Concerns about FSA categorisation of customers

The technical committee has been reviewing further proposals from the FSA on the categorisation of customers (now called clients, in order to be able to distinguish between customers, whether private or intermediate, and professionals). On the whole the latest consultation paper confirms points that we had already found acceptable and in some cases has adopted some of our suggestions.

Main points are:

- Despite some responses proposing a two-tier categorisation (ie customers and professionals), the FSA is sticking to three tiers, largely to accommodate corporates which are deemed to require a separate category from private customers.
- The main qualification for categorisation as an intermediate customer will be a listing on any EEA or IOSCO member country exchange. This is what we proposed.
- Non-listed companies and some other bodies can also be included as long as they have net assets of £5 million. We have concerns about this. Firstly, net assets is not a very reliable proxy for a company's size or expertise. Secondly, the definition of net assets is not clear eg, does it include intangibles.
- Opt-up to professional (market counterparty) status will only be allowed for those bodies starting out as intermediate customers not private customers, however expert they may be. We have some concerns about this, too. It is possible that a private (or public but not listed) trading or commodities company with very large turnover currently operating in the markets as a professional would be categorised as a private customer, able to opt up to intermediate status but not professional.
- There is a new test for intermediate customers to opt up to professional status. This originates from EU proposals and requires that companies meet any two of the following three hurdles:

1. balance sheet total of euro12.5 million
2. turnover of Euro 25 million
3. number of employees averaging 250

While this seems unnecessarily bureaucratic it should not cause problems for UK corporates wanting to opt-up other than the type of company mentioned above. These may scrape into the intermediate category but not meet the assets or employee tests to opt up. We are assuming that balance sheet total means total assets.

- Client classifications for opted up clients must be reviewed by the bank counterparty at least annually.
- In the transition to the new regime, intermediate customers currently treated as market counterparties by a bank may continue to be so without the bank having to undertake an assessment prior to N2 (the date that the new Act comes into force, currently predicted for early summer 2001).
- Re-categorisation, if needed, must occur within 12 months of N2. The existing categories can continue as long as the client gets at least as much protection as it would under the new categorisation.

The committee's response to the consultation paper (CP57) will be posted on the Association website.

Codes of conduct

We are expecting that the draft NIPs Code (the successor to the London Code for non-investment products such as sterling deposits and FX) will be put out for consultation very shortly. The technical committee is represented on two working groups developing this Code and so far it is looking encouragingly similar to the London Code. It is likely that some sort of suitability test will be included to accommodate the wide variety of market participants, whereas this will not be part of the Inter-Professionals Code relating to investment products. ■

Profiting from ACT comment

ICAEW – The determination of realised profits and distributable profits

Some time ago we responded to ICAEW proposals on this issue, disagreeing with several of their points. They seem to have dealt with all our concerns bar one. A company still cannot realise a profit by paying up a dividend to a UK parent from an overseas subsidiary, and then putting the funds back down again as capital injection, (even if the dividend received is bona fide) unless the capital injection is as an overdraft or short term loan. The technical committee is planning to make further representations on this point and this will be posted on the website. Anyone likely to be affected can contact me for a copy of the ICAEW's paper by e-mail. ■

New money market funds body

The growth in the availability of money market funds has resulted in the formation of a new body, the Institutional Money Market Fund Association IMMFA. The purpose of this body is to promote the use of such funds throughout the UK and the rest of Europe and to provide information to potential users. Funds are available in sterling, dollars and euro and minimum subscription size varies from £50,000 to £6 million. Most funds use 7 day or 30 day LIBID as a benchmark. Further information can be obtained from Ashley Meeks on 020 8673 1994. ■

Draft regulation on treasury shares

A DTI consultation document, incorporating draft regulations amending the Companies Act 1985 to allow treasury shares, is expected during October. Readers will recall that the Association has been lobbying for this change for some time. The present law prohibits repurchased shares being held 'in treasury' for resale at a future date but allowing such resale of shares would give companies greater flexibility to adjust their share capital and should lead to a reduction in overall cost of capital. A change in the law to allow shares to be held in treasury needs to be accompanied by other changes (such as greater disclosure) so that the impact of the present law on, for example, ensuring a fair market in a company's shares is maintained.

The existing requirements for shareholders to approve share buy-back programmes will remain and the regulations will state that companies which have repurchased their own shares will not be required to cancel them as long as the number of shares held in treasury does not exceed 10% of the issued share capital. This is a requirement of the EU Second Company Law Directive. The allowance will only apply to listed companies.

The Second Directive also provides that voting rights of treasury shares are suspended but it is likely that UK law will go further and suspend all rights of such shares, such as the right to receive cash dividends.

The big question remains whether pre-emption rights should apply to the resale of treasury shares in the same way as for issues of new shares. The draft regulations are likely to provide that the same rules apply and that pre-emption rights can be disapplied by agreement of the shareholders. Guidelines on pre-emption are issued by the Pre-emption Group which will, we anticipate, adopt the proposed framework for disapplication drawn up by ourselves, the Association of British Insurers and the National Association of Pension Funds. This framework, which was published as an ACT press release dated 5 May 1999, can be found on the Association website and in the June 1999 edition of *The Treasurer*. ■

David Creed addresses some of the issues in this month's DG piece on page 63.

Borrowers beware of ratchet loans

In the Budget 2000, the rules relating to the deductibility of interest on ratchet loans were regularised, but subsequently doubts were raised over the effectiveness of the drafting. We have been advised that the Budget changes do in fact achieve what we had hoped i.e. that interest on ratchet loans will be treated as interest not a dividend. In cases in which interest goes up if profits increase (not normally classified as a ratchet loan) this would, not surprisingly, be treated as a dividend.

However the Loan Markets Association (LMA) points out that the new rules apply only where the ratchet applies to the borrower's performance rather than group performance. They are lobbying to get it changed but this something that borrowers should look out for. This will normally be an issue if the borrower is not the parent company but, for example, a treasury vehicle. ■

Draft accounting standards

Accounting for financial instruments

We have heard that the expected draft standard is now not likely to be published by the Accounting Standards Board until November.

Accounting for share-based payment

The technical committee is reviewing the ASB's discussion paper on accounting for options and other share - related payments. Its controversial proposals cover all issues of shares or options to employees and suppliers as payment for goods or services. The paper proposes that transactions involving share-based payment should be measured at the fair value of the shares or share options at vesting date, the date at which the beneficiary becomes unconditionally entitled to the options or shares. In most cases, an option-pricing model should be used to establish the fair value.

One effect of the proposed accounting treatment would be that the value of employee share options would be recognised as an expense in the company's profit and loss account. This could have a severe impact on the results of start-up companies or other cash-hungry businesses which traditionally use share options as an alternative to high cash salaries in order to recruit and retain staff. ■

The Hotline is prepared by Caroline Bradley, Technical Officer of the ACT. For any comments or new items, please contact her at cbradley@treasurers.co.uk. Additional technical updates are available on the website: www.treasurers.org.