markets in Financial Instruments Directive

The Markets in Financial Instruments Directive (MiFID), published in the OJEU on 30 April 2004, supersedes the Investment Services Directive (ISD), which was adopted in 1993. The ISD was instrumental in creating a single market in financial services: it introduced the European passport for investment services providers and established the concept of regulated markets, the cornerstone of European securities regulation.

Prepared in accordance with the Lamfalussy Process, MiFID is a framework directive that will be supplemented with implementing measures adopted through comitology procedures on the basis of proposals submitted to the European Commission by CESR member-regulators.

### 1- Market architecture

MiFID establishes an overall framework for order execution that will allow regulated markets, multilateral trading facilities (MTFs) and internal trading systems to compete with each other across Europe. This should help to improve the quality and reduce the cost of order execution, chiefly to the benefit of investors.

However, this new organisational structure could jeopardise market efficiency and investor protection. It must be emphasised that competition among order execution platforms could fragment the market, thus reducing liquidity and, in turn, undermining the price formation process. What is more, investors may find it harder to access the

[24] Referred to in the AMF 2003 Annual Report

information they need for their decisions. In addition, the multiplicity of trading venues will make it more difficult for market supervisors to assess execution quality and detect infringements. Lastly, order internalisation could lead to conflicts of interests in firms that execute their clients' order in-house.

To mitigate these risks, a number of safeguards had to be introduced in order to guarantee market efficiency and protect investors' interests.

### a) Main aims of transparency rules

MiFID establishes equivalent requirements in terms of access and pre-trade and post-trade transparency[25] in an effort to ensure that the terms and conditions offered by regulated markets can be compared with those of MTFs[26].

As regards internal systems, which by definition are discretionary, orders executed by intermediaries do not reach the central market and, hence, do not contribute to price formation. It was therefore important to prevent such systems from becoming non-transparent pools of liquidity that would detract from overall liquidity and efficient price formation. Accordingly, internal systems are now subject to pre-trade transparency requirements that oblige them to disclose bid and ask prices for available financial instruments.

### b) Main rules on client order handling

In addition to transparency rules, and to ensure a link between internal systems and markets in the broad sense of the term, the directive requires these systems to disclose information – especially to MTFs – about limit orders they cannot execute immediately. Consequently, an internaliser that is unable to execute a limit order straight away must facilitate its rapid execution by immediately making it public via channels that are easily accessible to other participants. This requirement is intended not just to protect the client's interests but also to preserve the efficiency of the price formation procedure.

### c) The best execution rule

The best execution rule makes a vital contribution to investor protection and market efficiency. The mechanism provided for in MiFID is based on a "multicriteria" comparison that takes into account the full cost of a trade (i.e. the price of the financial instrument plus expenses, including fees and commissions) as well as the quality of execution, with particular emphasis on the speed and likelihood of completion and settlement, the size and nature of the order and any other criteria that may be relevant to proper execution.

To comply with the best execution rule, investment services providers must draw up an order execution policy, inform their clients about it and obtain their prior consent. They must also monitor the efficiency of the policy and remedy any shortcomings.

## 2 - Investment services

### a) Main innovations brought in by MiFID

A number of other innovations accompany the key reform of market architecture. The overhaul of the ISD provided the opportunity to extend the directive's scope, in terms of both financial services and instruments:
- investment advice is now classified as an investment service;
- a new ancillary service has been introduced, namely "Investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments";
- special "execution-only" arrangements for the order reception/transmission and execution services were introduced during negotiations on the Commission's draft text;
- the directive now covers commodity derivatives.

[25] This consists of the information provided by the trading system about pending trading interest: buy and sell orders, bids and asks displayed by account-holders (pre-trade transparency) and about transactions (post-trade transparency).
[26] The sixth recital of the directive provides that "Definitions of regulated market and MTF should be introduced and closely aligned with each other to reflect the fact that they represent the same organised trading functionality. The definitions should exclude bilateral systems where an investment firm enters into every trade on own account and not as a riskless counterparty interposed between the buyer and seller. The term "system" encompasses all those markets that are composed of a set of rules and a trading platform as well as those that only function on the basis of a set of rules. Regulated markets and MTFs are not obliged to operate a "technical" system for matching orders. A market which is only composed of a set of rules that governs aspects related to membership, admission of instruments to trading, trading between members, reporting and, where applicable, transparency obligations is a regulated market or an MTF within the meaning of this Directive and the transactions concluded under those rules are considered to be concluded under the systems of a regulated market or an MTF".

### b) Investor protection measures

These innovations are accompanied by rules to protect investors.

The rules of conduct and other rules that firms are required to apply when servicing clients have been brought into line with the new environment for investment services and activities. Particularly noteworthy is the introduction of a best execution obligation (Article 21) along with client order handling rules (Article 22). These principles supplement the organisational requirements set forth in Article 13 MiFID, particularly those on compliance, professional ethics and the prevention of conflicts of interest, which themselves are fleshed out with special rules for dealing with conflicts that cannot be prevented by organisational measures (Article 18). The ISD's conduct of business obligations has been clarified in terms of client disclosures and the duty to provide advice. Further, special rules have been set for the provision of an execution-only service. The new directive also specifies that conduct of business rules must be applied differently depending on whether the client is a private or professional investor.

Firms must obtain prior assent from clients when executing orders outside a regulated market or an MTF. This rule is of cardinal importance in Member States where internalisation, which used to be allowed only in certain circumstances, has become a standard execution method. The directive also foresees the need for standards to prevent conflicts of interest.

## 3 – Arrangements for supervision and cooperation among competent authorities

### a) Measures to strengthen oversight and cooperation

Market oversight arrangements have been strengthened to allow regulators to supervise the new market environment effectively and on an integrated basis. The greater the number of systems on which a trade can be executed, the harder it will be to supervise them, that is to say, to detect infringements such as price manipulation and non-compliance with the best execution rule. To address this problem, MiFID has introduced the following measures:
- The trade reporting system has been enhanced to ensure that all regulators concerned by an intermediary's activities are duly informed.
- The procedures through which authorities cooperate on supervisory and investigative matters have been amended so that an agency responsible for supervising a regulated market is expressly authorised to make direct contact with remote members of that market based in another Member State, while informing the competent authority of this state of such contacts.
- Special arrangements have been made so that authorities concerned by cross-border trades on a regulated market can introduce special cooperation procedures in certain circumstances.

### b) Clarification of authorities' powers

MiFID clarifies the responsibilities of competent authorities. It also strengthens the provisions on the exchange of information between regulators as well as the obligations for mutual assistance and cooperation, adapting them to the new market environment. Another of the directive's aims is the convergence of competent authorities' powers, with a view to strengthening rule-enforcement procedures across the EU. The powers granted to authorities and the sanctions they can impose are based on similar provisions in the Prospectus and Market Abuse Directives.

## 4- Comitology process

CESR set up three expert groups in spring 2003, without waiting for the final mandates from the Commission[27]. To coordinate the work of these groups, it also created a steering group composed of their three chairmen and headed by Arthur Docters Van Leeuwen, Chair of the Netherlands' Authority for Financial Markets (AFM) and of CESR. In addition, it established a consultative working group of market participants with whom the working groups could compare ideas and proposals.

This comitology process was organised around the following deadlines:
- The Commission issued its mandates to CESR in two stages. On 20 January 2004, it published a provisional mandate asking CESR for technical advice by 31 January 2005; and on 25 June 2004, it added a request for additional advice on other MiFID issues for 30 April 2005.
- CESR published an initial consultation paper for the first set of mandates[28] on 17 June 2004, covering a three-month period and excluding developments relating to best execution and market transparency, for which the Commission extended CESR's advice deadline until 30 April 2005. A second consultation paper on the first set of mandates was published on 17 November 2004.

[27] The Commission published the first set of provisional mandates (pending adoption of the directive) on 20 January 2004.
[28] CESR/04-261b.

## a) Expert Group on Intermediaries

The "Intermediaries" expert group, headed by Callum McCarthy, chairman of the UK Financial Services Authority, was tasked by the European Commission with preparing advice on implementing measures for MiFID. The advice, due to be submitted on 31 January 2005, focused on two areas: organisational requirements for investment services providers (Article 13) and the information addressed by providers to their clients (Articles 19.2 and 19.3). In June 2004, CESR issued an initial consultation paper, followed by a second paper in November dealing with the most controversial issues.

Article 13 sets out organisational principles for intermediaries in the areas of compliance, systems and controls (including risk control), outsourcing, record keeping, safeguarding of clients' securities and funds, and conflicts of interest.

CESR's most significant proposals concern the independence of the compliance function, an oversight requirement where operational functions or investment services are outsourced, the registration of orders received by telephone, and the requirement for intermediaries to draw up a policy for dealing with conflicts of interest in order to comply with Article 13.3 MiFID, which states that "all reasonable steps" must be taken to prevent conflicts of interest so that clients' interests are not adversely affected.

Article 19.2 MiFID provides that all the information sent to actual or potential clients must be clear and not misleading, while Article 19.3 specifies that the information provided to those clients must allow them to understand, inter alia, "the nature and risks of the investment service and of the specific type of financial instrument that is being offered".

Regarding client disclosures, CESR's proposal to place special emphasis on the quality of marketing materials (i.e. all forms of advertising and publicity) recommends that the majority of Level 2 measures should apply solely to non-professional clients, that precise information be made available only for certain products such as derivatives, and that warnings be issued to clients for the widest possible variety of situations, such as illiquid securities and margin purchases. CESR recalled that it would subsequently issue advice on the suitability of marketed products, in connection with Articles 19.4 and 19.5 MiFID.

In its second submission of advice, scheduled for 30 April 2005, CESR will also propose implementing measures to ensure best execution of client orders (Article 21 MiFID).

## b) Expert Group on Markets

Chaired until summer 2004 by Jacob Kaptein (AFM, Netherlands) and then by Karl Burkhard Caspari (BaFin, Germany), the Market Transparency expert group was charged with preparing advice on those MiFID articles dealing with pre-trade and post-trade transparency requirements (Articles 22.2, 28, 29, 30, 44 and 45), the definition and obligations of systematic internalisers (Article 2) and the admission of financial instruments to trading on a regulated market.

In June 2004, the group published its first consultation paper, on the pre-trade information to be published by regulated markets and MTFs. Among other things, the paper proposed that order-driven systems should disseminate their entire order book while quote-driven systems should publish all bids and offers given by market makers for the same security. Respondents to the consultation expressed reservations about the approach, which was both exhaustive in terms of information content and precise in its description of market models. Most of these observations were taken into account in the second consultation paper, published in March 2005 before CESR's approval of the final advice at end April 2005.

Regarding the post-trade information to be disclosed by regulated markets, MTFs and order internalisers, discussions focused principally on publication deadlines (in real-time, where possible) and the need, if any, for regulated markets and MTFs to publish data in an aggregated manner. Another point of discussion was whether intermediaries should be allowed to use their own website to disclose post-trade information or whether they should be encouraged to use channels such as data vendors' systems (e.g. Bloomberg and Reuters) or the data dissemination systems of regulated markets.

The paper also proposed three methods for calculating the size of transactions considered large in scale compared with normal trades in a given security (block trades). These large trades are eligible for exemption from the order display obligation and also for deferred publication.

A choice will have to be made between those methods that are precise but that require substantial data processing capabilities and those that are less precise but that are simpler and more transparent.

Regarding the admission of financial instruments to a regulated market, the consultation paper maintains a broad-brush approach, limiting its draft advice to equities and derivatives. The group's initial approach is due to be expanded in the coming months.

In November 2004, the expert group released a first consultation paper on Article 22.2 (limit order display) and, in particular, Article 27 (systematic internalisers). The group proposed a series of qualitative indicators for a better understanding of the definition of systematic internalisation, since the directive uses the phrase "organised, frequent and systematic" to describe this activity.

The other, particularly delicate issue addressed in the paper was the definition of securities with a liquid market, for which internalisers are required to display bids and/or offers for their chosen amount, up to the standard market size. The consultation paper sets out several approaches for this liquidity yardstick: inclusion in a national or European index, individual criteria based on trading volume, spreads, and turnover.

The introduction of systematic internalisation is one of the major innovations ushered in by MiFID, compared with the ISD; and it led to intense discussions during the adoption of the directive. The text results from a political consensus and leaves a number of technical issues to be tackled. The importance of these unresolved issues must not be underestimated.

### c) Expert Group on Cooperation and Enforcement

As part of the comitology process, the Co-op and Enforcement expert group, chaired by the AMF's Michel Prada, continued and completed its work on the following policy settings.

- Transaction reporting to competent authorities (Article 25)

Part of CESR's remit was to establish methods and procedures to be used for reporting financial transactions, as well as the form and content of those reports and the criteria for defining a "relevant market in terms of liquidity".

Under the directive, investment services providers are required to report trades to their competent authority,[29] regardless of the trading system they use. Furthermore, the competent authority of the most relevant market in terms of liquidity must also receive information relating to trade reports.

The expert group adopted a two-level approach to establishing the content of trade reports:
- defining the minimum common informational content that investment services providers must report to their competent authorities, regardless of the reporting arrangements adopted by the Member State (direct reports by the investment services provider or use of the waivers provided for in the directive). The format of these reports is to be determined at national level, using existing arrangements wherever possible;
- deciding, in view of the above, what information competent authorities should share systematically under a common format and/or standard. According to the directive, the competent authority of the most relevant market in terms of liquidity, the home authority responsible for the investment services provider's branch and the home authority of the service provider should all receive information about transaction reports. It has also been proposed that the information also be sent to the competent authority of the country where the trade was executed.

The trade-related information to be supplied by investment services providers should make it possible, among other things, to identify the transaction (date, time, reference number) and its characteristics (price, quantity, trading system, proprietary/client account, etc.) as well as the investment services provider, the financial instrument and the trade counterparty. A mandatory field for client/customer identification, using a single code unique to each investment services provider, will be included only where specifically required by the Member State's national law.

The expert group listed the principles, conditions and minimum criteria that a reporting system must satisfy in order to be approved:
- reports must be in electronic form (although the competent authority may grant exemptions in exceptional circumstances);
- reports must be timely, safe and confidential;
- erroneous transaction reports must be amendable;
- systems must have reliability/quality control mechanisms, validation tools, and precautionary measures in the event of failure;
- systems must be able to report the minimum content of transaction reports in the format and standard required at national level, together with any additional information the competent authority may require.

In October 2004, CESR asked an expert group to come up with proposals for establishing an efficient system for exchanging information among regulators. CESR's objective is to implement Level 3 measures that will clarify formats and standards for exchanges of information among competent authorities, along with the accompanying technical systems and procedures.

29 In principle, the home authority of the investment firm and, for branches, the authority of the country in which the branch is based.

- Cooperation between authorities concerned by a market operating on a cross-border basis (Article 56.2)

CESR was charged with proposing criteria for measuring the importance of a regulated market's cross-border business, together with the resulting impacts in terms of investor protection that would require cooperation between authorities. Article 56 par. 2 MiFID provides that, under such circumstances, the market's home and host authorities must establish proportionate cooperation arrangements. The expert group drew up an indicative list of quantitative and qualitative factors to be taken into account and suggested how these should be seen from the perspective of the host Member State.

In its proposals, the expert group identified situations in which a competent authority might invoke Article 56.2, particularly remote access to trading by investment services providers in the host Member State, admission to trading in the financial instruments of host-state issuers, and market operators that manage several regulated markets in more than one Member State.

- Cooperation (Article 58)

The expert group sought to take account of ongoing or previous work done by CESR, and especially CESR-Pol (notably the agreement on cooperation between CESR members).

Since Article 58 posits the general principle of cooperation among competent authorities, the group identified three types of information exchange:
- automatic transmission without a request to another authority (transaction reporting, notification of right of establishment or freedom to provide services, etc.);
- transmission in connection with the directive's consultation or reciprocal information procedures;
- transmission upon written request, where necessary, to authorities to allow them to fulfil their obligations (investigations, etc.).

Further, the group adopted the principle of enhancing the mechanisms for exchanging information between two authorities, taking into consideration the routine nature of that information. The procedural details for such exchanges must be worked out by CESR at Level 3. This pragmatic, hands-on approach should provide the necessary flexibility with regard to the requirement for competent authorities to supply each other "immediately" with the information needed to carry out their duties (Article 58 par. 1 MiFID).

Information will be exchanged through authorities designated as the single point of contact in each Member State. CESR will recommend that its members be that designated authority.

## D – Prospectus Directive

Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading (Prospectus Directive, Level I of the Lamfalussy Process) was voted on second reading by the European Parliament on 2 July 2003 and published in the OJEU on 31 December 2003.

Regulation (EC) No 809/2004 (Level II), based on CESR's technical advice, was adopted by the European Commission on 29 April 2004 and published in the OJEU on 30 April 2004. This regulation contains detailed implementing measures concerning the special information to be included in a prospectus; it also contains schedules adapted to the type of security and, to a lesser extent, the nature of the issuer. Because the regulation is based on a full harmonisation approach, Member States will not be able to exceed the information requirements laid down for these schedules. The regulation will take effect on 1 July 2005, the deadline for Member States to transpose the Prospectus Directive.

CESR mandated an expert group of regulators, the Prospectus Group, which, with the assistance of CESR-Fin on accounting matters, published a set of draft recommendations at end June 2004 and submitted them for public consultation until 18 October 2004. The recommendations were published on 10 February 2005[30].

The main aim of these recommendations is not to impose additional requirements on regulators but to avoid differences in rule interpretations among Member States and to elucidate some aspects of the regulation.

The recommendations are organised into three sections:
- The first section seeks to ensure that competent authorities enforce Article 23 of the regulation in a coordinated manner. This article provides that "where the issuer's activities fall under one of the categories included in Annex XIX, the competent authority of the home Member State, taking into consideration the specific nature of the activities involved, may ask for adapted information, in addition to the information items included in the schedules

[30] CESR/05-054b.

[…] including, where appropriate, a valuation or other expert's report on the assets of the issuer". The issuers covered by the article are property companies, mining companies, investment companies, scientific research based companies, start-ups and shipping companies.
- The second section seeks to clarify some of the points provided for in the Level 2 schedules about non-financial information, with particular reference to the history of the issuer's share capital, a description of the rights attaching to each category of shares, the information to be included in the registration document regarding securities issued by closed-end collective investment companies and transactions with related parties;
- The third section contains recommendations on financial disclosures. The main issues addressed are the criteria triggering the obligation to file pro forma financial statements; information about provisional results to be included in the prospectus; the presentation of accounts for issuers with "complex historical financial statements"; and the introduction of forward-looking information in order to distinguish between forecasts, objectives and trends.

## E – Market Abuse Directive

Most of the provisions of the Market Abuse Directive (MAD) and its implementing directives were transposed into the first version of the AMF General Regulation, published in the Official Journal of the French Republic on 24 November 2004.

MAD defines inside information and market manipulation. It prohibits anybody holding inside information from using it to acquire or dispose of the financial instruments to which the information refers, from divulging it to a third party otherwise than in the normal course of business, and from recommending other persons to acquire or dispose of financial instruments. It also outlaws market manipulation.

Furthermore, the directive requires issuers to disclose inside information as soon as possible and to draw up a list of persons with access to such data. It introduces a regulatory reporting requirement for any and all transactions in an issuer's securities undertaken by one of its managers or a person closely associated with him or her; while investment services providers are required to report suspicious transactions. In addition, Member States must introduce regulations to prevent conflicts of interests with investment analysts and financial journalists. MAD also provides for a system of exemptions for share buy-backs and stabilisation activity that comply with Regulation (EC) No 2273/2003 of 22 December 2003.

These provisions were transposed into Books II and VI of the AMF General Regulation. It is important to note that the AMF, like its predecessor, the COB, has long-established regulatory procedures for dealing with privileged information, as well as a system of administrative sanctions to punish insider dealing.

The positive disclosure obligations have been written into Chapter II ("Ongoing disclosure") of Book II, Title II, of the General Regulation. These obligations incorporate some provisions from former COB Regulation 98-07 on public disclosure and the true, precise and fair nature of information. The directive introduces an additional condition regarding delayed publication of inside information, since such delays must not mislead the public. Articles 222-14 and 222-15 of the AMF General Regulation transpose the obligation to report dealings in a company's securities by managers and persons closely associated to them. This obligation will entail a change in the law in order to extend the reporting obligation to senior managers, to establish which instruments are covered and to define "closely associated persons".

Title IV of Book II incorporates the disclosure obligations contained in former COB Regulation 98-07, applicable to issuers operating a share buy-back programme. Some of these provisions have been amended in the light of Regulation (EC) No 2273/2003, particularly as regards disclosure when implementing a buy-back programme. A transitional provision was included in Article 241-8 of the AMF General Regulation to cover shares acquired before the European regulation came into force.

The prohibitions set forth in MAD have been transposed into Book VI of the General Regulation, which comprises three titles. Title I deals with the scope of application, accepted market practices, and the regulatory procedure used to approve such practices. After consulting with the organisations concerned and with Euronext Paris and CESR member-regulators, the AMF accepted two market practices: the use of liquidity agreements that comply with the code of conduct of the French Association of Investment Firms (AFEI) of 6 December 2004, and the buy-back of shares to be retained and used subsequently as consideration for acquisitions. Title II defines privileged information and addresses insider trading. Book III deals with market manipulation; it also incorporates MAD's exemptions for share buy-backs and stabilisation activity.

Some of the provisions of the directive have still to be transposed into law. Once this has been done, the AMF will amend its General Regulation to finalise its regulatory framework for market abuse. In addition to the aforementioned amendments related to managers' dealings, the modifications are as follows:
- issuers will be required to prepare and update a list of insiders;
- suspicious transactions must be reported;
- simplified prospectuses for share buy-backs programmes will no longer have to be certified;
- The AMF's regulatory powers will be extended to cover the production and dissemination of investment recommendations. Since the directive provides for this regime to be applied to journalists, the Treasury

Department (*Trésor*) is holding discussions with representatives of the profession with a view to preparing a system of self-regulation tailored to the specific characteristics of the media;
- The AMF's power of sanction will be expanded to include the oversight and punishment of infringements relating to financial instruments admitted to trading on a regulated market in the European Economic Area, where such infringements occur partly on French soil. The new powers will also cover "attempted" insider dealing.

## F- Transparency Directive

The Transparency Directive was published in the OJEU on 31 December 2004. Member States have until 20 January 2007 to transpose the text, in accordance with its Article 31.

The directive adds to the measures provided for in the Market Abuse and Prospectus Directives by establishing a common disclosure regime in the European Union for issuers of securities admitted to trading on a regulated market. It includes requirements to disclose information about the publication of annual and half-yearly financial statements and the related management report, quarterly data, major holdings, specific information about changes to shareholders' rights, new debt issues, and so on. The directive is based on minimum harmonisation, meaning that competent authorities may impose stricter requirements on issuers falling under their jurisdiction.

The Transparency Directive requires issuers to publish regulated information so that all investors can access it free of charge and on a non-discriminatory and timely basis. The information must be transmitted to a centralised database approved by the issuer's Member State as the official storage facility[31]. Member States are free to choose the system they use to disseminate data to the market provided that it meets the objectives laid down by the directive and that at least one mechanism is officially appointed to centralise and store data.

Furthermore, where an issuer has its registered office in a country outside the European Union, the competent authorities of its home Member State may exempt it from some of the directive's provisions, provided that the law of this third country contains requirements that are equivalent or stricter.

Pursuant to the Lamfalussy Process, the European Commission gave CESR an initial mandate on 29 June 2004 to prepare implementing measures for the priority topics covered by the directive. The main themes of this first mandate were shared among three CESR working groups: major holdings, dissemination and storage of regulated information and half-yearly reports, and third-country equivalence. CESR also set up a Consultative Working Group of Experts composed of market participants skilled in the areas covered by the directive.

The Commission's first mandate dealt with the following areas:

- procedures on the notification of major holdings and the content of such disclosures;
- rules for supervising the use of exemptions from reporting requirements (e.g. market makers defined in the Transparency Directive);
- technical procedures for providing the public with periodic disclosure documents (annual and half-yearly accounts);
- methods for disseminating regulated information to the public;
- minimum content of half-yearly reports and the "nature of the auditors' review";
- equivalence rules for issuers in third countries;
- methods for eligible issuers to choose their competent authority.

In fourth-quarter 2004, CESR published consultation papers seeking comments and proposals from persons concerned by these matters. Once the public consultation procedure is complete, the amended paper will be submitted to the European Commission as advice by 30 June 2005 at the latest. The Commission will then prepare an implementing directive or a regulation that will once again be put out to public consultation in the European Union in second-half 2005. Finally, the European Commission will present the implementing measures for the directive with a view to harmonised transposition by Member States.

## G – Regulation of investment management

The conference of CESR chairmen held in Dublin on 11 and 12 December 2003 agreed to set up an expert group on investment management, composed of representatives of national regulators. The group is currently chaired by Lamberto Cardia, chairman of the Italian regulator, CONSOB.

[31] Anticipating the developments provided for in the Transparency Directive, the COB initiated a public consultation on methods for disseminating ongoing disclosures. See AMF 2003 Annual Report

The move was prompted by a decision from Ecofin on 3 December 2003 to extend the Lamfalussy Process to collective investment schemes[32]. It also follows on from comments submitted in response to CESR's public consultation on investment management.[33]

In June 2004, the expert group approved a provisional work programme[34] for 2004, 2005 and 2006. At the request of the AMF, among others, the group focused its initial efforts on harmonising transitional provisions for the entry into force of the directives governing investment products[35] and management companies[36].

In October 2004, the expert group received a formal mandate from the European Commission to clarify the definitions of the financial instruments eligible for inclusion as UCITS assets, namely derivatives, closed-end funds, money-market instruments not traded on a regulated market, embedded derivatives and index funds. CESR published a first consultation paper on the above topics on March 2005.

On 4 November 2004, CESR issued a report containing the findings of investigations carried out by its members into allegations of late trading[37] and market timing[38] in the European asset management industry. The report concluded that abusive practices using investment funds to benefit a small number of investors were rare in Europe. But the results of the study indicated that management companies could improve their internal procedures in order to remedy shortcomings that might result in censurable practices.

CESR's members conducted their investigations following revelations of abusive practices in the USA in autumn 2003. According to the report, the fact that there is no evidence of such practices is Europe is heartening, although vigilance is necessary. An annex to the report summarised the actions taken by each CESR member. In particular, some regulators modified the internal control procedures used by management companies, as well as the way in which forward pricing and fair value approaches are used to value investment funds' assets.

In 2004, the Investment Management group addressed issues such as the simplification of approval procedures for collective investment schemes, conduct of business rules (with particular emphasis on harmonised application of MiFID), outsourcing, and a common approach to non-UCITS schemes. The work programme for 2006 will concentrate on consistency with other directives (MiFID, distance selling, e-commerce) and the convergence of European regulators' supervisory systems.

At present, the Investment Management group is working closely with the European Securities Committee, which has taken over from the European Contact Committee for UCITS. It will have to demonstrate to industry professionals that it is capable of achieving convergence between national approaches that sometimes differ widely, while adopting standards to protect European investors.

Furthermore, on 27 April 2004 the European Commission adopted two recommendations for a uniform interpretation of rules on investments by collective schemes in derivatives (options, futures, swaps), along with provisions obliging the manager of such schemes to inform investors of their main characteristics in the simplified prospectus.

This last recommendation introduced standardised ratios that should allow investors to compare information about schemes' operating expenses (the "total expense ratio", or TER) and, in all cases, to measure portfolio rotation. In France, most of the issues addressed by the Prospectus Recommendation had already been provided for in a COB instruction on long-form prospectuses, issued on 1 November 2003[39].

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[32] At present, however, the group is unable to operate fully at Level 2 of the Lamfalussy Process because Article 53a of the UCITS Directive has not yet been officially amended. This article provides that the Contact Committee [now the European Securities Committee] is responsible for "the harmonised implementation of [the] Directive through regular consultations on any practical problems arising from its application and on which exchanges of views are deemed useful".

[33] Available on the CESR website at www.cesr-eu.org (ref. CESR/03-378).

[34] www.cesr-eu.org "Mandate for the Expert Group on Investment Management" 04/160

[35] Directive 2001/108/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), with regard to investments of UCITS.

[36] Directive 2001/107/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses.

[37] CESR defines late trading as an activity whereby "the fund manager accepts to receive and carry out subscription or redemption orders from certain investors after the deadline set for these transactions in the regulations of the jurisdiction in question or in the fund rules. This gives them the opportunity to utilise information received after the fund is closed and that has an influence on the market".

[38] CESR defines market timing as a practice whereby "investors place trades (subscription or redemption orders) for unit prices determined with stale prices of the funds assets which do not fully reflect recent market movements. Inefficiencies in investment fund pricing are exploited by the practise of short term buying and selling of investment fund units. Market timers can use the information about market movements which are not reflected in the previous unit price to predict the movement of the following day's price to advantageously buy or sell units".

[39] Referred to in the AMF 2003 Annual Report

The reform of Chapter VI of the instruction of 15 December 1998, set in train in 2004, will be based on the European recommendation on the use of derivative financial instruments.

The Commission announced that it expected news of the initial results of this initiative by end-February 2005 and that, in the light of these submissions and to the extent necessary, it might introduce other measures aimed at strengthening European standards.

# III – THE WORK OF THE IOSCO TECHNICAL COMMITTEE

IOSCO has a total of more than 190 ordinary and affiliate members. It operates several committees, including the Technical Committee, which is responsible for studying the world's developed and sophisticated financial markets.

## A – Financial and accounting disclosure

Standing Committee No 1 on Multinational Disclosure, Accounting and Auditing (SC1) is the specialised working group charged by the IOSCO Technical Committee with issues relating to financial disclosure by securities issuers. Its main task consists in promoting high-quality financial reporting standards to protect investors and safeguard the integrity and transparency of financial markets. SC1 is mainly active in monitoring and developing international accounting and auditing standards and implementing efficient supervisory mechanisms. It also has jurisdiction as regards worldwide harmonisation of rules on prospectuses.

SC1 usually meets three times a year. It has delegated the tasks of reviewing and drafting to four subcommittees:

- The work of the Accounting, Auditing and IFRS Interpretation Subcommittees and the Enforcement Subcommittee are addressed in section IV hereafter.

- The Disclosure Subcommittee was tasked in early 2004 with preparing a prospectus schedule for the issuance and/or listing of plain-vanilla debt securities issued by private companies[40]. The purpose of this schedule is to recap the minimum information required for such issues, based on the IOSCO Disclosure Standards for Cross-Border Offerings and Initial Listings of Equity Securities, published in 1998. This project is due to be completed by the end of first-quarter 2005.

## B – Regulation of secondary markets

In 2004, SC2 completed its review of two topics that had given rise to reports approved by the IOSCO Technical Committee in February and May 2004.

### 1- Report on stock repurchase programmes

Stock repurchase programmes (or "buy-backs") have been on the increase in financial markets across the world, The report identifies and assesses the main regulatory issues arising from these programmes, notably as regards the fair treatment of investors and the integrity and transparency of markets, and it examines how regulators have tackled these questions. The report concludes with a set of recommendations expressed as five high-level principles, accompanied by implementing measures intended to guide competent authorities when regulating buy-backs.

These principles cover:
- fair treatment of shareholders during stock repurchase programmes;
- supervision of the issuer as an insider and enforcement of market abuse rules on issuers implementing repurchase programmes;
- measures to ensure that repurchase programmes do not interfere with the integrity or orderly operation of markets;
- the proper use of derivatives;
- regulatory oversight of compliance with rules and requirements for repurchase programmes.

### 2 – Report on the transparency of the corporate bond market

The second aspect of SC2's work on secondary market regulation[41] results from three observations: trading methods have been developing rapidly; the levels of transparency offered by the new platforms are variable; and there is growing uncertainty about the benefits of enhanced transparency, for both fixed-income and equity markets.

[40] Issuers in specific industries such as banking, insurance and mining are required to provide additional information, which does not come within the subcommittee's remit.
[41] Transparency of primary markets does not come within the ambit of the report.

The report starts by taking stock of the corporate bond market. It observes that the structure and characteristics of corporate bonds have become increasingly complex in recent years, that private investors seem to be taking a greater interest in this market even though it is still dominated by institutions, and that most trades take place outside regulated markets on a bilateral basis.

The report also seeks to describe transparency rules for corporate bonds, given that the main factors affecting the levels of transparency are the possibility of admission to trading, the trading venue (on- or off-market), the type of participants and the size of the issue. In the past, regulators have apparently placed less importance on transparency in the bond market than in the equity market owing to the preponderance of institutional investors. However, prompted by recent developments in the market for corporate paper, together with the greater complexity of these products, the growing number of factors that influence pricing, and wider public holdings of corporate bonds, several regulators (notably Canada and the USA) have reconsidered the appropriate level of transparency for corporate bond trades – witness the development of the Trade Reporting and Compliance Engine (TRACE) by NASD.

The report concludes by encouraging regulators to improve their knowledge of their corporate bond markets, including the over-the-counter market, with emphasis on the types of bonds, trading volumes and methods, market participants, and the role played by credit ratings. Regulators need appropriate systems for gathering information and supervising the corporate bond market – including rules on best execution and investor protection – in an effort to enhance its integrity. Regarding the secondary market, regulators must assess the level of transparency needed to facilitate price discovery and enhance integrity, while giving due consideration to factors such as market size, types of participant, the possible admission to trading of corporate bonds on a regulated market, and the potential impact of greater transparency on market liquidity.

The report stresses that data consolidation can play an effective role in offsetting the fragmentation of corporate bond markets. Regulators in jurisdictions where prices and transactions are transparent but where information is not consolidated are urged to check whether there are any hurdles to data consolidation and whether they need to take action in this respect.

## C – Regulation of market intermediaries

### 1- Consultation paper on outsourcing in financial services

This document sets out seven principles applicable to investment services providers that rely on outsourcing. The consultation was conducted in parallel with the one on the same topic launched by the Joint Forum, to which IOSCO made a substantial contribution. The principles on outsourcing were amended slightly to reflect the general principles adopted by the Joint Forum for the insurance, banking and securities industries.

IOSCO, together with banking and insurance regulators, took an interest in this issue because of the growing reliance on outsourcing in financial services. Outsourcing has its advantages, especially by generating economies of scale and fostering competition in the market. But it also poses problems, both for outsourcing firms and for regulatory authorities. Firms must not lose control of their business, while regulators should be able at all times to monitor outsourced activities. For this reason, the regulators established the principle that outsourcing firms remain liable for the activities they subcontract.

IOSCO addressed the main problems raised by outsourcing and proposed the following guidelines:

#### a) Materiality of outsourcing

The outsourcing principles should be applied according to the materiality of the outsourced activity relative to the usual business activity of the outsourcing firm and to its regulatory obligations. Nevertheless, firms should consider the appropriateness of applying these principles, even in cases where the activity is not especially material.

For areas of business activity with no regulatory restrictions on outsourcing, firms should develop procedures for determining the materiality of their outsourcing arrangements. Since it is often difficult to distinguish between material and non-material activities, IOSCO proposes a number of factors that should be taken into consideration. These include (but are not confined to) the financial and operational impact on the outsourcing firm if the service provider (i.e. the subcontractor) fails to perform, the potential losses to the outsourcing firm's customers in the event of such non-performance, the cost of outsourcing, and the affiliation or other relationship between the outsourcing firm and the service provider.

#### b) Accountability of outsourcing firms

The principle is that the outsourcing firm and its managers retain full liability and accountability to the regulatory authority for all outsourced activities, to the same extent as if the services were provided directly.

Accordingly, the management of the outsourcing firm should develop and implement appropriate policies to satisfy the outsourcing principles, review their effectiveness, and address any risks in an effective and timely manner.

Whatever the level of outsourcing, the firm remains responsible for conducting due diligence.

Outsourcing firms must always be able to ensure that they are complying with all regulatory requirements. Moreover, outsourcing must not impair the ability of the regulator to perform its supervisory duties. It will pay particular attention to the outsourcing of activities to unlicensed entities.

### c) Outsourcing to affiliates

The IOSCO principles apply regardless of whether a firm subcontracts to an internal service provider (i.e. an affiliate) or to a provider that is external to its corporate group. However, to address the special relationship that exists between an outsourcing firm and its affiliate, the principles may be applied to those affiliates, with some modifications.

### d) Outsourcing on a cross-border basis

On this point, too, the principles make no distinction between whether the firm uses a service provider in the same jurisdiction or one based abroad. However, problems may arise as a result of a cross-border relationship notably because of distance and differences in operating environments. These factors must be taken into account when conducting due diligence or entering into an agreement with a foreign service provider.

### 2) Draft principles or recommendations for monitoring rule enforcement, having regard to the work done by other international bodies (CESR, Basel Committee)

SC3 has addressed a number of issues, which should result in the publication of principles. The main issues are as follows:

- the principle that market intermediaries should establish a compliance function to identify, measure, advise on, monitor and report on compliance with prevailing regulations;

- the role and responsibilities of senior management and boards of directors in ensuring observance of the compliance policy and reporting to the board of directors;

- the role and responsibilities of the compliance officer;

- the independence of the compliance function;

- the skills, experience, professional abilities, fitness and properness of staff with compliance responsibilities;

- disclosure to regulators in the event of a material breach of law or regulations by a market intermediary;

- assessment by market intermediaries of the effectiveness of the function, and periodic reviews by third parties such as auditors, self-regulatory organisations and regulators;

- regulatory and legal compliance by the intermediary's affiliates.

## D – Cooperation and exchange of information

In 2004, the AMF continued to play an active part in the work of IOSCO's Standing Committee on Enforcement and Exchange of Information (SC4). Chaired by the COB for fifteen years, SC4 has been headed by the UK Financial Services Authority since November 2003. It deals mainly with issues relating to market abuse and other types of securities fraud, as well as investigations, cooperation and international exchange of information between securities regulators.

Among the many topics discussed at the three meetings held in 2004, six are especially noteworthy:

- Exchanges of information with offshore jurisdictions, chiefly during inspections and investigations. Since these jurisdictions have now been identified, it has been possible to initiate discussions with them and alert them to the need to comply with minimum cooperation standards.

- New trends in market misconduct. At each meeting, SC4 examined new types of violations that had come to light in different countries, in order to alert other participants. This initiative will be repeated at each subsequent meeting.

- Asset freezes and funds transfers. SC4 began to address this issue in 2004, with a view to submitting a report to the Technical Committee in 2005. The project consists in comparing the powers of securities regulators seeking to freeze the assets of persons under investigation, studying ways of assisting foreign authorities in this regard, and looking at possibilities for transferring frozen funds from one country to another in case of an international investigation. As a result, it should be possible to determine whether legislative changes are needed;

- Issues related to the Internet. The Technical Committee asked SC4 to carry on with the work done by the Internet Project Team, which culminated in 2003 with a third report on the challenges and risks of using the Worldwide Web in the sphere of securities. Within the group, the AFM decided to lead a project aimed at determining what regulators expect of internet service providers in terms of record keeping, the possibility for regulators to request and receive recorded information, cooperation with foreign regulators, and so on. The resulting information would then be used to discuss any regulatory amendments that might be necessary;

- Matters related to money laundering, especially relations with the FATF and national agencies responsible for investigating and preventing this infringement (e.g. TRACFIN for France);

- Organising systematic transmission to other regulators of warnings issued at local level. The AMF, like most of its counterparts, regularly issues news releases to warn the public about misconduct by individuals or entities that are apparently in breach of securities regulations. This includes illegal or misleading investment proposals, investment solicitations that contravene laws or regulations, offerings of securities by companies listed on markets that are not recognised in France, and public issuance of financial products that are not recognised on regulated markets. To shield investors more effectively from the methods used by such individuals and entities, which often operate across several jurisdictions, SC4 decided to put in place, starting in 2004 and working through IOSCO, a permanent system whereby warnings previously issued in one member country would be exchanged with other countries.

## E– Customer due diligence

At the Presidents' Committee meeting on 18 May 2004,[42] IOSCO adopted vitally important principles and recommendations for identifying clients and end-beneficiaries of financial market transactions. Aimed at regulators, self-regulatory organisations and investment services providers, these principles cover the following areas:

- client identification and verification;
- beneficial owner identification;
- Know Your Client;
- record keeping;
- client identification where several firms are offering their services;
- measures to be taken if customer due diligence procedures fail;
- the role of regulators;
- international cooperation.

## F – Investment management

The AMF has chaired IOSCO's Standing Committee on Investment Management (SC5) since November 2003.

As its 2004 work programme shows, SC5 continued with efforts to establish conduct of business rules at international level. The committee produced a number of reports and put them out to public consultation prior to formal approval by IOSCO.

1- In a report titled "Elements Of International Regulatory Standards on Fees and Expenses of Investment Funds", SC5 laid down a series of common international standards for analysing expenses in collective investment schemes (CISs). Submitted for public consultation in spring 2004, the report addresses several key issues in a way very similar to that adopted by a French working group on the same topic,[43] i.e. introduction of a Total Expense Ratio (TER) that encompasses all fund expenses, calculation of the TER in the most harmonised

[42] IOSCO press release, 18 May 2004
43 "Report on fees and charges paid by investors in collectively managed schemes in France", COB monthly bulletin, October 2002, No 372.

possible manner, and dealing with fee rebates on transactions and in funds of funds. IOSCO formally approved these standards in October 2004.

2 – The report titled "Performance Presentation Standards for Collective Investment Schemes: Best Practice Standards" was formally approved by IOSCO in May 2004 following a public consultation. The report sets out standards for presenting funds' past performances in advertisements. These standards should make it possible to prepare clear, objective disclosures that do not mislead investors but allow them to make relevant comparisons between the past performances of funds in which they plan to invest. The report recommends using standardised formulas to calculate performance. Funds that choose not to do so should use the same formula or method over time.

3- The report titled "An Examination of the Regulatory Issues Arising from CIS Mergers" analyses regulatory approaches to mergers of CISs. Although these approaches vary – an issue analysed in the second part of the document – the report endeavours to establish common principles and standards. It recommends formal regulatory approval, particularly in contractual funds where unitholders are unable to express their opinion by voting. The information disclosed to unitholders should enable them to properly assess the reasons behind a merger and to understand its impact, especially on management fees. Investors who disagree with the terms and conditions of a merger should be allowed to redeem their units free of charge.

4- The report titled "Index Funds and the Use of Indices by the Asset Management Industry" describes recent developments in the market for index funds and the regulatory problems posed by these products. It should be noted that the AMF's work on the regulation of index funds has been clearly based on the categories[44] established by SC5.

5- The report titled "Best Practices Standards on Anti-Market Timing and Associated Issues" was published in February 2005 and put out to public consultation. Begun in March 2004, the document provides accepted definitions of late trading and market timing, and describes how these practices can be detrimental to investors. After recalling the general principle that a fund must be managed in the sole interest of all its unitholders, the report sets out recommendations aimed at all parties involved in managing, supervising and distributing funds. It also addresses the issues of portfolio valuation, agreements with distributors, compliance programmes, the duties of external auditors, and disclosure.

6- The report titled "Examination of Governance for Collective Investment Schemes" was published in February 2005 and was also put out to public consultation. It describes the different ways in which CISs are organised (i.e. according to a contractual model or as a "company"[45]). It goes on to say that, whatever the legal structure or jurisdiction, there is always an independent entity, such as a board of directors, trustee or depositary, which ensures that the scheme operates for the sole benefit of its investors. Therefore, while the responsibilities of this entity may vary from one jurisdiction to another, there is a common principle whereby controls must be carried out by an independent body, which deals with conflicts of interests, ensures that managers always act fairly and in accordance with rules, and makes certain that the fund is managed in the best interests of unitholders. The report also describes how jurisdictions such as Australia and Canada have devised innovative solutions in these areas (e.g. establishing an ad hoc independent committee) in order to provide an institutional counterweight and allow investors to monitor fund managers on a more regular basis. France has taken some initiatives, particularly in the spheres of payroll savings plans and life insurance. In a second document, to be drafted in second-half 2005, SC5 intends to establish a set of common principles that will be illustrated by best practices and provide inspiration for different jurisdictions. This contribution could be useful in anticipating forthcoming European discussions on CIS governance.

7- Published in 2005, the report titled "Anti Money Laundering, Guidance for Collective Investment Schemes" provides CISs with regulatory standards for preventing money laundering. It builds on the Forty Recommendations of the FATF, published in June 2003, and on a project conducted by SC4.

At an SC5 meeting in November 2004, the UK Financial Services Authority presented its "risk based approach", a methodology for identifying, assessing and ranking[46] the risks faced by regulators. In all likelihood, this methodology will serve as a basis for the work carried out by SC5 in the medium term. The committee will make even greater efforts to identify at an early stage the major trends shaping the investment management market before it sets itself any new mandates.

[44] The distinctions made by the AMF in its regulations are as follows: CISs replicating the performance of an index, CISs using enhanced index management and closely linked to an index, CISs managed actively on the basis of an index, CISs where performance is not linked to an index but where index performance is used for ex post assessment

[45] In France, a *fonds commun de placement* (FCP) or a *société d'investissement à capital variable* (SICAV).

[46] Risks are ranked primarily according to impact and likelihood of occurrence.

# IV – ACCOUNTING STANDARDISATION

Since the formation of the International Accounting Standards Board (IASB)[47] in 2000 and the decision by the European Union in 2002 to adopt the IASB's standards for its publicly traded companies, work on international accounting issues has been marked by greater efforts to achieve closer convergence between accounting standards, notably between IAS / IFRS[48] and US GAAP.[49] It has also revealed the need for a comprehensive and consistent set of international standards covering all material aspects of large companies' operations. It was this second factor that prompted the IASB to make a public commitment to publish a number of standards by 31 March 2004 at the latest in order to create what is commonly called the Stable Platform 2005.

## A – New IFRS

The IASB published a number of standards, some amended, others entirely new, at the end of 2003 and beginning of 2004. These are reviewed in brief below.

### 1 – IFRS 2: Share-based payment

The IASB published its second standard[50] in February 2004. IFRS 2 requires the expensing of all payments made in shares or based on the changing value of shares, except for transactions with the company's shareholders. These payments must be accounted for at fair value, depending on how the transaction will be settled (equity, cash, choice of equity or cash). The standard pertains to all equity-settled share-based payments granted after 7 November 2002 and takes effect on 1 January 2005, with the possibility of earlier application.

### 2 – IFRS 3: Business combinations (Phase I)

Like some of the other new or amended standards, the IASB's third standard was issued on 31 March 2004. IFRS 3 requires that business combinations be accounted for by the purchase method. The standard makes several other key modifications to existing accounting practice:

- A larger number of intangible assets and contingent liabilities are recognised at the acquisition date.

- Goodwill can no longer be amortised. Instead, it is tested for impairment annually and whenever indicators suggest that impairment may have occurred.

- Negative goodwill is now recognised immediately in the income statement (i.e. potential "bargain purchases" identified once all assets and liabilities have been measured at fair value).

- Much stricter rules apply to the possibility of recognising restructuring provisions in the accounts of the acquired entity.

IFRS 3 applies to business combinations agreed to after 31 March 2004.

### 3 – IFRS 4: Insurance contracts (Phase I)

Also published in March 2004, this new standard amends IAS 39 as regards insurance contracts and financial guarantee contracts. IFRS 4 temporarily exempts concerned companies from applying some of the requirements contained in other standards or provided for in connection with IAS/IFRS. It allows them to maintain their existing practices, pending publication by the IASB of a comprehensive standard on insurance contracts in Phase II, currently underway. IFRS 4 does, however, introduce the following requirements:

- provisions for claims under contracts or liabilities not in existence at the reporting date cannot be recognised (this rule is aimed at catastrophe and equalisation provisions);

- recognised insurance provisions must be tested for adequacy, and reinsurance provisions must be tested for impairment;

- provisions must be kept in the balance sheet until they are discharged or cancelled and cannot be presented net of the corresponding reinsurance assets.

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[47] Formerly the International Accounting Standards Committee (IASC)
[48] The IASB standards comprise International Financial Reporting Standards (IFRS), adopted by the IASB, and International Accounting Standards (IAS), formerly adopted by the IASC and amended, where appropriate, by the IASB.
[49] Generally Accepted Accounting Practises, applicable to US companies
[50] IFRS 1 was presented on pp 51-52 of the AMF 2003 Annual Report.

This new standard comes into effect on 1 January 2005.

## 4- IFRS 5: Non-current assets held for sale and discontinued operations

IFRS 5 was published in March 2004 and also comes into effect on 1 January 2005. It replaces IAS 35 while incorporating some of its concepts, such as the definition of discontinued operations. This new standard will permit substantial convergence with its US equivalent, SFAS144[51], which serves as the basis both for establishing the timeline for identification of discontinued operations (which in turn determines the change in accounting classification) and for presenting these assets or operations in profit or loss.

## 5 – IFRS 6: Exploration for and evaluation of mineral resources (Phase I)

In September 2002, the IASB recognised that it would be unable to complete work on a comprehensive standard on exploration for and evaluation of mineral resources in time for the Stable Platform 2005. It therefore decided to produce a transitional standard in order to avoid uncertainty about the consistency of the accounting treatment used by IFRS adopters.

Published in December 2004, IFRS 6 allows companies operating in the extractive industries to continue using the accounting policies they applied prior to adopting IFRS. These companies should initially account for exploration and evaluation expenses at cost; for subsequent valuations, they can elect to adopt the revaluation model provided for in IAS 16 and IAS 38. Method changes are permitted only if the information they provide is more relevant and at least as reliable as that available under the previous method. Impairment tests must be carried out whenever impairment indicators are present. These indicators are specific to the exploration for and evaluation of mineral resources.

## 6 – Amendments to existing standards

These amendments concern:

- IAS 19[52], relating to the possibility of recognising actuarial gains and losses immediately in equity and to the treatment of multi-employer benefit plans in groups of companies.

- IAS 39,[53] relating to the first-time application of the standard and initial recognition at fair value. This amendment facilitates the transition by, among other things, providing relief from retrospective application of the "day 1 profit" rule and by allowing companies to apply provisions that limit differences with US GAAP.

## 7 – Ongoing work

Although the Stable Platform 2005 was completed on time, certain standards, including some of the most recent ones, will be either amended or replaced. Major developments and amendments to existing standards are planned as from 2005.

| | **Q1 2005** | **Subsequent date** |
|---|---|---|
| Cash flow hedges of forecast intragroup transactions – amendment to IAS 39 | Standard amended | |
| Financial guarantee contracts and credit insurance – amendment to IAS 39 | | Standard amended |
| Financial instruments – disclosures – withdrawal of IAS 30 and revision of IAS 32 | | Standard amended |
| Business combinations – Phase II: application of the purchase method | ED[54] | |
| Consolidation – Special purpose entities – replacement of IAS 27 and SIC-12 | | ED |
| Government grants – replacement of IAS 20 and convergence with US GAAP | ED | |
| Financial instruments puttable at fair value – amendment to | | |

[51] Accounting for the Impairment or Disposal of Long-Lived Assets
[52] Published in December 2004.
[53] Published in December 2004.
[54] Exposure Draft

| | | |
|---|---|---|
| IAS 32 | | ED |
| Financial instruments – fair value option | Standard | |
| Insurance contracts – Phase II – replacement of IFRS 4 | | n/a[55] |
| Interests in joint ventures – two-phase project, including the removal of options from IAS 31 | | n/a |
| Performance presentation | | n/a |
| Revenue recognition: concept, liabilities and equity – joint project with FASB aimed at eliminating practical inconsistencies | | n/a |
| IFRS-US GAAP convergence – amendment to IAS12 | | ED |
| IFRS-US GAAP convergence – amendment to IAS 37 | ED | |
| Small and medium size entities | | ED |

Source: AMF

Furthermore, the IASB and the US Financial Accounting Standards Board (FASB) confirmed in April 2004 their intention to develop a common conceptual framework. The timetable for this project has not yet been established.

## B - IFRIC interpretations

The International Financial Reporting Interpretation Committee (IFRIC) is responsible for interpreting IASB standards. IFRIC published five new interpretations in 2004.

### 1 – IFRIC 1: Changes in Existing Decommissioning, Restoration and Similar Liabilities

IFRIC published its first interpretation in May 2004. IFRIC 1 pertains to the accounting treatment of changes in the value of liabilities for decommissioning, restoration and similar operations that gave rise initially (i.e. when the asset was acquired) to recognition of a tangible asset (IAS 16) and a liability, pursuant to IAS 37.

Under IAS 37, the amount recognised as a provision for the obligation should be the best estimate of the expenditure required to settle it at the balance sheet date. This future cost is measured at present value, and IFRIC 1 confirms that it should be discounted at a market-based rate.

Two factors that can cause the liability to change in value are treated in the same way: changes in future cash flows (due to a change in costs or schedules, for example), and revisions to the discount rate. IFRIC 1 analyses both these cases in detail. A third reason for a change in value, the passage of time (the unwinding of the discount), is simply confirmed. IFRIC 1 states that such changes are recognised as a financing cost as they occur.

However, the impact of value changes is reflected differently, depending on whether the asset in question is recognised according to the cost model or the revaluation model.

#### a) Cost model

Changes in estimates relating to the liability will alter the carrying amount of the asset during the financial year.

However, the carrying amount of this asset may not be less than zero. In consequence, if the decrease exceeds the carrying amount, the excess must be recognised immediately in profit or loss.

Any increase in the cost of an asset as a result of an increase of the amount of the liability leads to consideration of whether the carrying amount of that asset is still justified by future cash flows. If applicable, an impairment test is performed in accordance with IAS 36.

#### b) Revaluation model

In the revaluation model, a change in the liability does not result in a change in the carrying amount of the asset.

An increase in the amount of the liability will normally result in an expense being recognised in profit or loss, except when a revaluation surplus in respect of the related asset had previously been recognised in equity. In this

[55] n/a: not available – timetable not yet established

case, the negative impact of the change in the liability must be set first against the revaluation surplus in equity, up to the amount of the surplus, and any balance must be recognised as an expense in profit or loss.

Likewise, any reduction in the liability will normally result in an increase in the revaluation surplus in equity, unless changes in the carrying amount of the related asset had previously been recognised in profit or loss. In this case, the positive impact of this decrease in the liability is first recognised as income in profit or loss, up to the amount of the previously recognised losses, and any balance is recognised in the revaluation surplus.

If the decrease in the amount of the liability is greater than the carrying amount of the asset (after depreciation) that would have been recognised under the cost model, the excess must be recognised immediately in profit or loss.

A change in the amount of a liability is an indication that the asset should also be revalued at the balance sheet date. If such a revaluation is carried out, it must relate to all the assets of the same class.

## 2- IFRIC 2: Members' Shares in Cooperative Entities and Similar Instruments

Published in November 2004, IFRIC's second interpretation responds to a widespread need in Europe, where cooperative entities issue securities on regulated markets.

This is significant insofar as members' shares in such entities have some characteristics of equity, while also giving holders the right to redeem their investment in cash. Redemption may be subject to certain conditions.

IFRIC 2 confirms that, where the holder has a right to request redemption, the securities issued generally qualify as financial liabilities. However, the interpretation sets out some of the conditions in which these instruments are considered as equity, not liabilities. These conditions are satisfied if:

- the entity has the unconditional right to refuse redemption of members' shares, or

- if redemption of members' shares is prohibited by law, regulations or the entity's charter. Such prohibitions may be partial, in which case a portion of the shares (those not subject to the ban) will qualify as financial liabilities.

## 3- IFRIC 3: Emission rights

IFRIC 3 was published in December 2004. It stipulates that emission rights obtained from a regulator or purchased are intangible assets that must be recognised at fair value where this exceeds cost. Subsequently, if the residual value of these rights, calculated with reference to an active market, is higher than the amount paid, the intangible asset is not amortised. Where no active market exists, the residual value is deemed to be zero and the asset must be amortised. Impairment tests must be carried out whenever impairment indicators are present.

Where emission rights are issued for less than their fair value, the difference is a government grant that must be recognised as income on a systematic basis throughout the compliance period. This policy must be applied regardless of how the tangible asset is used (consumed or sold).

Pollutant emissions create a liability that will be reflected in future depletion (market purchases or consumption of rights included in assets). This liability must be measured according to the market value of the corresponding rights and not the value of the rights included in assets.

This interpretation becomes mandatory on 1 March 2005, but earlier application is encouraged.

## 4- IFRIC 4: Determining Whether an Arrangement Contains a Lease

Also published in December 2004, this interpretation responds to the recent emergence of contracts that are not designated as leases but that nonetheless convey the right to use a specific asset for a given period of time in return for one or more payments. Such arrangements include services outsourcing, the right to use data transmission capacity over a telephone system, and so on.

These arrangements contain a lease if they meet the following criteria:

- fulfilment of the arrangement depends on a specific asset (even if the asset is not formally identified in the arrangement);

- the arrangement conveys the right to use the asset, i.e. to control most of its output.

These arrangements must be analysed when they are put in place. They are revalued only if key provisions of the initial contract are changed, e.g. an amendment to its terms and conditions, a material change in the specific asset, or the exercise of a right of extension.

Where the analysis shows that the arrangement is or contains a lease, the contract must be accounted for under IAS 17, meaning that lease-related payments must be distinguished from other payments. If this distinction cannot be made, there are two alternatives: an asset and a financial liability, both measured at the asset's fair value, must be recognised in the case of an operating lease; while under an operating lease, all payments must be treated as rent.

IFRIC 4 may be applied to the first set of IFRS-compliant comparative financial statements.

## 5 – IFRIC 5: Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds

IFRIC 5 relates to the rights arising from the financing of restoration or rehabilitation obligations where the following conditions are fulfilled:

- hedging assets are administered separately from liabilities (i.e. they are ring-fenced in a separate legal structure or "fund");

- there are restrictions on the contributing entity's rights of access to the financing assets.

Except where the contributor incurs no obligation if the fund defaults, the hedging assets must be accounted for separately from the liability arising from rehabilitation obligations. The entity must assess its degree of control over the hedging assets and then apply IAS 27, IAS 28, IAS 31 and interpretation SIC-12 accordingly. Even where the contributor does not have control, joint control or significant influence, an asset must be recognised in the balance sheet. It should be measured at the lower of the amount of the rehabilitation obligation and the contributor's share of the net assets of the fund. Changes in the value of this asset are recognised in profit or loss.

In some cases, additional contributions may be required at a future date. As long as such future increases are unlikely, they are simply a contingent obligation. Accordingly, no additional liabilities need be recognised in the balance sheet but the appropriate disclosures must be made in the notes to the financial statements.

## 6- Amendment to SIC-12: Consolidation – Special Purpose Entities

In November 2004, IFRIC amended the scope of Interpretation SIC-12, which relates to special purpose entities. Initially, this interpretation did not apply to employee benefit programmes covered by IAS 19.

With effect from 1 January 2005, programmes that include a reference to share-based compensation come within the scope of IFRS 2. The amendment to SIC-12 means that they will no longer be excluded from this interpretation.

This amendment also specifies that long-term employee benefit programmes are not included in the scope of SIC-12.

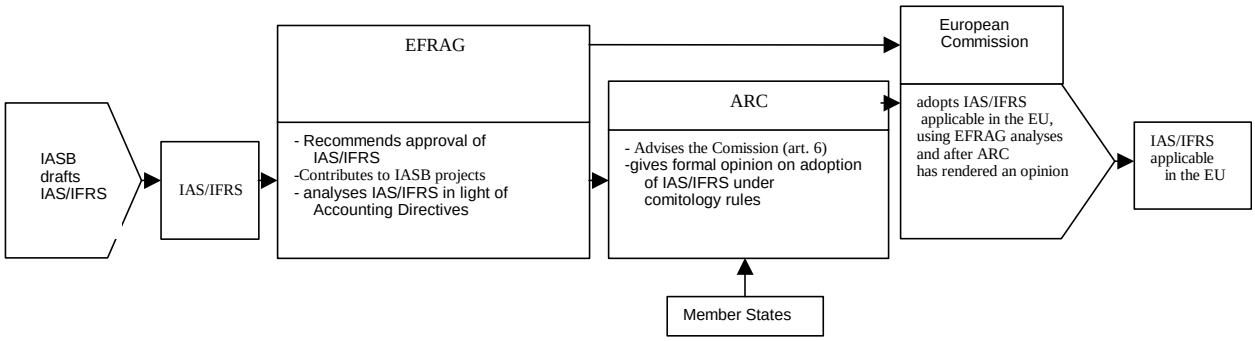
### 7 – Forthcoming work

IFRIC plans to issue draft or final interpretations on the following topics in 2005:

| | Scheduled publication date |
|---|---|
| IFRIC 6 – Applying IAS 29 Financial Reporting in Hyperinflationary Economies for the First Time | Q2 |
| IFRIC 7 – Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions | Q1 |
| D12 – Service Concession Arrangements – Determining the Accounting Model | February 2005 |
| D13 – Service Concession Arrangements – The Financial Asset Model | February 2005 |
| D14 – Service Concession Arrangements – The Intangible Asset Model | February 2005 |
| Additions to D13 and D14 – Examples | February 2005 |
| D15 – Scope of IFRS 2 | Q1 |
| D16 – Group and Treasury Share Transactions | Q1 |
| D17 – Sales and Leasebacks with Repurchase Agreements | Q2 |
| IFRIC 8 – Service Concession Arrangements – Determining the Accounting Model | H2 |
| IFRIC 9 – Service Concession Arrangements – The Financial Asset Model | H2 |
| IFRIC 10 – Service Concession Arrangements – The Intangible Asset Model | H2 |
| IFRIC 11 – Changes in Contributions to Employee Share Purchase Plans | H2 |
| IFRIC 12 – Scope of IFRS 2 | H2 |
| IFRIC 13 – Group and Treasury Share Transactions | H2 |
| IFRIC 14 – Sales and Leasebacks with Repurchase Agreements | Q4 |

## C – Status of IFRS approved by the European Commission

**Approval procedure for IAS/IFRS**




A major step forward was made in 2002 and 2003 with the publication of Regulation (EC) No 1606/2002, which established the principle that listed companies in the European Union should adopt IFRS for their consolidated financial statements[56]. At that time, however, the IASB had not produced all the standards that were due to be included in the Stable Platform 2005. It caught up with its schedule at end-2003 and early 2004, publishing five new standards and amending fourteen existing ones. At European level, each standard (and each interpretation) is then submitted to the European Financial Reporting Advisory Group (EFRAG) for its opinion on the technical aspects and to the Accounting Regulatory Committee (ARC) for an endorsement authorisation at political level. ARC represents the views of Member States .

In 2004, ARC took decisions both on the IASB's amendments to IAS 1 to 41 and on the new standards, IFRS 1 to 5.

ARC unanimously adopted IFRS 1, on first application of IFRS, at its meeting on 3 February 2004.

[56] The majority of IAS were adopted between 2002 and 2003 (Regulation (EC) No 1725/2003), with the exception of IAS 32 and IAS 39 on financial instruments and the associated interpretations (SIC5, 16 and 17).

After intense discussions[57] at its meeting on 1 October 2004, ARC partially approved the amended version of IAS 39 on the accounting treatment of financial instruments. Two provisions have been carved out:

- use of the fair value option for liabilities (a practice that is contrary to Article 42 of the 4th EU Directive);

- the paragraphs on hedge accounting that restricted the recognition of demand deposits.

Nevertheless, Article 2 of Regulation (EC) No 1725/2003, amended, which confirms ARC's partial approval, states that these issues must be revisited at the earliest possible opportunity and by 31 December 2005 at the latest. ARC members called for an amendment relating to the fair value option by April 2005 and one on portfolio hedging before the end of 2005.

ARC unanimously adopted the following standards, amendments and interpretations at its meeting on 30 November 2004:

- amendments to IAS 1, 2, 8, 10, 15, 16, 17, 21, 24, 27, 28, 31, 33 and 40, and to the corresponding SIC interpretations; [58]

- new standards IFRS 3, 4 and 5, and the amended versions of IAS 36 and 38;

- IAS 32 on disclosure and presentation of financial instruments, and interpretation IFRIC 1[59].

At the last meeting of the year, on 20 December 2004, ARC voted by a substantial majority in favour of IFRS 2 on share-based payment, several hours after the USA published FAS123R, which introduces a similar accounting treatment for stock options.

ARC has yet to approve the most recent interpretations (IFRIC 3 to 5) and IFRS 6, which does not become mandatory until 1 January 2006. IFRIC 2 is due to be approved in first-half 2005.

## D - International and European cooperation on accounting matters

### 1- IOSCO Standing Committee 1

In 2004, Standing Committee No 1 (SC1) of the International Organisation of Securities Commissions (IOSCO) devoted much of its attention to examining the plan to reform the IASC Foundation, initiated by that body's trustees[60]. It also continued promoting high-quality accounting standards through its responses to IASB exposure drafts, its active role as IFRIC observer,[61] and representation on the Standards Advisory Council (SAC)[62].

### 2 – CESR-Fin

CESR-Fin is a permanent committee of the Committee of European Securities Regulators (CESR) active in the area of financial reporting. Chaired by John Tiner, Chief Executive of the UK Financial Services Authority, its main role is to assist with the introduction of IFRS in Europe. It has established two sub-committees for this purpose: the Sub-Committee on International Standards Endorsement (SISE) and the Sub-Committee on Enforcement (SCE). SISE is chaired by Paul Koster, a member of the executive board of the Netherlands' Authority for Financial Markets, and is responsible for assessing the quality of IFRS from a regulatory standpoint. SCE, headed by Lars Østergaard, director of accounting affairs at the Danish financial supervisory authority, is in charge of promoting harmonised enforcement of these standards in Europe. CESR-Fin has also set up an Audit Task Force to deal with audit-related developments [63].

#### a) SISE

In 2004, SISE concentrated on the mandate issued by the European Commission to CESR regarding the equivalence between IFRS and the generally accepted accounting practices of certain third countries. The mandate was promoted by Directive 2003/71 on prospectuses and Directive 2004/109/EC on the harmonisation of transparency requirements for issuers. Both directives provide that issuers registered in a country outside the European Union are exempt from the requirement to publish financial statements under IFRS, provided the GAAP

[57] Three member states (representing 15 votes) abstained and four others (17 votes) voted against the endorsement proposal. Despite this, the proposal was adopted with a qualified majority of 92 votes.
[58] Standard Interpretation Committee, former name of the IAS interpretation body
[59] International Financial Reporting Interpretation Committee

[60] The trustees are the governing body of the IASC Foundation, under Article 3 of its constitution.
[61] IOSCO has two observer seats at IFRIC, one of which is held by the AMF.
[62] IOSCO has four seats on the SAC, one of which is held by the AMF.
[63] See E3 below

in force in that country are deemed equivalent to the IASB's standards. The choice of third countries concerned by the initial examination (USA, Canada, Japan) was dictated by the large number of issuers incorporated in those jurisdictions and listed on a European Union market. CESR must issue its technical advice to the European Commission by 30 June 2005 at the latest.

Based on SISE's work, CESR published a concept paper on 21 October 2004 and put it out to public consultation until 22 December 2004. The main topics addressed in the paper are:

- a definition of equivalence and a review of the goals in terms of investor benefit: understandability, relevance, reliability and comparability;

- a technical method for assessing foreign GAAP, based on identifying material differences;

- possible remedies in the event of non-equivalence (additional information, reconciliation and / or restatement);

- introduction of an early warning mechanism to monitor developments in considered GAAP.

The evaluation phase for US, Canadian and Japanese GAAP will take place in 2005.

b) SCE

In 2004, SCE continued with efforts to ensure that European regulators adopt a harmonised approach to IFRS enforcement. It concentrated in particular on devising a mechanism for close and effective coordination among all entities responsible for enforcement in Europe, such as securities regulators and financial review panels. The aim of this mechanism is two-fold: to ensure high-quality enforcement of international accounting practices and to make certain that individual decisions taken by EU Member States do not result in the promulgation of multiple sets of accounting standards.

To that end, SCE drew up Standard No 2: Financial Information – Co-ordination of Enforcement Activities, which lays the foundations for this coordination. Published by CESR in 22 April 2004, this standard establishes the following principles:

- when an entity responsible for enforcement of national GAAP takes a decision concerning an issuer, it must consider previous decisions taken by its European counterparts and discuss the matter with them, operational constraints permitting;

- decisions are entered into a Europe-wide central database;

- decisions that could have an impact on harmonised enforcement of IFRS in Europe will be discussed at special meetings known as European Enforcers Coordination Sessions (EECS), organised by SCE and comprising all the abovementioned entities.

Standard No 2 was implemented in 2004, giving rise to a set of guidelines, [64] which were submitted for consultation, as well as the first EECS, held in January 2005. The data base is due to go live in April 2005, just a few months after the changeover to IFRS on 1 January 2005.

One of the key tasks facing SCE in the coming months will be to draw a demarcation line, via its coordination activities, between issues relating to enforcement and those involving IFRS interpretations, for which IFRIC has sole jurisdiction.

SCE also contributed to the concept paper on foreign GAAP equivalence. It provided the description of the mechanisms put in place by non-EU countries for public supervision of standards enforcement. SCE suggested that the European Commission should describe these mechanisms on the basis of CESR Standard No 1: Financial Information – Enforcement of Standards on Financial Information in Europe.

## E - Harmonisation of international rules on auditors

### 1- IOSCO working group

In 2004, IOSCO's Standing Committee No 1 (SC1) pursued its effort to promote high-quality standards for auditing and auditor independence. This consisted, inter alia, in:

[64] "Guidelines for Implementation of Co-ordination of Enforcement of Financial Information"

- preparing a questionnaire[65] on the mechanisms used by member-countries of the Technical Committee and the Emerging Markets Committee to oversee their audit industry. The findings of this survey will be released in spring 2005, making it possible to measure the extent to which these systems have evolved since 2002, when IOSCO first published its recommendations on the independence and public oversight of auditors[66];

- preparing a response to the project organised by the International Auditing and Assurance Standards Board (IAASB) to clarify audit standards. The aim of this keynote project is to achieve a clear-cut distinction in audit standards between "requirements", which are mandatory, and "presumptive requirements", from which an auditor may depart if it implements alternative procedures that, in its view, will reach the same standard. SC1 expressed support for the project, with the proviso that IAASB limits the use of presumptive requirements and does not call into question the aim of protecting the public interest, which applies when auditing the financial statements of any publicly listed company;

- addressing the issue of the concentration of audit firms at world level and its potential impact on audit quality. Although there is no immediate threat, the current situation, in which four firms occupy an oligopoly, must be monitored closely.

SC1 plans to continue its activities in the field of auditing in 2005. It will take part in the IAASB's Consultative Advisory Groups and the IFAC Ethics Committee, maintain regular contacts with IAASB members, and continue to work on that organisation's standards. It will also work on the mandates its has received from the Technical Committee in connection with the publication of the report of the post-Parmalat task force.

## 2 – Reform of IFAC and the Monitoring Group

The Monitoring Group of Regulators, composed of leading representatives from the world's financial regulation community [67] and coordinated by the chairman of the AMF, as vice chairman of the IOSCO Technical Committee, pursued its discussions with IFAC with a view to implementing the Public Interest Oversight Board (PIOB). The formation of this body was enshrined in the IFAC's articles in 2003. The PIOB has ten members: seven are appointed by the Monitoring Group and two are supposed to be chosen by the European Commission. Its remit is to oversee the procedures of all IFAC committees (auditing, ethics, educational) that involve the public interest. In 2004, the chairman of the AMF was responsible for coordinating the positions of Monitoring Group members.

The PIOB was formally established in Paris on 28 February 2005. However, the question of representation on the board has still not been settled.

## 3 – Proposal to modernise the 8th Directive – CESR-Fin creates an Audit Task Force

The European Commission issued its proposal to amend the 8th Company Law Directive on auditing on 16 March 2004. The aim of this highly significant project is to ensure that the system used to audit European listed companies is on a level equivalent to that resulting from the Sarbanes-Oxley Act in the USA. The main principles of this proposal are to:

- lay down ethical principles to guarantee objectivity and independence, for example where an audit firm provides its customers with services in addition to auditing. The Commission's proposals in this regard stem from a free-market system predicated on "risks to independence" and "safeguards", which is less stringent than the system in force in France under the Financial Security Act;

- impose strict public oversight of the audit industry and encourage cooperation at European and international levels;

- introduce a system of external quality-assurance reviews for audit firms;

- require the use of international standards for all audit engagements in the European Union.

The proposal also contains a special section on the auditing of public interest entities, a category that includes listed companies. These special provisions provide that:

- auditors must publish a report on the transparency of their organisation;

[65] "IOSCO Auditor Oversight Survey"

[66] "Principles for Auditor Oversight, Statement of the Technical Committee of IOSCO; Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence, Statements of the Technical Committee of IOSCO, October 2002"

[67] International Association of Insurance Supervisors (IAIS), Word Bank, Basel Committee, FSF, IOSCO

- the governance body of the audited entity must set up an audit committee including at least one independent member and having authority in accounting and / or auditing matters. The audit committee should have special powers to choose an audit firm and verify its independence;

- key audit partners must be rotated;

- external quality review cycles are shortened to three years.

The European Council discussed the proposal and expressed its political agreement on a text amended by Member States at the end of 2003. The proposal is now before the European Parliament and should culminate in a directive in 2005.

To provide support for the drive towards modernisation in the EU audit industry, CESR-Fin created a new permanent sub-committee, the Audit Task Force (ATF), which is responsible for all audit-related issues. Chaired by the AMF, the ATF began work in 2004, and in spring 2005 will submit its work programme for the next three years to CESR-Fin. Among other things, it will ensure that European regulators are represented in the comitology process envisaged by the European Commission.

# V – THE AMF AND INTERNATIONAL COOPERATION

## A– Bilateral cooperation

In the realm of international cooperation, the AMF has constantly endeavoured to forge closer links with its sister regulators. Continuing with the bilateral meetings organised by its predecessors, the COB and the CMF, it played host to more than twenty delegations in 2004. These meetings provided an opportunity to exchange views and practical experiences in a wide range of areas related to financial regulation and vocational training.

In its time, the COB signed 35 cooperation agreements with its foreign counterparts to organise matters such as the exchange of information, the conduct of investigations, and technical cooperation. The AMF is pursuing its predecessor's international commitments, in accordance with the Financial Security Act of 1 August 2003. These bilateral relations have been strengthened by two multilateral memorandums of understanding between members of CESR, with 27 signatories, and IOSCO, with 22.

Also in 2004, the AMF continued to cooperate with other regulators on market investigations and supervision and on exchanges of information on financial intermediaries. It opened 32 investigations at the request of foreign authorities, mainly concerning transactions by French-based intermediaries in foreign listed securities.

## B- The French-speaking community: Institut Francophone de la Régulation Financière (IFREFI)

### 1- Chairmen's Meeting and training seminar initiated by the Swiss regulator

The Institut Francophone de la Régulation Financière (IFREFI) comprises the regulatory authorities that use French as a working language. Initiated by the COB in 2000, the institute has been established progressively as a flexible framework for dialogue and cooperation. The founding charter was signed in 2002, and since then the institute has organised its meetings around two central events.

The Chairmen's Meeting provides the opportunity for a high-level exchange of views on recent developments in financial regulation and allows the participants to give in-depth consideration to one topic of mutual interest every year. The 2004 meeting, held in Mont Pèlerin, Switzerland, at the invitation of that country's regulator, the CFB, focused on international standards for financial regulation. It examined the preparation and aims of these standards as well as the implementation assessments organised by the International Monetary Fund, the World Bank and IOSCO. The meeting was attended by 18 delegates representing 25 countries and 13 financial markets.[68] Five new signatories, representing the regulatory authorities of Cameroon, Monaco, Romania, Tunisia and the Central African Economic and Monetary Community (CAEMC/CEMAC), were added to the IFREFI charter.

[68] The following jurisdictions and organisations were represented: Algeria (COSOB), Belgium (CBFA), Cameroon (CMF), Central African Economic and Monetary Community (CAEMC/CEMAC, comprising 5 countries), France (AMF), Luxembourg (CSSF), Monaco, Morocco (CDVM), Quebec (AMF), Romania, Switzerland (CFB), Tunisia, and the West African Monetary Union (WAMU/UMOA, comprising 8 countries)

The Chairmen's Meeting is usually followed by a training seminar. In 2004, the seminar dealt with issues relating to the supervision of collective investment schemes, investment management and savings.

## C– IOSCO enforcement committee and pilot programme

The committee responsible for enforcing the IOSCO Principles continued its work in 2004. It is using every means possible to encourage access to the "Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation", the main tool for regulatory analysis. Two regional seminars – one in April in Bombay for Asia-Pacific and the other in Bahrain in November for Africa-Middle East – were organised to train regulators' staff in the use of the methodology.

The AMF contributed to these initiatives by helping to facilitate the regional seminars, financing the French translation of the IOSCO Methodology, and cooperating with fellow IFREFI members in organising a French-language seminar on all aspects of financial regulation covered by the methodology.