Industry codes – do they have a future?

David Creed examines current proposals for the new industry codes of good practice and questions how far the Financial Services Authority (FSA) should go.

For about the last 18 months, I have been present at approximately 20 meetings, held mostly at the offices of Merrill Lynch in Farringdon Road, to examine what is, or could be, market abuse. More recently, Brian Welch has been representing the Association on a parallel committee looking at the drafting of the replacement for the London Code of Conduct. It is encouraging that the Association has been invited into consultation with FSA officials and other representative bodies on the thinking behind the FSA's intentions on market regulation, but is all this effort proving worthwhile?

Whenever a treasurer operates in a market he is expected to abide by the code of conduct ruling the market, which has often evolved over many years of practitioner development. For instance, each futures market has its own code of practice, in some cases it is codified and in others unwritten rules understood by frequent users of the market govern behaviour. Is there a place for these codes within the new regime that will be introduced by the FSA next year with the implementation of the Financial Services and Markets Bill (FSMB), which is currently working its way through the Lords?

Interestingly, the FSA does not have power to endorse industry codes under the new Bill, with the exception of the Takeover Panel's Code. Were the FSA to wish to adopt an industry code formally, the code would need to conform with the structure of the FSA Handbook and be rewritten as FSA 'rules'. The FSA would also have to consult widely on their adoption and ensure that the proposal had a positive cost benefit analysis.

The two FSA codes which will apply to market conduct under the new regime will be the Code of Market Conduct (COMC) on market abuse and the Inter-Professionals Code (IPC) which covers standards of conduct expected of dealings between professionals and which will replace the London Code of Conduct. The IPC was published in mid May as CP47 with a request from the FSA that users comment as soon as possible on its contents. The Association will be responding to the FSA during July. There is a clear distinction between these codes: they derive from different powers in the Bill, and the focus of the COMC is on the multi-lateral relationship between the market participant and the rest of the market, whereas the focus of the IPC is on bi-lateral dealings. Both are ultimately concerned with market confidence and integrity.

The COMC is aimed at those markets prescribed by HM Treasury, essentially the markets centred on the six regulated investment exchanges. The COMC will apply equally to those persons authorised under the act as well as those who will remain unauthorised. On the other hand, the IPC has a much wider coverage of investments (over-the-counter as well on-exchange instruments) but its scope will be limited to firms' dealings with market counterparties, ie to the top tier of professionals in the markets.

The COMC defines market abuse in terms of three tests of behaviour: distortion of the market, misleading impressions and misuse of information. In addition, to be defined as abuse, it must constitute behaviour which falls below the standards that a reasonable regular user of the market would expect to see.

Inter-Professionals Code

The IPC will explicitly defer to the COMC where the COMC applies. It also needs to be interpreted in the light of any relevant exchange rules. Some parts of the IPC (eg, the rule on off-market price transactions) are 'switched off' in deference to exchange rules in those areas.

The consultation with industry on the nature and scope of the IPC will be on the expectation that the IPC will provide a core of standards that apply to all the investments that it covers: foreign exchange (FX) and money markets investment products (eg, CDs, swaps and options)*, equities, bonds, commodities and energy derivatives. There is also an opportunity to have more detailed market-specific annexes if there is a demand from industry for these to be included. As currently drafted the IPC comprises: guidance on the principles (the majority of the IPC itself), specific rules in one or two areas (such as off-market price transactions) and informal/'good practice' material which is separately identified with a different status. For instance, master agreements will be covered in this section.

Existing codes

Existing industry codes already embody good practice guidelines, including benchmarks where appropriate. If a reasonable regular user test remains as part of the definition of market abuse, then behaviour covered by these codes may have an element of 'safe harbour' status in relation to whether or not specific behaviour constitutes market abuse. However, this will depend on the degree to which the behaviour covered by these codes is actually relevant to the COMC.

Recent consultations between members of the FSA and industry practitioners have wrestled with the way in which

*FX spot and forward and money market deposits are not investments and therefore not regulated by the FSA and not covered by the IPC. The Association is represented (by Brian Welch and our technical officer, Caroline Bradley) on two more committees developing a code for these markets.

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specific industry codes could be incorporated within the new regime. Should they remain on a stand alone basis, be stand alone but be explicitly recognised in the IPC, or should the codes themselves, or parts thereof, be made into specific specialist annexes of the IPC?

This may appear to be a rather dry issue, but in fact will influence all users of markets, possibly to a significant degree. The previously unregulated structure within which each market authority developed its own good practice guidelines and operating code allowed a natural evolution over time. The codification of good practice can however have a variety of effects on market conduct. It can help establish greater certainty for participants and a 'level playing field' between participants of different sizes. It can also potentially inhibit innovation and competition if it is too prescriptive and rigid in its embodiment of market practice.

How far should the FSA be involved?

The FSA's Consultation Paper asks to what extent the industry believes the FSA should be involved in the development and promulgation of industry codes of good practice. Might direct FSA publication of industry documents inhibit the development of such codes? This might arise because of its need to consult before publication and because the FSA cannot delegate its rule-making powers to industry bodies. Or might the FSA do better to recognise specific industry codes? A further alternative way forward might be for the FSA to look at any industry code and, rather than incorporating it within the FSA rules, simply identify which elements of the industry code would be in breach of the FSA's own rules.

It is vital that the interaction between the IPC, the COMC and industry codes is viewed as a positive development for the City. If the London markets are seen to be becoming overly codified, or if the markets were not seen to be clean and fair, London's premier position as the world's financial centre could be eroded. However the consultation behind the development of the FSMB and the FSA's codes of practice has been considerable and should give us encouragement that the FSA will get it right first time. ■

David Creed is director general of the Association of Corporate Treasurers.

Financial assistance

Caroline Bradley considers whether the discharge of acquisition debt could be seen as financial assistance.

One of our members has had cause to review the provisions of Section 151 of the Companies Act 1985 on financial assistance and is concerned at the open-ended nature of it. We thought it was worth reminding readers that it is possible to violate S151 accidentally during the financial reorganisation after an acquisition through the discharge of acquisition debt.

Financial assistance, ie, providing financial support for the purchase of your own shares (or those of your parent company) during an acquisition, is prohibited. 'During' in this context means before, or at the same time as, the acquisition is made. However S151 (2) extends the prohibition, as an anti-avoidance measure, to include any assistance with the discharge of any liability (eg, borrowing) that has been incurred for the purpose of the acquisition, and there is no time limit to the prohibition relating to such discharges. This means that acquiring companies have to be very careful how they repay debt taken on to fund an acquisition.

There are a few exemptions in these provisions for a 'valid' purpose but the application of the exemptions is uncertain and subject to varying interpretation. S153 allows assistance (including discharge of the liability) where the assistance is not principally for the purpose of the acquisition (or the discharge of a liability) or it is an incidental part of some larger purpose and provided that it is given in good faith in the interests of the acquired company. Dividends upstreamed from the acquired company are allowed, as are various procedures relating to restructuring under companies legislation. Lending money in the ordinary course of the acquiring company's business is allowed as is provision of cash for an employee share scheme, provided that net assets (of the acquired company) are either not reduced or reduced by no more than distributable profits.

It is not certain that group cash management is a valid 'larger purpose' nor is it certain that the regular day-to-day cash management activity of a holding company or even a finance subsidiary is 'lending in the ordinary course of its business'. The lack of any cut-off relating to the change of control, ie there is no specified length of time beyond which S151(2) will no longer apply, leaves an open-ended risk of violation in the case of the acquisition of a public company.

One solution for a private company (or for a public company which is prepared to re-register as a private company) is to take advantage of the 'whitewash' provisions of Ss151-158. These are only available if the company providing the financial assistance has net assets which are not reduced (except to the extent covered by distributable profits) by the assistance. A statutory declaration detailing the assistance and the company's solvency, accompanied by an auditor's report is needed. A special resolution that approves the giving of the assistance must normally be made before (usually at least four weeks before) any assistance can be given.

If the acquired company is the parent of the company providing the assistance, further requirements apply.

To avoid accidentally violating the financial assistance provisions, treasurers must take care when financing acquisitions that the repayment of any acquisition-related borrowings should be made out of cash from sources completely unrelated to the acquired companies, or out of cash dividends from the acquired company, or consider whether a S155 whitewash will be possible (to enable the borrowings to be repaid out of the acquired company's resources).

In a further complication, regular

readers of the Hotline will be aware that the calculation of distributable reserves is becoming a matter of some uncertainty. The technical committee is monitoring developments and commenting, when appropriate, on proposals issued by the Accounting Standards Board, ICAEW and the Company Law Review panel. ■

Tax

Double taxation relief

You will have seen that the Treasury has responded to heavy lobbying by the CBI and other parts of industry by deferring the abolition of mixers until March 2001. We have responded to a number of representations from members, the most we can recall on any issue, by continuing to comment (most recently in a letter to the Number 10 Policy Unit) on the damage done to confidence by the way in which this change was imposed. ■

Funding

Corporate bonds

Yet another government-initiated review, designed to remove barriers to competition and innovation in the capital markets, is being conducted by Paul Myners, chairman of Gartmore. Among other things, he will be investigating why fund managers fail to invest in instruments such as corporate bonds. One reason may be the lack of supply, a traditional complaint among sterling bond investors. Lately these investors have become vocal in their dissatisfaction with other aspects of corporate bonds including major price movements, many generated by 'events' such as merger and acquisition activity and restructurings. Big losses have been experienced in telecommunications and utility bonds. Investors feel they are taking equity-type risks with inadequate reward and are starting to put pressure on issuers to improve terms.

In recent months Vodafone Airtouch promised to pay compensation to investors in some of its bonds if the acquisition of Mannesmann caused a rating downgrade. Kelda, owner of Yorkshire Water Services, was forced by investor pressure to increase the coupon on a 31-year sterling bond issue by 25bp when its rating outlook changed from stable to negative.

Other investors are pressing for changes to bond documentation to give them more protection particularly in relation to bank lenders who generally have the benefit of financial covenants. The Association of British Insurers has been quoted as questioning the adequacy of protection for investors in bond documentation. However pressure from sterling investors to tighten up on documentation could drive issuers to the euro eurobond market where more issuer-friendly standards persist. ■

Regulation

FSA conduct of business rules

The technical committee is continuing its work on relevant parts of the new Financial Services and Markets Bill. The main issue currently under consideration is the Conduct of Business Sourcebook (COBS) containing rules and guidance applying to business between authorised counterparties and intermediate customers. As yet COBS does not include provisions relating to three areas we have concerns about, ie mandates, taping and 'best execution'. 'Best execution' is to be dealt with in a further consultation later in the year.

Mandates

The Financial Services Authority (FSA) is well aware of our concern that mandates are not mentioned in either COBS or the Inter-Professionals Code (IPC) which will apply to dealings between market counterparties. In the draft consultation paper on the IPC, it is noted that the current London Code guidance on mandates is omitted from IPC because mandates are a customer issue and customers are outside the scope of IPC.

It considers that "if guidance in this area is considered useful it might appear as part of COBS". We will be writing to the FSA suggesting that guidance on mandates is provided as an addendum and referred to in both IPC and COBS. ■

Regulation of money transmission

Following the publication of the Cruickshank report on banking, we have been asked to comment on Government proposals to open up access to payment systems and to set up a regulator to oversee access charges. At present they seem to be looking for ideas to incorporate into consultation papers and have asked for responses by 5 June. This is probably only the start of a drawn out process so any comments and ideas would be very welcome both before and after this date. Please contact me on cbradley@treasurers.co.uk. ■

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The Association's technical officer