



## **New EU Regulations to Have Significant Impact on Financial Services Firms**

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The CME is offering this article because it delineates the effects of new European Union regulations on firms that deal in financial futures.

### **Introduction**

The Investment Services Directive ("ISD") and the Capital Adequacy Directive ("CAD") come into force on 1st January 1996 and all EU Member States are required to have brought in compliant local legislation by that date.

In future all investment firms conducting relevant financial services activities will need to be authorised in their home State and will need to assess both new local rules and the extent to which their crossborder activities will forthwith require prior approval and/or be affected by new marketing, authorisation and conduct of business rules in other EU States in which they have customers. The services and instruments covered are listed in Tables 1 and 2.

### **TABLE 1: ISD Investment Services**

1. (a) Reception and transmission of orders, on behalf of investors, in relation to one or more of the instruments listed in Table 2  
(b) Execution of such orders other than for own account
2. Dealing in any of the instruments listed in Table 2 for own account
3. Managing portfolios of investments in accordance with mandates given by investors on a discretionary, client by client basis where such portfolios include one or more of the instruments listed in Table 2
4. Underwriting in respect of issues of any instruments listed in Table 2 and/or the placing of such issues

### **TABLE 2: ISD Instruments**

1. (a) Transferable securities  
(b) Units in collective investment undertakings
2. Money market instruments
3. Financial futures contracts, including equivalent cash settled futures instruments
4. Forward interest rate agreements
5. Interest rate, currency and equity swaps

6. Options to acquire or dispose of any instruments listed above, including equivalent cash settled instruments

The ISD initially gained headlines as part of the EU free market movement. Its underlying concept is that Member States may not have rules which prevent or restrict financial firms from establishing offices or conducting business on a cross border basis in other Member States. There is, however, already a relatively free market in EU financial services and many firms, from both within and outside of the EU, have successfully established overseas offices throughout the EU with little or no hindrance in practice (the Italian SIM Law being an exception). Moreover, since the ISD does not lay down uniform marketing rules but leaves it to Member States to regulate marketing within their own borders, each jurisdiction is still free in practice and within certain limits to restrict cross border marketing to the general public. Plus ça change, plus c'est le meme!

The greatest impact felt by investment firms in their day to day business is therefore likely to be a significant increase in the level of rules and regulations to which they are subject, both domestically and in respect of cross border business. This will result from the imposition of minimum standards on all EU based investment firms in respect of authorisation requirements and procedures, capital requirements, compensation schemes and conduct of business rules. Such uniform minimum standards are the quid pro quo for freedom to establish in, and conduct business with citizens of, other Member States.

Whilst the principle of uniform minimum standards is wholly laudable, the extent to which investment firms will henceforth be subject to detailed regulations throughout the EU has probably not yet been appreciated by many firms. It is ironic that legislation which is deregulatory at the macro level will result in greater regulation on a day to day basis throughout the EU. Thus the impact of the Directives in jurisdictions such as the United Kingdom, France and the Netherlands—which already have detailed and sophisticated regulatory regimes—should not be underestimated. Their rules will have to be amended to conform to the Directives' requirements and several jurisdictions will be bringing in 'super equivalent' rules which go beyond the minimum requirements of the ISD.

In those other countries which have previously not regulated persons conducting relevant investment services, the impact of the Directives obviously will have the greatest effect; the requirement to implement licensing regimes and detailed codes of conduct will radically alter the current environment for such firms.

Apart from the impact on local firms, the new rules will mean that there definitely will be a requirement for firms to seek permission to do investment business in other EU jurisdictions (if they do so via a branch or subsidiary). Although the position is not entirely clear, the ISD also envisages the need to seek permission to conduct cross border services, whereas firms are not usually subject to any form of local requirement at the present time.

In addition, firms established in one Member State and subject to that home State's conduct of business rules in respect of business carried on in that State will be subject to the host State's conduct of business rules if they carry on ISD business in that State, whether by establishing a branch or through occasional visits to provide services across borders.

The following is a brief resume of some of the ISD and CAD provisions which are likely to have the most significant long term impact on relevant firms. A number of the more detailed provisions are not considered here and, of course, each Member State is free within certain restrictions to implement the ISD and CAD in its own manner and to impose other conditions in addition to the minimums required.

### **The Investment Services Directive**

Freedom of establishment and to provide cross border services

The fundamental concept of the ISD is contained in Article 14, which provides that each Member State must allow firms authorised in other Member States to conduct investment business in their own jurisdictions without any further authorisation requirement or imposing local capital rules. Such business can be conducted through a branch office or on a cross border basis, but there is no automatic right to set up a subsidiary company.

There are notification requirements via the relevant firm's home State to ensure it is duly authorised there in respect of the relevant type of business. Firms conducting the core services mentioned in Table 1 must, if required, be permitted to conduct certain related non core services, which are detailed in Table 3.

#### **TABLE 3: ISD Instruments**

1. Safekeeping and administration in relation to one or more of the instruments listed in Table 2
2. Safe custody services
3. Granting loans or credits to an investor to allow him to carry out a transaction in one or more of the instruments listed in Table 2 where the firm granting the credit/loan is involved in the transaction
4. Advice on capital structure, industrial strategy and related matters and mergers and acquisitions
5. Services related to underwriting
6. Investment advice concerning one or more of the instruments listed in Table 2
7. Foreign exchange services where these are connected with the provision of investment services

Investment firms conducting dealing services must also be permitted to deal on local regulated markets and to become members of or have access to local settlement and clearing systems. As a result, current rules in certain jurisdictions prohibiting banks and other credit institutions from becoming

members of regulated markets must be removed.

### **Authorisation and ongoing supervision requirements**

In return for safeguarding the basic right to branch into or deal across borders with persons in other Member States, investment firms throughout the EU will be subject to certain minimum authorisation requirements and ongoing supervision. For example, investment firms must:

- have their head office and registered office in the same Member State
- at all times comply with the capital requirements of the CAD (see page 5)
- have managers with sufficient experience
- produce a business plan or equivalent programme of proposed operations and an organisational structure
- have sound administrative and accounting procedures, including internal control mechanisms (e.g., in relation to personal account dealings by employees) and control and safeguard electronic data processing
- have arrangements for safeguarding customer assets and keep such assets segregated from the firms' own assets
- keep adequate transaction records
- be structured and organised so as to minimise conflicts of interests
- comply with local conduct of business rules covering both the core and non core services, which contain principles designed to ensure:
  - honesty and fair dealing in the best interests of clients and the integrity of the market
  - firms act with due care, skill and diligence
  - firms have sufficient resources and procedures for their business
  - firms seek sufficient information from customers regarding their financial position, experience and objectives
  - firms make adequate disclosure of material information
  - firms attempt to avoid conflicts of interest, and where these arise customers are treated fairly
  - firms who execute transactions (as opposed to investment managers) treat the ultimate customer as his client (as opposed to an introducer or order passer) for the purpose of complying with suitability requirements

### **Compliance with local rules**

If an investment firm wishes to establish a branch office in another Member State or to conduct business on a cross border basis it must, in future, notify its local competent authority and await permission to do so. Although the applicant firm will not be subject to local capital or authorisation requirements, it will become subject to local conduct of business rules. To date, this has been the case in only a very limited number of jurisdictions and in relation to only a very limited class of services. In future, since all EU countries will have to have local conduct of business rules, any EU firm conducting cross border investment services will need to appraise itself of those local rules and how they will affect the way business is conducted. For example, the ISD specifically provides that EU States may have rules requiring business with local citizens to be conducted only on regulated markets unless specific

authorisation to do so is sought. Any such permission may take into account the need for investor protection and the professional or institutional nature of the investor.

Moreover, it is likely that a number of countries will use the opportunity to bring in local marketing rules in relation to investment services, whereas at present there are very few countries which have detailed rules in these areas (although some have a general prohibition on cold calling).

### **Approval of controllers and the acquisition of interests in investment firms**

Investment firms must notify competent authorities of the identity of their shareholders, who will have to be approved as suitable. Moreover, anyone proposing to acquire a qualifying holding of 10% of the capital or voting rights or a significant influence over the management of a firm must be approved in advance, as must increases in capital/voting rights resulting in various thresholds being held (specifically 20%, 33% and 50%). Similarly, disposals of qualifying holdings or of interests which would take a holding below one of the above thresholds must be notified.

### **Transaction reporting**

Investment firms will be required to report transactions relating to shares and debt instruments (including futures and options on the same) conducted on all regulated markets to their home State (unless it is agreed that reporting to the host State will suffice).

Regulators also will be required to collate detailed information to ensure investors have sufficient information at the time of trading and to review historic information, although there is recognition of the possible need to delay publication of transactions and/or the identity of the parties in certain circumstances—e.g., due to the exceptional size of transactions or illiquidity.

### **Information sharing and other reciprocal arrangements**

As would be expected, there are detailed information sharing provisions (and indeed requirements) for co operation amongst competent authorities both within Member State and across Member States. The ISD permits the competent authorities of home Member States to conduct direct verification of compliance by regulated firms in respect of business conducted in other Member States if they so wish in certain circumstances.

There are provisions dealing with the protection of confidential information received by competent authorities, subject to certain exceptions such as disclosure in relation to criminal proceedings and in relation to bankruptcy or similar proceedings. This may preclude the situation which recently arose in the UK where a self regulatory organisation was required to disclose information in relation to civil proceedings.

### **Relations with non EU firms and States**

There are notification requirements whenever a non-EU firm establishes an office or subsidiary in a Member State or acquires a qualifying holding in an EU investment firm so that central information can be maintained. Member States are also required to report any difficulties experienced by EU firms in doing business in any non EU jurisdictions or acquiring interests in firms in such jurisdictions and periodic reports will be made by the EU Commission. If comparable facilities are not provided to EU firms as compared to those afforded by the EU to non EU firms, the Commission may initiate negotiations and/or Member States may be precluded from allowing further firms from relevant jurisdictions to be authorised in Member States.

### **Capital Adequacy Directive (CAD)**

Investment firms will be required to comply with the minimum base capital requirements which apply to each of the four different categories. The appropriate category for each firm will be determined according to the services that the individual firm provides.

Although banks and other substantial institutions will have no difficulty in complying with these requirements, smaller fund managers and brokers in most jurisdictions (including the UK) will find that they will in future be subject to higher base capital requirements. This will particularly be the case if they hold client money and/or deal for their own account, which attracts the highest level of base capital.

In addition to the base capital requirements, the CAD contains detailed capital provisions in relation to position risk, large exposures, consolidated supervision and reporting requirements. As with the ISD, the following is brief summary only of some of the relevant issues.

### **Risk requirements**

The CAD begins with the assumption that investment firms and banks must comply with the EU Own Funds Directive unless they elect to comply with the CAD in relation to their “trading book” activities and which should result in a lower capital requirement. So far as the trading book is concerned, in addition to meeting the base capital requirements, firms will require sufficient capital to cover position risk, counterparty risk and large exposure requirements. Such additional requirements must in all cases be equivalent to not less than 13 weeks’ operating expenses. The “trading book” is defined as proprietary positions held for resale and other short term trading, as opposed to long term investment positions.

### **Consolidated supervision**

Henceforth, investment firms may find themselves subject to capital requirements in respect of position risks and large exposures calculated on a group basis where the relevant company has a bank or investment company subsidiary or an interest in such a company or if the parent of the group is a “financial holding company”— i.e., a financial institution the subsidiaries of

which are almost exclusively investment firms or other financial institutions at least one of which is an investment firm.

Generally, the regulator of the investment services group's parent company will have responsibility for consolidated supervision of the group although the CAD does permit delegation to other competent authorities in certain circumstances. The CAD permits consolidated supervision to be waived in certain circumstances. There are also provisions permitting the offsetting of requirements which would otherwise apply individually to each group company.

### **Reporting obligations**

There are general provisions requiring investment firms to report financial information demonstrating compliance with their obligations under the CAD every 16 months depending on the obligations to which they are subject.

### **Conclusion**

As will be apparent from the preceding, the implementation of the ISD and the CAD will have a significant impact on the way in which investment firms conduct their day to day business. Changes will undoubtedly be required to systems and internal procedures to implement the new CAD method of calculating regulatory capital and monitor applicable rules and regulations in both the firm's home State and in any host State in which it conducts ISD business. As stated at the beginning of this article, many Member States are currently amending their existing rules and drafting new rules to implement the Directives and firms should monitor on going developments in each EU jurisdiction in which they conduct ISD business to ensure that they are not caught unawares by any changes.

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This article provides a general overview of the subject matter and does not purport to give legal advice; the detailed rules are complex and specific advice should be sought in each particular case.



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