

**-SPECIAL REPORT-**

**EC REGULATION AND LEGISLATION – A USER’S GUIDE FOR INSURERS**

27<sup>th</sup> June 2005

## **E.U. Regulation and Legislation – A User’s Guide for Insurers**

Since 1973, there has been steady progress towards a single European financial market, marked by important milestones such as the Investments Security Directive, the Money Laundering Directives and the Banking Directives. After putting these gradual reforms in place, the European Commission has established the Financial Services Action Plan (“FSAP”), which has set a deadline for 2005 for the completion of the single market process. As a result, the UK financial market, and the insurance industry in particular, has recently faced a dynamic legal environment. On top of this general movement, there have been a variety of additional European legal measures outside of the FSAP framework which, directly or indirectly, will affect the British insurance industry. These major changes present the British insurance industry with both opportunities and challenges, and cannot be ignored.

What follows is a general guide to the changes in European law of which insurers and their employees should be aware, as well as an overview of the legislative structures of the EU itself.

This paper does not constitute legal advice, and specific legal guidance should be sought where appropriate.

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## A. E.U. STRUCTURE

The procedure for the initiation, scrutiny, drafting and enforcement of European legislation is notoriously complicated. One of the key things to understand is that there is no single procedure in place; it will vary depending upon the area of policy it affects. Broadly speaking however, there are four main bodies which are involved in the process:-

### European Commission

The European Commission is in a sense the civil service and government of the institution of the EU itself, though it has a mixture of administrative, executive, legislative and judicial roles and responsibilities.<sup>1</sup> A new Commission is appointed every five years – the present Commission under President Barroso, has been in place since November 2004. At present, the Commission has 25 members (aside from ancillary staff which are numbered in the thousands), with one commissioner from each EU country. The European Commission's main roles are to:

1. Propose legislation to Parliament and the Council – the Commission has the sole right to instigate legislation, which must be in the pan-European interest and which is in accord with the concept of '*subsidiarity*' (i.e. that legislation is put in place at the most appropriate level of government);
2. Manage and implement EU policies and the budget - the Commission is responsible for managing and implementing the EU budget, as well as policies and programmes adopted by Parliament and Council.<sup>2</sup> A prime example of this can be found in the Commission's enforcement of competition policy throughout the EU;
3. Enforce European law (jointly with the Court of Justice – see below) - the Commission, together with the Court of Justice, is responsible for making sure EU law is properly applied in all the Member States. If not, it will issue an official letter to the Member State in question. Failing remedy, the Commission will then refer the issue to the Court of Justice which will then take action; and
4. Represent the EU on the international stage - for example, by negotiating agreements between the EU and other countries. This allows the EU to speak on the international stage 'with one voice' where appropriate.<sup>3</sup>

### Council of the EU

This is the main decision-making body of the EU, which represents the interests of the Member States. Its meetings are attended by one minister from each of the EU's national governments – the minister chosen generally depends on the policy issues that are being addressed. The Treaty of Rome allows it to exercise (in cooperation with Parliament) legislative powers, coordinate the general economic policies of the Member States, and conclude international agreements. The Council can be configured in a variety of ways depending upon the issues before it; the two relevant configurations for the purposes of this article being Economic and Financial Affairs (ECOFIN) and Competitiveness (Internal Market, Industry and Research). Within such policy

<sup>1</sup> Bainbridge and Teasdale, Companion to the European Union (1996: London, Penguin)

<sup>2</sup> Article 155 EEC

<sup>3</sup> [http://europa.eu.int/institutions/comm/index\\_en.htm](http://europa.eu.int/institutions/comm/index_en.htm)

areas, the relevant national minister can commit his state to European measures on behalf of his government. Three of its main roles are to:-

1. Pass European laws. In many areas it legislates jointly with the European Parliament. As a rule, the Council only acts on a proposal from the Commission, and the Commission normally has responsibility for ensuring that EU legislation, once adopted, is correctly applied. Adoption of any legislative proposal rests with the Council<sup>4</sup> - the system of voting within the Council depends upon the area of policy being addressed<sup>5</sup>;
2. Co-ordinate the broad economic policies of the member states, largely through ECOFIN; and
3. To conclude international agreements between the EU and one or more states or international organizations.<sup>6</sup>

### **European Parliament**

Since 1979 citizens of the Member States have sent their representatives to the European Parliament in Strasbourg by holding direct elections. In the period between 2004 and 2007, there are 732 representatives, though this is set to expand a little as further enlargement takes place.<sup>7</sup> These are divided into seven pan-European political parties, with the remainder acting as unattached MEPs. The European Parliament has its seat in Strasbourg, and MEPs are elected for five years.

Traditionally, the European Parliament's role was essentially consultative during the legislative process. Recent reforms, however, have increased its participation in the process. The European Parliament can take part in the legislative process alongside the Council through what is called the 'co-decision procedure' (see below). This allows the European Parliament and the Council to act on an equal footing in scrutinising and passing legislation as instigated by the Commission.<sup>8</sup> The European Parliament must also be consulted on other important political or institutional decisions, and can put forward proposals to the Commission as to areas or issues which they believe requires the instigation of new legislation.<sup>9</sup>

The European Parliament can censure the Commission, and potentially can even lead to its dismissal.<sup>10</sup> In fact, the European Parliament played a key role in the resignation of the entire Commission in 1999 under Jacques Santer.

### **European Court of Justice**

The European Court of Justice ("ECJ"), which is based in Luxembourg, is the supreme judicial body of the EU. It is meant to ensure that Community law is interpreted and applied in the same way in each Member State – making its application identical for all parties and in all circumstances. It also has the power to settle legal disputes between Member States, EU institutions, businesses and individuals. Each Member State contributes one Judge each to the Court.

<sup>4</sup> P.Kent, Law of the European Union (2001: Harlow, Pearson) p.22

<sup>5</sup> Under Article 205, voting may be by simple majority (rarely), qualified majority and unanimity.

<sup>6</sup> [http://europa.eu.int/institutions/council/index\\_en.htm](http://europa.eu.int/institutions/council/index_en.htm)

<sup>7</sup> [http://www.eu.int/institutions/parliament/index\\_en.htm](http://www.eu.int/institutions/parliament/index_en.htm)

<sup>8</sup> P.Kent, Law of the European Union (2001: Harlow, Pearson) p.21

<sup>9</sup> [http://europa.eu.int/institutions/parliament/index\\_en.htm](http://europa.eu.int/institutions/parliament/index_en.htm)

<sup>10</sup> Article 201

The Court can:

1. Proffer advice to national courts regarding the application of Community law via preliminary rulings;
2. Adjudicate in proceedings brought about because a Member State is not fulfilling its obligations under Community law;
3. Annul legislation on the grounds of illegality; and
4. Adjudicate in proceedings brought about because European institutions are obliged to take specific action in certain circumstances, yet are failing to do so.<sup>11</sup>

Unlike Courts in Common Law countries, the Court of Justice is run along continental ‘inquisitorial’ lines, with greater emphasis placed on written rather than oral submissions. It has attached to it a junior chamber in the form of the Court of First Instance which hears all cases brought by natural or legal persons, but not those brought by Member States or EU institutions themselves.<sup>12</sup> There is then a right of Appeal to the Court of Justice itself.

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<sup>11</sup> [http://europa.eu.int/institutions/court/index\\_en.htm](http://europa.eu.int/institutions/court/index_en.htm)

<sup>12</sup> P.Kent, Law of the European Union (2001: Harlow, Pearson) p.30

## B. E.U. LEGISLATION

EU legislative procedures are complicated and varied – largely because they are specific to the type of legislation being prepared. The main dynamic which differentiates one from the other is the relative role of each of the EU institutions; most specifically the Commission, the Council and the European Parliament. They can essentially be broken down into the following:-

1. The initiation of legislation by the Commission, which is then voted upon by the Council.
2. The Framework Method, whereby the Council implements a framework measure and then delegates power to the Commission to draft the detail. As a result, the Commission can effectively carry through legislation on its own. The Council maintains control of this delegation by setting up supervisory committees to guide the Commission. A variation of this is the Comitology Procedure, whereby the Council maintains control of the Commission's ability to draft such legislation through the use of specialist committees which work with the Commission as legislation is prepared and adopted.
3. The Consultation Procedure whereby the Commission and Council Act together, again with the Commission initiating the process, and then consult Parliament. Since this is a consultation, Parliament's opinions do not necessarily bind the other two institutions.
4. The Assent Procedure, whereby Parliament has an effective veto power over the legislative process, but has no role in amending suggested measures.
5. The Co-operation Procedure whereby Parliament has two readings of proposed legislation at both the preparatory stage, and once Council and Commission have reached agreement (i.e. a 'common position') over a draft. Parliament can then amend, accept or refuse the legislation. Council can over-ride a rejection by Parliament, but only by unanimous vote. If amendments are proposed by Parliament, it is up to the Commission whether they are adopted before sending the legislation to be voted on by the Council.
6. The Co-Decision Procedure, whereby Legislation is initially proposed by the Commission. It is then sent to Parliament which suggests amendments. These amendments are sent along with the original proposal to the Council. Where there are no amendments by Parliament, or the Council accepts what amendments there are, the Council (by majority vote) can adopt the legislation. If it does not accept Parliament's amendments, it sets out a '*common position*' which it sends back to the Commission and Parliament. Parliament then has three months to consider the text and make amendments. If the Council still does not accept these amendments, a Conciliation Committee made up of Member State representatives is appointed to try and reach agreement. Any product of this committee must be approved by a majority vote of the Parliament and Council. If agreement cannot be reached, the whole process must be started again with the Commission initiating a new proposal.

Legislation is mainly composed of primary legislation (Treaties), and secondary legislation. Regulations and Directives are the most important types of secondary legislation, though it should be noted that Decisions of the Commission and Council also have a part to play, as they are legally binding.

### Treaties

Primary legislation includes Treaties and other agreements having similar status, which are agreed by direct negotiation between the governments of Member States. Such primary legislation or Treaties are then subject to ratification by the national parliaments. The same procedure applies for amendments to the Treaties. The European project is itself based on four founding Treaties which form the legislative bedrock of the EU:

1. The Treaty establishing the European Coal and Steel Community (ECSC), which was signed in April 1951 in Paris, entered into force in July 1952 and expired in July 2002;
2. The Treaty establishing the European Economic Community (EEC), which was signed (along with the Treaty on the European Atomic Energy Community – see below) in Rome in March 1957, and entered into force in January 1958. It is often referred to as the Treaty of Rome; and
3. The Treaty establishing the European Atomic Energy Community, which was signed alongside the EEC Treaty;
4. The Treaty on European Union, which was signed in Maastricht in February 1992, entered into force in November 1993. 'The Maastricht Treaty changed the name of the European Economic Community to simply 'the European Community'. It also introduced new forms of co-operation between the Member State governments - for example on defence, and in the area of justice and home affairs. By adding this inter-governmental co-operation to the existing Community system, the Maastricht Treaty created a new structure with three 'pillars' which are political as well economic.<sup>13</sup> This is the European Union ("EU").

In addition to these there are further Treaties which have helped form the EU as it now stands, and includes, for example, the Treaty of Accession 2003 which allowed for the entry of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia into the EU.

## Regulations

Regulations directly bind Member States and do not require codification into national law to be effective. EU Regulations have a general scope, and are obligatory in all their elements and directly applicable in all Member States of the EU (i.e. no further domestic legislation is required to give them effect). For this reason they constitute the most powerful or influential form of EU law.

A Directive (see below) on the other hand, is only applicable in the Member States when the objectives it contains have been transposed into national law. Regulations have the force of law and Member States are required to introduce measures for their enforcement, such as penalties for infringement and to clearly identify which national agency will be responsible for enforcement.

The Court of Justice has established a differentiation between what it calls 'Basic Regulations' and 'Execution Regulations'. Basic Regulations establish essential rules governing a certain matter and are normally adopted by the Council. Execution Regulations technically organise these principles; they are usually taken by the Commission or the Council acting on the basis of Article 211.<sup>14</sup>

Because Regulations have direct effect, the individual countries do not need to pass local laws to bring them into effect, and indeed any local laws contrary to the regulation are overruled, as

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<sup>13</sup> The first pillar is composed of the European Communities, and basically consists of traditional areas of cooperation within the European Community such as the single market, trade and agriculture. The second pillar consists of the Common Foreign and Security Policy. The third pillar comprises police cooperation and cooperation in the area of criminal law. [http://europa.eu.int/eur-lex/en/about/abc/abc\\_12.html](http://europa.eu.int/eur-lex/en/about/abc/abc_12.html)

<sup>14</sup> Under Article 211 the Commission has a duty to ensure the provisions of the Treaty are implemented by the Member States and institutions.

European Union Law is supreme over the laws of the Member States. Member states therefore have to legislate in the light of, and consistently with the requirements of, EU Regulations.

## Directives

Directives are legally binding as well, but Member States are responsible for implementing the Directives using the appropriate process under national law by a certain date. This allows for a certain degree of discretion on the part of Member States in implementing measures. Article 189 of the European Economic Community (“EEC”) Treaty states:

*"A Directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods."*

Because Directives require implementation, the ECJ has recognized that in some cases individuals have the right to enforce their Directive rights, even when Member States have failed to meet the required deadline for implementation. To some extent this is also true of certain EC Treaty Articles, international treaty provisions and decisions, depending on the circumstances.

Individuals can potentially enforce those rights against Member States in domestic courts. *Van Gend en Loos v. Nederlandse Administratie der Belastingen*<sup>15</sup> established that EC law not only creates obligations for Member States, but also establishes rights for individuals. The ECJ ruled that Article 12 of the EEC produces "*direct effects and creates individual rights which national courts must protect.*" Therefore, individuals have a right to enforce European Directive rights in national courts.

If the provisions of the Directive giving rise to the individual rights are unconditional and sufficiently precise, the individual is entitled to rely on those provisions of the Directive against the applicable national law.<sup>16</sup> There is in effect a three-part test to determine whether the provisions of a Directive might be capable of direct effect:

1. The provisions must be unconditional and sufficiently precise as to the creation of an individual right;<sup>17</sup>
2. The date for implementation of the Directive must have passed;<sup>18</sup> and
3. The right claimed by the person/body in question must be as against a public body<sup>19</sup> or an emanation of the state – it cannot be claimed against private actors.<sup>20</sup>

In the *Francovich*<sup>21</sup> case, the ECJ found that the full effectiveness of European law and the protection of rights would be impaired if individuals were unable to obtain compensation in such circumstances. This is particularly important in the case of Directives, which require State implementation.

For a state to be liable in such circumstances, *Francovich* elaborated a further three-part test.

<sup>15</sup> Case 26/62

<sup>16</sup> *Becker v. Finanzamt Munster-Innenstadt* Case 8/81

<sup>17</sup> *Van Gend*

<sup>18</sup> *Pubblico Ministero v Ratti* case 148/78

<sup>19</sup> *Marshall v Southampton & South West Hampshire Area Health Authority* [1986] ECR 723

<sup>20</sup> *Foster v British Gas* [1991] ICR 84 (ECJ),

<sup>21</sup> Cases C-6/ and 9/90 *Francovich and Bonifaci v Italy* [1991] ECR I-5403

1. The purpose of the Directive must be to grant rights to individuals;
2. It should be possible to identify the content of those rights from the Directive; and
3. There must be a causal link between the breach of the state's obligation and the harm suffered by the individuals.

While Member States have discretion to determine the procedural and substantive conditions for compensation, those conditions may not be any less favorable than those for similar internal claims.

In cases where national legislation has been implemented, but is inconsistent with a Directive, the ECJ has again found a right to compensation from the Member State in question. The ECJ stated in *Brasserie du Pêcheur v. Germany*<sup>22</sup> that there must be a "*sufficiently serious breach*" to find state liability. Furthermore, the ECJ has found that Member States will be held liable for violations by their political sub-units<sup>23</sup>, but could discharge that liability by adopting a national law providing for damages from the responsible political sub-unit.

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<sup>22</sup> Case 48/93

<sup>23</sup> *Konle v. Austria*, Case C-302/97

## C. BACKGROUND: E.U. REFORM OF FINANCIAL SERVICES

In 1988 the Council invited the Commission to establish a framework for action in order to hasten and improve the development of a single European market in financial services, including insurance. Ten years later, the Commission published a paper called *‘Financial Services: Building a Framework for Action’*, which laid out the path by which this was to be achieved. Justification for the necessary reform was based on the beneficial effects which it was hoped a single financial market might give rise to. These included:

- Improved allocation of capital through the creation of broader, deeper and more efficient capital markets, which would in turn lead to enhanced liquidity and reduced transaction costs;
- Better interaction between savers and investors as a result of greater competition and freedom of choice;
- European growth as a result of a relatively unified and powerful financial system;
- Enhanced competitive edge on the international capital markets.

Subsequently, the Financial Services Action Plan (“FSAP”) was published, which sought to bring about the single financial market by 2005. The general aims of the plan included:

- Comparable and transparent financial reporting;
- Acceptance and enforceability of collateral within the EU;
- Harmonisation of cross-border restructuring;
- Development of open and secure retail markets to ensure consumer protection, and to remove restrictions on companies’ ability to make cross-border sales;
- Ensure market stability within the EU via effective regulative and supervisory regimes; and
- Harmonisation of tax and corporate governance rules.

Within the overall objective of completing the Single Market in financial services, the FSAP has the following specific objectives:

### A single EU wholesale market

This objective is intended to enable securities issuers to raise finance in a competitive Europe-wide market and to enable single entry point access to investors. It also aims at offering investment services throughout the EU within a sound prudential framework, and creating legal confidence for securities trading and settlement.

### Open and secure retail markets

The second objective is aimed primarily at giving consumers information and safeguards to enable them to participate in the single financial market, but also at ensuring that barriers are removed to the cross-border provision of consumer financial services (with the necessary legal and regulatory protection) and at facilitating small-value cross border payments within the EU.

### Prudential rules and supervision

The third objective is focused on ensuring that no lacunae remain in the EU prudential framework and that the framework itself is capable of successful enlargement. In addition, it attempts to set rigorous standards that will sustain stability in the EU financial market.

At present a company wishing to offer financial services products in different Member States faces considerable barriers, through having to comply with the different regulatory requirements of each state. The hope is to gradually bring the practice of the Member States into convergence.<sup>24</sup> The FSAP aims at setting minimum standards through legislation and then to use Europe-wide committees of regulators and supervisors to work out the detail.

The main FSAP measures address the following areas in particular:

1. Securities issuance and trading
2. Securities settlement
3. Accounting
4. Corporate restructuring
5. Insurance
6. Long-term savings
7. Retail payments
8. Electronic money
9. Money laundering
10. Financial supervision
11. Corporate insolvency
12. Taxation of savings income

Despite all the good intentions of the participants, it was clear early on in this process that progress had stalled. As a result, a committee chaired by Alexandre Lamfalussy was tasked with identifying the barriers faced by the FSAP, and working out how to surmount them. The committee concluded that a new approach to reform was required; one which was faster and more flexible, which increased the involvement of national regulators and which involved extensive consultation with markets and interest groups otherwise outside the political process. Their report (referred to as the ‘Lamfalussy Report’), published in 2001, proposed new legislative techniques for the reform of European financial services and securities law.

It proposed a new four-level approach known as the ‘Lamfalussy Process’ for the adoption, implementation, evolution and enforcement of legislation within the Member States.

- Level 1 comprises Directives and Regulations which define the broad framework principles, or ‘essential elements’ of each piece of legislation. The Commission, Council and Parliament agree on the key political orientation for each Directive or Regulation with advice from the European Securities Committee (“ESC”). The legislative procedure used here is generally that of Co-Decision whereby the Commission, Council and Parliament must all agree on the final text of a piece of legislation.
- Level 2 is made up of technical implementing measures for the Level 1 legislation. The Level 2 measures will contain the detail of the legislation that has been left out at Level 1

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<sup>24</sup> This led to the birth of bodies such as CESR (“Committee of European Securities Regulators”), CEBS (“Committee of European Banking Supervisors”) and CEIOPS (“Committee of Supervisory Bodies for Insurance and Pensions”).

- and are designed to ensure the speedy adoption of legislation, as well as to avoid the lengthy consultation process involved in amending the Level 1 measures.
- Level 3 is to improve co-operation between national regulators and to ensure consistent transposition and interpretation of the Level 1 legislation and Level 2 implementing measures. The Committee of European Securities Regulators (“CESR”) acts as a regulatory committee within Level 3, ensuring consistent implementation of the Level 1 and 2 measures.
  - Level 4 is not yet at an operational stage. It is expected that level 4 will involve the Commission conducting rigorous checks on the texts of national implementing measures and their application and taking action in the form of infringement proceedings against any member state found not to be correctly (or promptly) implementing any piece of legislation.

The European Parliament’s Committee on Economic and Monetary Affairs presented a draft report on the current state of integration of EU financial markets on 18<sup>th</sup> January 2005<sup>25</sup>. A further report was published on 16<sup>th</sup> February 2005.<sup>26</sup> The reports consider how all players in the EU financial services market should go forward after the completion of the Commission’s 5-year FSAP and the 42 regulatory measures. Thus far, 39 measures have been adopted, including several measures not initially planned by the FSAP. The reports also highlight a number of issues relating to enforcement, supervision, pros and cons of competition between regulators, the Lamfalussy process, and retail financial services.

Much of the industry has called for a regulatory pause due to the burden of such heavy legislative change, and one has been promised by Internal Market Commissioner McCreevy in several public statements.<sup>27</sup>

### **UK adoption of the FSAP**

In the UK, HM Treasury, the FSA and the Bank of England are the key institutions in terms of implementation, consultation and adaptation of the FSAP. HM Treasury is responsible for the UK’s strategy towards financial services legislation in the EU. The Chancellor represents the UK at ECOFIN, and Treasury Ministers are directly accountable to Parliament. HM Treasury is responsible for UK policy at Level 1 and Level 2 of the Lamfalussy process (see earlier).

The FSA on the other hand has responsibility in the UK for the authorisation and supervision of financial services institutions and markets within the agreed legislative framework for regulatory policy. The FSA contributes at Level 2 of the Lamfalussy process through the provision of technical advice on implementing measures, and is responsible in the UK at Level 3 through the Regulators’ Committees.

The Bank of England is responsible for the overall stability of the UK financial system and has a role in promoting the effectiveness of UK financial services. It will contribute to the Lamfalussy process, and provides a window on the ECB’s impact on the functioning of the EU financial sector.

<sup>25</sup> (2004/xxxx(ini))

<sup>26</sup> CEPS report, launched on 16<sup>th</sup> February 2005 by the Chairman of the CEPS task force, Alistair Sutton, CEPS chief executive, Karel Lannoo and the rapporteur of the EP’s Economic and Monetary Affairs Committee, Ieke Van den Burg.

<sup>27</sup> [www.euractiv.com/Article](http://www.euractiv.com/Article)

## D. INSURANCE SPECIFIC PROVISIONS

### 1. The Life and Non-Life Insurance Directives

The central rules for life and non-life insurance (though notably not reinsurance) at an EU level can be found in the Life Directive<sup>28</sup> and the Non-Life Directives (of which there are three)<sup>29</sup>. These cover the authorization of undertakings which intend to write life and non-life business, the ongoing requirements that continued authorization requires and the ability of insurers to operate across Europe.

To be authorised, a firm must contact the relevant authorities in the Member State in which its head office is located (in the case of the UK, this is the FSA). Insurers must restrict their objects to insurance business “*to the exclusion of all other commercial business*”.<sup>30</sup> This is intended to stop any adverse impacts of ‘external’ commercial events on insurers’ capital margins. Insurers must submit a scheme of operations to the relevant authority, maintain a minimum guarantee fund and be run by people of good repute, qualification and experience.<sup>31</sup> Once authorised, that firm will be able to act as an insurer throughout the EU without having to seek further authorisation.

Importantly, the Life Directive forbids EU insurers from writing both life and non-life business within the same entity. Those which were doing so before the Directive came into force, can continue to do so, though activities must be operated separately to the extent that they have separate solvency margins.

In order to remain authorised, the insurer must adhere to the minimum requirements set out in the Directives as to solvency requirements<sup>32</sup>, including:-

- the calculation of future liabilities;
- the admissibility of certain assets to cover such liabilities (including limits and extent to which certain assets can be used – in order to encourage diversification);
- minimal solvency requirement and guarantee fund (in the case of life insurers, the minimum guarantee fund<sup>33</sup> is €3m, though it varies for non-life insurers depending on types of risks written<sup>34</sup>);

National authorities are required to supervise authorised insurers, which can analyse and investigate insurers’ situations and businesses, take any appropriate measures to ensure they comply with the relevant laws and prevent irregularities which compromise the position of assured people. They are also to ensure enforcement takes place, through the courts if necessary. These requirements are now embodied in the investigatory and enforcement powers of the FSA.

<sup>28</sup> Directive 2002/83/EC (Recast Version)

<sup>29</sup> Directive 73/239/EC, Directive 88/357/EC and Directive 92/49/EC

<sup>30</sup> Article 6 of the Life Insurance Directive and Article 8 of the First Non-Life Insurance Directive

<sup>31</sup> See Article 7 and 29 of the Life Insurance Directive, and Articles 9 and 17 of the First Non-Life Insurance Directive.

<sup>32</sup> Note further Life and Non-Life Insurance Solvency Directives 2002/12/EC and 2002/13/EC

<sup>33</sup> That is one third of the minimum level of solvency – essentially a minimum capital requirement.

<sup>34</sup> For full details of technical and accounting requirements, please see the Life and Non-Life Directives themselves, as well as Directive 91/674/EC which deals with insurer’s accounts and Directive 2002/12/EC (Life Solvency Directive) which has had its terms incorporated into the Life Directive.

Where an insurer's solvency level is falling below minimum requirements, the competent home authority can require the insurer to submit a plan for stopping financial decline, which is then subject to approval. In acute situations, the competent authority can restrict the ability of the insurer to dispose of its assets and must inform authorities in other Member States of the insurer's status.

Authorisation can be withdrawn in certain circumstances, such as failure to meet conditions. If it is withdrawn, then the authorities of other Member States must be informed, and authorities must take all necessary action to protect the interests of those insured by the relevant company – including stopping the disposal of assets.

Authorisation offers certain benefits to insurers in return for their obligations – once you are authorised in one Member State, you are authorised for the whole of the EU. Once authorised, an insurer can simply notify its home authorities that it intends to offer insurance in another Member State on a cross-border basis. If insurance is to be offered in another Member State using a branch office, the insurer must again notify their home authority. The home authority must then confirm that the insurer satisfies minimum solvency requirements, and inform the foreign authority. The home authority may refuse to confirm this if it has doubts as to the solvency, administration, management or otherwise of the insurer. Once the foreign authority has been informed, it can then impose certain conditions on the opening of the branch to ensure it is 'in the interest of the general good' – a phrase which is inevitably open to potential abuse in terms of market protection.

Since the Life and Non-Life Insurance Directives do not apply to reinsurers, there is no corresponding 'passporting' regime for European reinsurers. Despite this, the FSMA provides a means by which reinsurers can potentially 'passport' as long as their home regime provides equivalent protection to that of the UK regime.

For non-EU insurers wanting to provide insurance within the EU, several conditions must be met – as set out in the Life and Non-Life Directives. The main conditions in such circumstances are that:-

- it must be authorised under its national law to provide insurance;
- it must set up a branch or agency in the Member States in which it wishes to operate;
- it must designate a general representative or agent who is approved by the Member State regulator;
- it must have a minimum level of assets in the Member State; and
- it must keep a solvency margin as provided for in the Directives.

If these requirements are met, then the non-EU insurer's branches and agencies will still be subject to many of the restrictions borne by EU insurers, but cannot 'passport' to other Member States – they must be authorised by each one in which it operates.

Recently, changes to the regime covering the capital requirements for insurance companies have been proposed, in the form of a proposed 'Solvency II' Directive (with the Life and Non-Life solvency provisions often referred to as 'Solvency I').

### Solvency I

As noted, these are the existing solvency margin rules comprising two Directives of 2002<sup>35</sup> which have been implemented by all but one Member State and apply to financial years starting from 2004 onwards. The Solvency I provisions have increased both the minimum guarantee fund and the minimum required solvency margin in general – particularly for liability business. As a result, smaller insurers are now looking to their regulatory capital, assets and other available sources to cover it. For the weaker amongst them, these changes are likely to prove something of a challenge in terms of supervision, access to capital and indeed survival.

## Solvency II

The Commission (in co-operation with the Member States) has started the Solvency II project to assess whether more fundamental changes to the EU insurance solvency regime would be needed. The proposed Solvency II Directive is intended to provide a more principle-based approach to the calculation of appropriate solvency levels by bringing together subjects such as a more risk-based approach, harmonisation of the establishment of technical provisions, new risk transfer techniques and recent developments in financial reporting.

The proposed Solvency II project represents an overhaul of the current prudential and supervisory framework for insurance, and is key to the future operation of the insurance and reinsurance industries. It is to be implemented through the Lamfalussy legislative process thus speeding up the process and sparing the European Parliament and Council from dealing in-depth with the technical details.

It contains a fundamental and wide-ranging review of the current regime in the light of current development in insurance, risk management, finance techniques, financial reporting and so forth. As in the US, where the Secretary of Labor recently announced her plan to reform the regulations governing defined benefits pension funds, the Commission has been working on pan-European regulatory changes to address concerns about life insurers' solvency. The Solvency II Directive thus amounts to a pan-European regulatory framework. It will not only set minimum capital requirements but will also provide for a stronger role for the supervisory process, and will contain rules for insurers' transparency towards the market and towards clients.

One of the key objectives of Solvency II is to establish a solvency system that is better matched to the true risks of an insurance company. Solvency II concentrates on the financial position of an insurance undertaking<sup>36</sup> and is divided into two distinct phases of operation:

- The first one consisting of studying the subjects in relation to the general form of solvency system; and
- The second one – more technical – will be devoted to the details of the taking into account of each risk in the new system.

Solvency II is bringing far-reaching conceptual changes to the concept of supervision. Specifically, risk management should be integral to corporate management along with an atmosphere of accountability for the risks they accept. This new concept is known as 'overall solvency'. In contrast to the 'solvency margin' method used in previous Directives, 'overall solvency' is not limited to one set of Regulations that apply to the insurer's balance sheet, but also addresses the overall financial condition of an insurance company in the following areas:

<sup>35</sup> (Directive 2002/13/EC and Directive 2002/12/EC)

<sup>36</sup> [www.insurancejournal.com/news/international/2004/08/18/45037.htm](http://www.insurancejournal.com/news/international/2004/08/18/45037.htm)

- Business operations, such as products and prices, administration, and quality of senior managers; and
- External environment, such as economic cycles, competitive conditions, and quality of shareholders.

## 2. The Insurance Mediation Directive (“IMD”)<sup>37</sup>

The Directive sets out minimum standards across Europe for the sale and administration of general insurance and life insurance – measures primarily aimed at insurance brokers. More specifically, the purpose of the Directive is to enable insurance intermediaries to avail themselves of the freedom of establishment and the freedom to provide services in Member States of the EU, reduce barriers to cross-border insurance mediation and improve customer protection.

Relevant requirements include:-

- Registration of all insurance and reinsurance intermediaries with a competent national authority (in the case of the UK this is the FSA). Such registration enables these intermediaries to take up and pursue their mediation activities throughout the EU. The registration requirement is not required if certain narrow conditions are met. As a result, someone selling travel insurance with a holiday, for example, would not be covered by the Directive as long as the premium was below €500;
- Sufficient professional requirements, so that intermediaries have appropriate knowledge, reputation and ability to carry out their activities. It also sets out minimum professional indemnity cover, and a minimum financial capacity;
- Notification of local authorities when setting up in another Member State;
- The establishment of procedures to enable customers and consumer groups to make complaints about intermediaries, and encouragement of complaints and redress procedures for settlement between intermediaries and customers out of court;
- The provision of appropriate information to customers prior to the making of an insurance contract, including details of registration, interest of more than 10 per cent in a given insurance undertaking, whether an insurance undertaking (or its parent) has an interest of more than 10 per cent in the intermediary and details of the relevant complaint procedure;
- The intermediary is also required to inform the customer of the basis of his advice; whether it is fair analysis (i.e. an objective and broad survey of options in the market), whether he is contractually tied to one or more undertakings or whether he is not contractually obliged, but does not provide his advice on the basis of fair analysis.

It is characteristic of this Directive that the rules applying to intermediaries are far stricter when they are dealing with individual consumers than when dealing with businesses or their representatives – protection of consumers being a core role of the legislation.

The Directive offers a ‘passport’ for EU retail insurance intermediaries allowing them to operate within different Member States. It also places a requirement on insurance intermediaries operating, or wishing to operate in other EEA states<sup>38</sup> (either through a branch or on a cross-

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<sup>37</sup> Directive 2002/92/EC of The European Parliament and of the Council of 9 December 2002 on Insurance Mediation

<sup>38</sup> i.e. the EU Member States plus Norway, Iceland and Lichtenstein.

border basis) to give prior notification to their home state regulator. A host state has the option of requiring home states to pass on such notifications received from their authorised firms. The passport rights thus consist of the right of a person to set up a branch in another EEA state or to do business there on a cross-border basis, subject to the fulfillment of the conditions in the relevant Directive. These ‘passporting’ rights only apply within the EEA.

IMD implementation in the UK is included within the new regulatory regime for general insurance intermediaries as applied through the FSA. These rules are embodied in the Insurance Conduct of Business (“ICOB”) module of the Handbook and the Prudential Sourcebook (“PRU”)<sup>39</sup>, which are based on the IMD and the DMD (see below). Pursuant to these rules, UK insurance and reinsurance intermediaries have ‘passporting’ rights under the IMD as from 15<sup>th</sup> January 2005.

The notification procedure for UK firms wishing to exercise passport rights under the IMD in other EEA states is set out in Schedule 3 to the FSMA. Chapter 13 of the Supervision Manual explains how this procedure works. If an EEA state does not want information about intermediaries wishing to passport into its country, a UK intermediary will be able to set up a branch or provide cross-border services in that country, once it has notified the FSA that it wishes to do so.<sup>40</sup> If on the other hand such information is demanded by the EEA host state, there is a different notification procedure. The UK intermediary must notify the FSA of its intention. The FSA will then pass the relevant information to the relevant supervisory authority. The intermediary can begin its ‘passporting’ activities in that EEA state one month after the FSA has informed it that the information has been passed to the other supervisory authority.

The FSA has estimated that there are around 15,000 general insurance primary intermediaries that can be considered to be small firms (firms that have 1 to 5 advisers). Implementation of the IMD will have a significant effect on those firms in terms of compliance requirements. The IMD will likewise have a significant impact on small secondary intermediary firms in the way they become involved in the selling of insurance. The FSA has estimated that there are between 70,000 and 150,000 general insurance secondary intermediaries. This body essentially comprises intermediaries for whom general insurance is not the main activity such as car showrooms, mobile phone companies etc., but are involved in offering various types of insurance as an ancillary part of their activities. As a result of implementation of the IMD, the FSA has concluded that many of these firms may decide to discontinue this activity, become appointed representatives of regulated insurers, or limit themselves simply to providing information rather than being regulated by the FSA. It is worth noting that people buying insurance on behalf of their company do not have the status of insurance intermediaries.

The deadline for the adoption of the IMD was 14<sup>th</sup> January 2005.

### **3. European Mutual Societies**

The proposed Regulation on the Statute for a European Mutual Society has been drawn up to enable mutual societies to take advantage of the single market in the same way as companies can, without having to forego their specific character as groupings of mutually insuring people.

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<sup>39</sup> This text provides prudential standards for insurers and was scheduled to come into force on 31<sup>st</sup> December 2004.

<sup>40</sup> SUP 13.3.2AG - branches; SUP 13.4.3G(4)(b) – cross-border services

The European Mutual Society (ME) is to be a grouping of natural and/or legal persons which guarantees its members, in return for a subscription, full settlement of contractual undertakings entered into in the course of the activities authorised by its rules - whether concerned with providence, insurance, health assistance, credit, or otherwise.

The proposed Regulation provides that a ME may be formed by:

1. Two or more of the national legal entities ;
2. By at least 500 physical persons resident in at least two Member States where the ME is essentially carrying on activities other than providence<sup>41</sup> ; and
3. By conversion of an existing mutual society, without the society being wound up or a new legal person being created, provided it has at least 500 members in a Member State other than that of its central administration, and can show that it is carrying on a genuine cross-border activity.

The proposed minimum amount of the ME's formation fund is set at €100,000. However, this is without prejudice to national provisions providing for a higher amount in the case of mutual societies engaged in certain types of activity. The management and representation of the ME is to be the function either of a management board, with a supervisory board monitoring its activities (the two-tier system), or of an administrative board (the one-tier system).

The following operations will require the authorization of the supervisory board or the deliberation of the administrative board:

1. Closing or transferring a large establishment or a substantial part of such an establishment;
2. Substantially reducing, extending or altering the activities of the ME;
3. Making substantial organizational changes within the ME;
4. Establishing cooperation with other legal persons which is both long-term and of importance to the activities of the ME, or terminating such cooperation; and
5. Raising loans in respect of operations in excess of the ceiling laid down in the rules, issuing securities and assuming or guaranteeing liabilities of a third party.

As regards the drawing-up, auditing and disclosure of its annual accounts, and its consolidated accounts if any, the ME is to be subject to the law of the Member State in which it has its registered office.<sup>42</sup> An ME may be wound up either by a decision of the general meeting, in particular where the period fixed in the rules has expired or where the formation fund has dropped below the minimum laid down in the rules, or by the courts, in particular where the registered office has been transferred outside the Community.

#### **4. Reinsurance Regulation**

On 21<sup>st</sup> April 2004 the Council made a proposal for a Directive on Reinsurance Supervision, which aimed to produce a harmonised framework for reinsurance supervision in the EU. Under

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<sup>41</sup> Providence mutuals cover risks such as illness, handicap, infirmity and death. They are normally subject to specific legislation.

<sup>42</sup> This gives effect to the fourth Council Directive on annual accounts 78/660/EEC, the seventh Council Directive 83/349/EEC on consolidated accounts and the eighth Council Directive on the approval of persons responsible for carrying out the statutory audits of accounting documents 84/253/EEC.

this Directive, supervision of reinsurers (in accordance with Directive provisions) would be carried out by competent authorities in their home country, and on the basis of this they could operate throughout the EU.

The project has its foundations in a sound and prudent regime enacted in the interest of policyholders, who will benefit indirectly via their insurance companies. Supervised reinsurance under this legislation is intended to bring more financial stability to reinsurers in line with the capital requirement rules which already apply to direct insurers. It is hoped that this will reduce the risk that policyholders will suffer financial losses as a result of the potential insolvency of their direct insurance company.

Problems in the EU reinsurance market which were thought to necessitate this Directive include:

- Uncertainty for direct undertakings (and their policyholders) on the quality of the supervision that their reinsurers are subject to;
- The existence of barriers to cross-border reinsurance services (for example collateralisation requirements for outstanding claims against reinsurers in some Member States); and
- Heavy administrative burdens due to different supervisory rules in Member States.<sup>43</sup>

It is also thought that the introduction of harmonised reinsurance supervision is important for the standing of EU reinsurance companies internationally and for ongoing discussions with third countries on market access.

The proposed system has three main features: mutual recognition of the supervision in the member state where the insurance undertaking is licensed, a mandatory licensing system, and quantitative solvency requirements that are in line with those of direct insurance.

The proposal is essentially a ‘fast track’ solution for reinsurance pending proposals covering the insurance industry as whole under the long-term ‘Solvency II’ project (see below).<sup>44</sup> It would abolish national systems which currently oblige reinsurers to pledge assets to cover unearned premiums and outstanding claims provisions. Authorisation for reinsurers would be a true passport enabling them to carry on their businesses anywhere in the EU either by establishing themselves in other member states or by providing services directly from their home or another member state.<sup>45</sup> Meanwhile, national regulators would remain responsible for non-EU reinsurers based in their territory.

The draft report for the Directive was made in March 2005. The latest version of the draft law includes some changes to the original proposal introduced in April 2004. In particular, the EU has cast off its earlier plan to force reinsurers to provide specified collateral to cover risks.<sup>46</sup> Accordingly, Member States have agreed that the EU Directive to create a single European reinsurance market will phase out any existing collateral requirements. Likewise, the Council appears to want to exclude finite reinsurance from the provisions of the Directive.<sup>47</sup>

<sup>43</sup> [europa.eu.int/comm/internal\\_market/insurance/reinsurance\\_en.htm](http://europa.eu.int/comm/internal_market/insurance/reinsurance_en.htm)

<sup>44</sup> Solvency II’ project is dealt with later in this paper under the IAS section.

<sup>45</sup> [www.eubusiness.com/topics/Finance/EUNews.2004-04-22.5909](http://www.eubusiness.com/topics/Finance/EUNews.2004-04-22.5909)

<sup>46</sup> Germany, France and Portugal demand collateral, an example being in the form of letters of credit.

<sup>47</sup> LeBoeuf Lamb EU Insurance Advisory, January 2005 p.3

The Reinsurance Directive was adopted by the European Parliament on 7<sup>th</sup> June 2005, subject to amendment. The Member States are to be given a two year time limit to implement its terms, once definitively adopted.

## 5. Committee of European Insurance and Occupational Pensions Supervisors

The Committee of European Insurance and Occupational Pensions Supervisors (“CEIOPS”) has a formal role in the EU legislative process and is concerned with defining best supervisory practices in order to facilitate convergence.<sup>48</sup> The Committee, chaired by Mr. Henrik Bjerre-Nielsen, is an advisory body set up to implement European Union (EU) insurance and pensions legislation. CEIOPS plays the same role as the CESR in securities and the CEBS<sup>49</sup> in banking. It may coordinate practices in specific cases, but does not have the power to instruct members or observers.

CEIOPS is a network of supervisors created as part of the extension of the Lamfalussy process. It is a ‘Level 3’ committee in the Lamfalussy process and the three main roles of the Committee include:

- Improving coordination and convergence between insurance and occupational pension’s regulators by providing a forum for supervisory cooperation and the exchange of information on supervised institutions;
- Advising the EU Commission, particularly with the preparation of draft implementing measures for insurance, reinsurance and occupational pensions Directives; and
- Ensuring a more consistent and timely implementation of EU legislation in Member States.

As a result of public consultation, CEIOPS approved its “*Statement of Consultation Practices*”, which states the principles and procedures that CEIOPS commits itself to following in its consultation of third parties. It also approved its “*Guidelines for Co-ordination Committees in the Context of Supplementary Supervision of Insurance Undertakings in an Insurance Group*”, the purpose of which is to enhance consistency and effectiveness in the work of the supervisory committees established for each multinational insurance group. The Pensions Regulator is a member of the CEIOPS working group considering effective implementation of the European Directive Activities and supervision of institutions for the occupational retirement provisions Directive<sup>50</sup>, and the practical issues that will arise from the provisions for cross border pension schemes. The group is working towards a common understanding of the Directive, so that it can consider the systems needed for appropriate co-operation and co-ordination

## 6. The 5<sup>th</sup> Motor Insurance Directive

The Motor Insurance Directives are intended to aid the free movement of vehicles in the EU. With the first three Directives, the Community took major steps towards establishing a single

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<sup>48</sup> [www.ceiops.org](http://www.ceiops.org)

<sup>49</sup> The Committee of European Securities Regulators and the Committee of European Banking Supervisors

<sup>50</sup> 2003/41/EC

market in the field of motor insurance. These Directives oblige all motor vehicles in the Community to be covered by compulsory third party insurance and ensure the abolition of border checks on insurance so that vehicles can be driven as easily between Member States as within one country. They were also aimed at providing better protection for victims of accidents, including those caused by unidentified or uninsured vehicles; all passengers in the vehicle (including the family of the driver) are covered by compulsory insurance. Furthermore the Motor Insurance Directives provide for a mechanism to compensate the local victims of accidents caused by vehicles from another Member State.

The 4<sup>th</sup> Motor Insurance Directive<sup>51</sup> was adopted in 2000 and was intended to make it easier for residents of an EEA state who have been victims of motor accidents in another EEA state which are caused by the use of vehicles insured and based in an EEA State (other than the victim's State of residence) to pursue a claim.

On 7<sup>th</sup> June 2002 the Commission adopted a Proposal for a 5<sup>th</sup> Motor Insurance Directive to modernise the existing Motor Insurance Directives and improve the protection of victims. The draft 5<sup>th</sup> Directive covers a range of topics, some of which might have an impact within the UK, but most of which will not.

It is not only that some aspects of the Directives adopted in the 1970s or 1980s need to be updated (in particular, review of the minimum amount of cover). There is also a need to fill gaps or provide solutions to problems that arise very frequently. This is the case, in particular, for:

- The large number of people (e.g. students, workers residing temporarily abroad and individuals with secondary residences) who complain about the difficulties of finding insurance for a temporary stay in another Member State;
- Individuals wishing to purchase a new or second-hand car in another Member State who encounter difficulties in finding short-term insurance cover before the vehicle is registered in the country of importation;
- The growing demand for motor insurance cover for pedestrians and cyclists;
- Motorists wishing to obtain from their existing insurer a statement relating to their claims record in order to negotiate a contract with another insurance undertaking.

Finally, the 4<sup>th</sup> Motor Directive applies only to the settlement of claims in respect of accidents which occurred outside the victim's Member State of residence. The new settlement mechanism as proposed in the 5<sup>th</sup> Directive has two basic objectives:

- To ensure that “*visiting victims*” are compensated quickly; and
- To set up an efficient system for providing a minimum of compensation and legal expenses.

It is now proposed to extend this settlement mechanism to all accidents, regardless of the victim's state of residence. The proposal aims to revise the Motor Insurance Directives in order to achieve the following main objectives:

1. To update and improve the protection of victims of motor vehicle accidents by compulsory insurance;

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<sup>51</sup> 2000/26/EC

2. To fill gaps and clarify certain provisions of the Directives, thereby ensuring increased convergence as regards their interpretation and application by the Member States; and
3. To provide solutions to problems which arise frequently in order to create a more efficient single market in motor insurance.

## **E. GENERAL FINANCIAL PROVISIONS APPLYING TO THE INSURANCE AND OTHER INDUSTRIES.**

### **1. Corporate Governance**

Following the rejection of a proposed Takeover Directive by the European Parliament in July 2001, the Commission set up the Group of High Level Company Law Experts, otherwise known as the Winter Group, whose task was to advise the Commission on a new proposal for a Directive and on how to set up a modern EU framework for company law. Their remit included corporate governance; an issue which has gained great prominence in recent years.

The collapse of Enron in the US and European corporate scandals, such as that of Dutch retailer Ahold and Italian agrifood giant Parmalat, have forced issues of corporate governance and financial reporting onto the EU policy agenda. The EU has thus begun to systematically address corporate governance issues within the scope of its Company Law and Financial Services Policies.

In reaction to the Enron collapse, a declaration was made at the European Council of March 2002 in Barcelona, that responsible corporate governance is a precondition for economic efficiency. The Council required measures to be taken to guarantee the transparency of corporate governance and corporate accounts and to better protect shareholders and others concerned. The Commission and the ECOFIN<sup>52</sup> Council in Oviedo in April 2002 agreed to extend the mandate of the Winter Group to review a number of specific issues including the role of non-executive and supervisory directors, management remuneration, the responsibility of management for financial statements, and auditing practices.

These and other corporate governance issues form a major part of the final Winter Report. It also addresses a number of company law subjects, such as capital formation and maintenance rules, group and pyramid structures, corporate restructuring and mobility, the European Private Company and other European legal forms of enterprise, as well as certain general themes for future development of company law in Europe.

The Winter Report, presented on 4<sup>th</sup> November 2002<sup>53</sup>, recommends that the short-term priorities should be to improve the EU framework for corporate governance through:

- Enhanced corporate governance disclosure requirements;
- Provision for a strong and effective role for independent non-executive or supervisory directors, particularly in three areas where executive directors have conflicts of interests, i.e. nomination and remuneration of directors and supervision of the audit of the company's accounts;
- Establishment of an appropriate regime for directors' remuneration, requiring disclosure of the company's remuneration policy and individual directors' remuneration, as well as prior shareholder approval of share and share option

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<sup>52</sup> ECOFIN is an independent group of companies working in the fields of banking and finance, pensions, investment consulting and financial planning for private investors.

<sup>53</sup> The Report can be found at

[http://europa.eu.int/comm/internal\\_market/en/company/company/modern/consult/report\\_en.pdf](http://europa.eu.int/comm/internal_market/en/company/company/modern/consult/report_en.pdf)

- schemes in which directors participate, and accounting for the costs of those schemes to the company;
- Confirmation as a matter of EU law of the collective responsibility of directors for financial and key non-financial statements of the company;
- Creation of an integrated legal framework to facilitate efficient shareholder information, communication and decision-making on a cross-border basis, using where possible modern technology, in particular the company's website; and
- Setting up of a structure to co-ordinate the corporate governance efforts of Member States.

The Winter Report argues however, that the EU should not strive to create a single European code of corporate governance. This is on the basis that the underlying company law in Member States is not harmonised in key areas and the other conditions which discipline company governance also vary widely in the different Member States. Instead, it proposes that the EU actively coordinate the corporate governance efforts of Member States through their own company laws, securities laws, listing rules, codes or otherwise, to facilitate convergence and avoid divergence, and to facilitate mutual learning. Member States are to designate a national code of corporate governance with which listed companies subject to their jurisdiction are to comply or in relation to which they must explain deviations. Member States are then to participate in the co-ordination process by the EU. The process itself is to be voluntary and non-binding, with the strong involvement of market participants. The Winter Group also calls upon the Commission to pursue its recommendations in establishing an Action Plan for a modernization of European Company Law.

Subsequent to the Winter Report, the Commission adopted an Action Plan on 21<sup>st</sup> May 2003 to improve corporate governance rules. The Action Plan aims at strengthening shareholders' rights and protection for employees and creditors, as well as fostering the efficiency and competitiveness of business. Among the most urgent initiatives, the Commission lists:

1. Mandatory publication by listed companies of an Annual Corporate Governance Statement;
2. Detailing companies' corporate governance structures and practices;
3. Development of a legislative framework governing shareholders' rights (such as asking questions or voting in absentia);
4. Adoption of a Recommendation, which aims at promoting the role of (independent) non-executive or supervisory directors;
5. Adoption of a Recommendation on Directors' Remuneration, promoting more transparency and influence among shareholders; and
6. Establishment of a European Corporate Governance Forum to encourage the coordination of national codes' enforcement and monitoring.

The proposals contained in the Action Plan are prioritised over the short, medium and long-term, and are aimed at restoring market confidence. In order to achieve this, the Action Plan on company law and corporate governance is complemented by ten priorities the Commission has proposed to improve and harmonise the quality of statutory auditing.

## 2. Capital Regulation

Reform of capital regulation in the insurance markets (see Solvency II above) is heavily influenced by what is taking place amongst investment firms, banks and other credit institutions – all of which are to fall under the new Basel II Accord. The original Basel Accord (commonly referred to as Basel I) was agreed in 1988 by the Basel Committee on Banking Supervision in order to help strengthen the stability and integrity of the international banking system. The new Basel II Accord was intended to build on the first Basel Accord, by rendering the international system more sensitive to risk management practices and was endorsed in June 2004.

The Commission published its subsequent proposal for a new capital requirements framework for banks and investment firms in July 2004. The 'Capital Requirements Proposal' which reflects the revised Basel II Accord, uses a 're-cast' technique to amend the existing Banking Coordination Directive ("BCD") and Capital Adequacy Directive ("CAD"), rather than create a wholly new Directive. Within the EU, much of the Basel II provisions will be implemented by a new Risk-Based Capital Directive ("RBCD").

It is hoped that Basel II-style Regulation will offer the following advantages:

- A more flexible, risk sensitive approach;
- Incentives for better risk management;
- Better competitive equality;
- More emphasis on a company's own internal control, management and risk control;
- Encouragement of market discipline; and
- A wider range of credit risk mitigation techniques.

In furtherance of these aims, Basel II is split into three main pillars:

1. Minimum Capital Requirement. This encompasses the new concept of operational risk and a new credit risk framework;
2. Supervisory Review. This is intended to ensure that banks have sound internal processes to assess adequacy of capital based on risk evaluation; and
3. Market Discipline. Market discipline takes the form of disclosure requirements that are intended to provide information about a banks exposure to risks arising from the methodologies chosen in Pillar 1. The aim is to provide a means of disclosure between banks.

The new Capital Adequacy Directive ("CAD3") will represent the minimum requirement that will apply to both banks and insurance/investment firms. The new Accord is expected to come into force on 1<sup>st</sup> January 2007.

Under the Basel II regulatory regime, the purchase of insurance can reduce the amount of capital that must hold against operational risk by as much as 20 per cent. As implementation of this regime approaches, financial institutions will need to devise methods for valuing insurance that will be rigorous enough to pass muster with bank regulators. According to the Basel II framework, a bank's *"risk mitigation calculations must reflect the bank's insurance coverage in a manner that is transparent in its relationship to, and consistent with, the actual likelihood and impact of loss used in the bank's overall determination of its operational risk capital."* Thus, if a bank wishes to reduce the amount of capital it must hold by purchasing insurance, it must develop a process for understanding the relationship between insurance and operational risk determined by the bank.

Under the new regulatory regime, financial institutions will likely be the first insurance buyers to take advantage of innovative approaches to transferring and financing operational risk in the form of finite insurance<sup>54</sup> and other Alternative Risk Transfer methods.

### 3. International Accounting Standards Regulation (“IAS”)

The IAS<sup>55</sup> are a uniform set of global accounting standards, developed by the Board of International Accounting Standards Committee (“IASC”).<sup>56</sup> Between 1973 and 2001 the International Accounting Standards Committee released its International Accounting Standards (“IAS”).

In June 2000, the Commission published its Communication on "*EU Financial Reporting Strategy: The Way Forward*" in which it was proposed that all publicly traded Community companies prepare their consolidated financial statements in accordance with one single set of accounting standards (i.e. the IAS) by 2005 at the latest. In June 2002, the European Council of Ministers approved the Regulation that would require all EU companies listed on a regulated market to prepare accounts in accordance with the IAS for accounting periods beginning on or after 1<sup>st</sup> January 2005. Such companies included banks and insurance companies. The IAS Regulation<sup>57</sup> was adopted on July 2002 by the European Parliament and the Council,<sup>58</sup> and is directly applicable in all Member States.

Under this Regulation it is required that for each financial year starting on or after 1 January 2005, companies governed by the law of a Member State shall prepare their consolidated accounts in conformity with IAS if, at their balance sheet date, their securities are admitted to trading on a regulated market of any Member State within the meaning of Article 1(13) of Council Directive 93/22. Within the requirements of the Regulation, Member States have the option to:

- Require or permit IFRS<sup>59</sup> for unlisted companies;
- Require or permit IFRS in parent company (unconsolidated) financial statements;
- Permit companies whose only listed securities are debt securities to delay IFRS adoption until 2007; and

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<sup>54</sup> This is an insurance arrangement in which the limit of coverage, the time period involved and the premium paid acknowledge the time value of money. The liability is generally limited in the aggregate. While risk transfer takes place, typically most premiums are put into an experience fund which accrues interest and pays losses. The insured has the right to all money within the experience fund which can be paid back as a profit commission at the end of the transaction or applied to ongoing programs.

<sup>55</sup> The International Accounting Standards Board (“IASB”) publishes its accounting standards in a series of pronouncements called International Financial Reporting Standards (“IFRS”). It has also adopted a body of Standards issued by the IASC. Those statements continue to be designated as the IAS.

<sup>56</sup> In June 1973 the International Accounting Standards Committee (IASC) came into existence, with the stated intent that the new international standards it released must *'be capable of rapid acceptance and implementation world-wide'*.

<sup>57</sup> (EC)1606/2002

<sup>58</sup> The measures necessary for the implementation of this Regulation are to be adopted in accordance with Council Decision 1999/468/EC of 28 June 1999 which lay down the procedures for the exercise of implementing powers conferred on the Commission

<sup>59</sup> International Financial Reporting Standards

- Permit companies that are listed on exchanges outside of the EU and that currently prepare their primary financial statements using non-EU accepted accountancy standards to delay IFRS adoption until 2007.

The overall purpose of the Regulation is to facilitate an efficient and cost-effective functioning of the European capital market. The Regulation also reinforces freedom of movement of capital in the European internal market and helps to enable Community companies to compete on an equal footing for financial resources available in the Community capital markets, as well as in world capital markets.

### ARC & IAS 39

According to Article 6 of the IAS Regulation of 2002, the Commission shall be assisted by an Accounting Regulatory Committee (“ARC”) composed of representatives of the Member States. The Commission shall submit draft implementing measures concerning international accounting standards to the ARC for its opinion.

On 19<sup>th</sup> November 2004, the European Commission adopted via adoption of an international accounting standard titled “*IAS 39: Financial Instruments: Recognition and Measurement*”. The standard was intended to establish universal principles for recognising, measuring, and disclosing information about financial assets and financial liabilities. It significantly increases the use of fair values in accounting for financial instruments, and supplements the disclosure provisions of IAS 32.<sup>60</sup> This standard is applicable for annual periods beginning on or after 1 January 2005.

IAS 39 applies to all types of financial instruments. Importantly, it does not apply to (amongst other things) rights and obligations under insurance contracts, though IAS 39 does apply to financial instruments that take the form of an insurance (or reinsurance) contract but that principally involve the transfer of financial risks and derivatives embedded in insurance contracts.

In February 2005 the European Commission passed an amending Regulation<sup>61</sup> which adopted IAS in accordance with the 2002 Regulation.<sup>62</sup>

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<sup>60</sup> Financial Instruments: Disclosure and Presentation

<sup>61</sup> No 1725/2003

<sup>62</sup> This is the Regulation of the European Parliament and of the Council as regards International Financial Reporting Standards (IFRS) 1 and 2 and International Accounting Standards (IASs) No 12, 16, 19, 32, 33, 38 and 39 (1)

In the UK, the Finance Act 2004 included measures to ensure that companies choosing to adopt the IAS to draw up their accounts receive broadly equivalent tax treatment to companies that continue to use UK Generally Accepted Accounting Practice (“GAAP”).<sup>63</sup> Sections 50 to 54, under the heading of Accounting Practice, and Schedule 10 (Amendment of enactments that operate by reference to accounting practice) of the Finance Act contain the relevant provisions. Section 50 of the Finance Act redefines “*generally accepted accounting practice*” to include both the IAS (as adopted by the EU) and UK GAAP for periods beginning on or after 1 January 2005. From January 2005, therefore all British companies can use the IAS as an alternative to British accounting standards.

It is mandatory from 2006 onwards for companies whose financial statements are prepared in accordance with the fair value accounting rules set out in the Companies Act, and may be used for 2005 on a voluntary basis.

#### **4. Distance Marketing Directive (“DMD”)**

The aim of the DMD<sup>64</sup> is to establish a common framework for the distance marketing of financial services across the EU. Its main provisions provide increased protection and greater choice for consumers by setting minimum standards for information that must be provided in entering into ‘distance means’ financial services contracts, with mandatory ‘cooling-off’ periods. This will apply in connection with the purchase of financial contracts by post, fax, internet and telephone. The DMD requires information to be provided “*in good time before the consumer is bound by any distance contract or offer*”. The kind of information that must be provided includes:-

- details about the supplier including its identity, its representatives, its supervisory authority etc;
- a description of the financial service being provided, including price, risks warnings, additional costs etc;
- a description of terms of the distance contract including a right to withdraw within a certain period, minimum duration, early termination penalties, law of the contract etc;
- details about means of redress in the event that something goes wrong, including whether there is a complaint system in place, whether a guarantee fund is in place or other compensation provisions.

As noted, the DMD allows for cooling off periods for consumers, this being 14 days (or 30 days in the case of life insurance and personal pensions) during which the consumer may withdraw from a contract without penalty. Certain types of insurance are exempted from this provision – though conventional insurance does not fall amongst them.

The DMD also prohibits the supply of financial services to a consumer without a prior request when the supply includes a demand for payment. As a result, an absence of reply on the part of a consumer should never lead to obligations related to the unsolicited supply of financial services. Likewise restrictions have been placed on unsolicited marketing including the use of fax machines and automated telephone dialers.

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<sup>63</sup> In December 2004 the ASB issued 6 new FRS intended to converge UK GAAP with IAS. These include FRS 25 and 26 which are the UK equivalents of IAS 32 and 39. FRS 26 is mandatory in 2005 only for listed companies without subsidiaries.

<sup>64</sup> 2002/65/EC – Member States had until 9<sup>th</sup> October 2004 to implement its provisions.

Enforcement of this Directive in the UK is the responsibility of the FSA. Most aspects of the Financial Services (Distance Marketing) Regulations 2004 came into force on 31<sup>st</sup> October 2004. The requirements relating to the provision of minimum information come into force on 31<sup>st</sup> May 2005.<sup>65</sup>

## 5. EU Competition Regulation

One of the key functions of the EU is to create a single market for the benefit of both consumers and producers, and to ensure that it functions in such a way that competition within it is not distorted by market abuse by large companies by means of cartel, monopoly and other arrangements such as price fixing. The framework for achieving this objective is set out in Articles 81 and 82 of the EC Treaty – the former relating to concerted practices by companies, and the latter relating to abuse of a dominant position by a company. In the UK, the Competition Act 1998 reflects the principles in these two Articles, s.60 of the Competition Act states that British competition authorities operate in a way that is consistent with the principles of the EC Treaty, the case law of the European courts and the decisions and statements of the Commission.

The Commission was given extensive powers of investigation in relation to Article 81 and 82 infringements, including extensive powers of investigation including ‘dawn raids’ and rights of entry to premises. Ordinary rules of legal privilege and non self-incrimination will apply, and there is protection for business secrets. Likewise, the Commission must present a case against the relevant parties, and hear their own case. If an infringement is found, punishments can be substantial – for example fines of up to 10% of turnover. The level of fine is likely to be affected by considerations of gravity, duration and behavior such as non-cooperation in the relevant investigation or ending an infringement as soon as the Commission intervenes. It should be noted that substantial changes have taken place recently in terms of investigation and enforcement (see below).

### Article 81

Article 81 forbids all agreements, decisions and concerted practices between undertakings which may affect trade between Member States, and which are aimed at preventing, restricting or distorting competition within the Common Market. Examples of this would include price-fixing and market sharing. Any agreement in breach of this prohibition will be void unless exempted by the Commission. Companies located outside the EU will still be subject to Article 81 if the effects of its anti-competitive actions are felt within the EU. Small agreements which do not particularly affect competition within a market do not fall under Article 81.

Traditionally, companies could consult the Commission to find out whether any proposed agreement or practices would be likely to fall under Article 81. The Commission could then issue them a comfort letter advising as to the agreement or practice’s likely status, though such a letter, like other kinds of Commission guidance, do not bind national courts and could not be invoked before the ECJ. Companies could also notify the Commission of an agreement/practices in order to seek an exemption which might be granted if it improved the production/distribution of goods, contributed to technical/economic progress, allows consumers a fair share of the benefit, has no unnecessary restrictions and does not eliminate competition. In order to cut workloads, block

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<sup>65</sup> <http://www.fsa.gov.uk/Pages/Library>

exemptions were introduced to cover arrangements such as franchising<sup>66</sup> and research and development<sup>67</sup> so that they would, within certain boundaries, be exempted without the relevant company having to notify the Commission of them.

The Commission has likewise allowed block exemptions for certain ‘vertical’ (i.e. up and down the supply chain) arrangements<sup>68</sup>, where suppliers do not make up more than 30 per cent of the relevant market on which it sells goods/services, or purchases goods/services. Once this condition is satisfied, there are further restrictions, such as a buyer having an annual turnover of no more than €1000m, and the relative status of buyer and supplier.

### Article 82

Article 82 is aimed at curbing the abuse of a ‘dominant position’ by companies – for example the charging of artificially high prices by companies in a monopoly position. Again, such abuse must affect trade between Member States before Article 82 can be invoked. First, dominance of a particular market must be demonstrated, which raises often complicated questions as to market definition. Second, the dominance of the company must be established which relies on analysis of several aspects such as their market share, the market share of their competitors, control of production and distribution, conduct, performance and so forth. There is much caselaw on this subject, though there is no hard and fast rule. The third task for the Commission is to establish abuse by the dominant company which is either exploitative or anti-competitive in nature. Article 82 in fact provides examples of such abuse including unfair prices (where prices do not related to economic value of a product), limited production and contractual discrimination (i.e. between different customers). Unlike Article 81, Article 82 did not have a system of individual or block exemption.

Articles 81 and 82 was supplemented by Regulation 4064/89, under which the Commission investigated mergers (and potentially joint ventures) which fell into certain brackets. This Regulation has since been re-cast (see below), though many elements have been retained, so it is still worth looking at its provisions. Under this Regulation, the mergers must have a ‘Community dimension’ and involve:-

- Companies with a combined aggregate worldwide turnover of €5 billion, where the aggregate Community-wide turnover of at least two of the companies is more than €250 million, unless each of the companies achieves more than two-thirds of its Community-wide turnover within one and the same Member State; or
- Companies with a combined worldwide turnover of €2.5 billion where in at least three Member States the combined turnover of all of the companies is more than €100m, in each of at least three Member States the turnover of at least two of the companies is more than €25 million and the aggregate worldwide turnover of each of at least two of the companies is more than €100 million, unless each of the companies achieves more than two-thirds of its Community-wide turnover within one and the same Member State.

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<sup>66</sup> Regulation 4087/88

<sup>67</sup> Regulation 418/85

<sup>68</sup> Regulation 2790/99

Under the Regulation, once notified the Commission has a month to analyse the merger, based on considerations of market structure, market positions, competition, consumer interests and so forth. The Commission then has three options:-

- If it finds the merger does not fall within the scope of the merger legislation, it will record that finding by a Decision;
- Where it finds the merger is subject to the legislation, but that it does not raise serious doubts as to its compatibility with the common market, it will make a declaration that it is in fact compatible; or
- If it finds that the merger is subject to the legislation, and does in fact raise serious doubts as to its incompatibility with the common market, it will decide to initiate proceedings against those companies. In certain circumstances however, the Commission may suggest changes to the proposed merger which would render it compatible, and make a declaration accordingly assuming such changes are carried out by the relevant companies.

### Reform of Competition Rules: Regulation 1/2003

On 1<sup>st</sup> May 2004 businesses across the EU faced the most radical reform to the EU's competition rules since 1962. It was on this date that Regulation 1/2003, on the implementation of the rules on competition as laid down in Articles 81 and 82 of the EC Treaty, became effective.<sup>69</sup> The reforms devolve much of the enforcement function of EU competition law to the National Competition Authorities ("NCAs") of the Member States, and will see the investigation and enforcement powers of the Commission increased. This reform is likely to have profound implications for business operations across the continent.

The 1<sup>st</sup> May 2004 also marked the enlargement of the EU to 25 member states and it is against this historical context that modernisation must be seen. An enlarged EU will provide new and different competition challenges. According to the European Commissioner for Competition Authority, Mario Monti:

*"We will have to guarantee that business and authorities are able to operate under the same competition policy constraints in the whole EU, despite marked divergences between economic development and competition background that will exist within our borders."*<sup>70</sup>

The main changes introduced by the new Regulation are:

1. The abolition of the notification system – it has been suggested that this may in fact reduce certainty for companies seeking guidance in their competition affairs;
2. Decentralised application of the EU competition rules (through increased co-operation with national courts and NCAs);
3. The Commission and the NCAs shall have the power to provide one another with, and use, evidence in any matter of fact or of law including confidential information;
4. Where two or more NCAs have received a complaint or are acting on their own initiative against the same agreement, the fact that one authority is dealing with the case shall be

<sup>69</sup> Regulation 1 will replace Regulation 17/62 which sets out the existing procedural rules for enforcement of Articles 81 and 82.

<sup>70</sup> Speech by Mario Monti on 24<sup>th</sup> October 2003, Fordham Annual Conference on International Antitrust Law and Policy.

- sufficient grounds for the others to suspend the proceedings before them or to reject the complaint;
5. The Commission can provide informal guidance to undertakings in exceptional circumstances;
  6. Introduction of what is hoped to be a more efficient complaints procedure;
  7. The creation of a new electronic address for information about suspected infringements;
  8. The Commission will be able to take oral statements from staff of undertakings under investigation;
  9. The Commission will be able to raid private homes; and
  10. The Commission is given specific power to impose a structural remedy where no equally effective behavioural remedy is available.

Clearly not all of this is good news for business. Firms are no longer be able to obtain the legal security of direct clearance from the Commission for deals involving major capital investments. Instead firms have to rely on US style self-assessment and regular antitrust audits. Critics have noted that this has the effect of decreasing the certainty with which companies can address competition issues, with all of the consequences that could be expected such as overly cautious business strategies and increased compliance expenses. Companies also face a Commission equipped with an enhanced arsenal of powers and resources to tackle cartels and other anti-competitive behaviour. Controversially, the Commission gets the power to raid the homes of executives employed by firms it believes are involved in illegal price-fixing, cartels and other anti-competitive activity. Executives will also have to get used to the idea of antitrust decentralisation. The Commission will only be actively involved in the biggest cases. In smaller cases, firms will find the local NCAs such as the Office of Fair Trading handling the case.

The European Merger Regulation, as was, provided that where merging companies' turnover meets prescribed thresholds (see below) they are to be notified to and assessed by the Commission rather than NCAs. The Commission announced in June 2000 a review of the Merger Regulation following a report indicating the thresholds may be too high as a number of mergers with significant cross-border effects were not being caught by the stipulated thresholds. The review also considered other aspects of the merger Regulation in the context of the modernisation of the Commission's competition laws.

#### Reform of Merger Rules: Regulation 139/2004

This Regulation, which applied as from 1<sup>st</sup> May 2004 has made some important changes to the merger regime established by its predecessor, and has essentially re-cast Regulation 4046/89. As a result, the criteria for judging whether a merger is subject to Commission scrutiny remains the same (see above).

Changes include:

- a clarification of the basic criterion for analyzing mergers (which is wider and more flexible one than the traditional 'dominant position' criteria);
- a more flexible and commercially sensible notification procedure (most particularly a new 'pre-notification procedure' to clarify competence of the relevant authority to look into a merger, and the ability of companies to notify proposed mergers before a binding agreement has been reached between parties);
- a simplified system of referral between Member States and Commission;
- a more flexible timetable for investigation;

- strengthened powers of investigation and enforcement for the Commission (backed up by the ability to impose significant fines for non-compliance or delay);

Under the original Merger Regulation, the Commission has exclusive jurisdiction for mergers between firms with a combined worldwide turnover of at least €5 billion and a turnover within the European Economic Area of more than €250 million for each of them. In this way, mergers can be assessed in a single procedure and don't have to go through a number of different procedures in individual EU countries (the "*one stop shop*" principle). In cases where the companies concerned have more than two-thirds of their European turnovers in one and the same Member State, the merger is examined by the relevant national competition authority. This is because local authorities are generally in a better position to examine the potential effects of such merger than the Commission – thus adhering to the devolvement principle. The procedural changes in the 2004 Regulation have gone some way to increasing the role of the national competition authorities, and ensuring that regulation is devolved to the most appropriate level.

The Commission must bear in mind the 'carbon test' which is a substantive test to decide whether a merger must be challenged or not. The 1989 Regulation was based on the concept of dominance: a merger must be blocked if it creates a dominant position, and therefore would likely result in higher prices, less choice and innovation. This concept has been interpreted by the Commission and the European courts along the years as applying also to situations of "*joint dominance*" or duopolies (for example Gencor and Lonrho) as well as to situations of "*collective dominance*"<sup>71</sup> or oligopolies (for example Airtours and First Choice).

The test has now been adapted to make clear that all anti-competitive mergers resulting in higher prices, less choice or innovation are covered. This is achieved by a new test, which states that a merger must be blocked if it would "*significantly impede effective competition*". Dominance, in its different forms, will remain the main issue, but the test now clearly encompass anticompetitive effects in oligopolistic markets where the merged company would not be strictly dominant in the usual sense of the word (i.e. much bigger than the rest). The central question is now whether sufficient competition remains after the merger has taken place, so that consumers retain sufficient choice in their spending decisions – thus allowing for efficient and competitive market behaviour.

The Commission regards this change in the wording of the test as a clarification of, rather than an addition to, its powers. It claims that the new test enhances legal certainty for the business community by making it clear that the test enshrined in the Regulation covers all categories of anti-competitive mergers.

## 6. Taxation

The EU Treaty envisages a single market and the principle that member states do not impose unjustifiable barriers hindering cross-border trade and investment. The European Court of Justice has already ruled that protecting a Member State's tax base is not a justifiable reason for allowing fiscal impediments to the single market concept.

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<sup>71</sup> The concept of collective dominance is a legal concept which is based on the economic proposition that in highly concentrated markets it is likely that the small number of firms surviving will recognise their interdependence and the futility of aggressive competitive behaviour.

Generally, a state can only tax the profits of a company resident in that state, but, usually, cannot tax the profits of the company's foreign subsidiaries. Therefore, it can be advantageous for a company in a high-tax country to let profits arise in a lower taxed foreign subsidiary. Tax can then be deferred until a dividend is paid or the shares in the subsidiary are sold. Some countries exempt capital gains and/or dividend tax from foreign subsidiaries, in order to achieve a permanent tax advantage. High tax countries fearing substantial profit shifting to low tax countries introduced domestic Controlled Foreign Companies ("CFC") rules in order to protect their revenue. Such rules are generally aimed at rendering the profits of overseas subsidiaries and affiliates taxable within the jurisdiction of the home state of the controlling or parent company.

Recently, there has been some doubt over whether or not the UK's CFC legislation is in accordance with EU law. Early in 2005, the ECJ is expected to rule on whether it is lawful for the Inland Revenue to apply the CFC rules to the profits earned by two Irish subsidiaries of Cadbury Schweppes Plc, which benefited from a special Irish corporate tax rate of 10% during the mid 1990s.<sup>72</sup> The Advocate General is expected to deliver an opinion imminently, with the final judgment following later this year.<sup>73</sup>

Cadbury Schweppes argued that the UK's CFC Rules unfairly discourage the establishment of European subsidiaries and capital flows and are thus contrary to EU law. If it wins its case, the future of the UK's rules applying to European CFC's will be unclear and the government may be forced to amend its CFC legislation.<sup>74</sup> Likewise both these issues would provide new tax planning opportunities to multinational groups controlled from the UK and allow claims against previous CFC assessments.

This is the first case where the ECJ has been requested to settle a question on the compatibility of a Member State's CFC legislation with fundamental EU freedoms.<sup>75</sup> The CFC rules seek to tax the profits of overseas subsidiaries, which are controlled by UK companies or individuals as they arise, irrespective of whether they are distributed back into the UK. Under these rules, the UK controlling company may have a tax charge even though it may not have received any cash from its subsidiary. There are a number of exemptions available to prevent this legislation being applied when foreign subsidiaries exist for good commercial reasons and not for tax avoidance purposes.

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<sup>72</sup> The Special Commissioner UK Inland Revenue had requested the ECJ for a preliminary ruling on whether UK's CFC rules are compatible with the EC treaty particularly with the Freedom of establishment (Art. 43), the freedom to provide services (Art. 49) and the free movement of capital (Art.56). Case C-196/04, Cadbury Schweppes, OJ, 26 June 2004, C-168, 3

<sup>73</sup> From <http://www.lwk.co.uk>, 14<sup>th</sup> March, 2005.

<sup>74</sup> The free flow of capital concept applies to all UK tax laws passed since 1 January 1994 affecting not just intra-EU but worldwide transactions. Since 1994, numerous measures have been added to UK law which have tightened the CFC rules. It is uncertain whether this additional legislation is now enforceable on a worldwide basis or will simply have to be revised as part of a wider overhaul of the CFC rules.

<sup>75</sup> The Treaty of Rome of 1957 established four freedoms for the single market - (i) of free movement of persons, (ii) free provision of services, (iii) free movement of goods and (iv) freedom of establishment. From [www.gtnews.com](http://www.gtnews.com). Previously the Finnish Council of State had considered an application of the Finnish CFC Rules to a Finnish parent company and its Belgian coordination centre as compatible, refusing to refer the case to the ECJ (the 20<sup>th</sup> May 2002 decision).

The ECJ ruling on this matter is anxiously awaited throughout the EU as other Member States with similar tax rules are keen to know whether the application of such rules within the EU constitutes a restriction of the fundamental freedoms that are laid down in the EC Treaty.<sup>76</sup> It is difficult to predict the result, with technical arguments and political concerns conflicting. On the one hand, the ECJ (which has heard about 40 tax cases and ruled in favour of the taxpayer in 90% of them) is likely to be keen to continue its gradual standardization of Europe's tax systems. On the other hand, governments would be justified in complaining that this was hardly the intention of the EC Treaty, and to ask whether it is wise to allow the ECJ to rewrite the tax rules in this way.

CFC legislation has been an impediment to the full exploitation by multinational groups of lower tax rates within the EU. The extent to which Ireland and, in particular, the 10% tax rate in the International Financial Services Centre ("IFSC" as started in 1989) has been directly and indirectly targeted by other Member States' CFCs can be seen from the dates from which many of these CFC rules were introduced.

Corporation tax raises about £30 billion each year for the UK Exchequer. Around 80% of total Corporation Tax receipts are paid by about the top 20% of corporate taxpayers (mainly banks, retailers and oil companies). If all of the provisions of the CFC Rules which have been identified as potentially subject to future litigation are indeed struck down, and are not replaced by the Government, then the cost could be around £8 billion to £10 billion per year.

Further provisions apply to the taxation of savings income in the form of the Interest Payments Council Directive<sup>77</sup> which is to come into effect on 1<sup>st</sup> July 2005.<sup>78</sup> This measure forms one of the elements of a larger 'tax package' aimed at tackling tax competition within the EU. Such competition currently has the effect of presenting investors with an unequal playing field depending upon where they choose to put their capital, as a result of differing burdens of taxation.

The ultimate aim of the Directive is to enable savings income in the form of interest payments or similar payments made in one Member State to individuals resident (for tax purposes) in another Member State to be made subject to taxation in accordance with the laws of the latter Member State.

The Directive will require each Member State to provide details of payments of interest or other similar income paid by a person within its jurisdiction to an individual resident in that other Member State to the tax authorities of the latter Member State. Certain non-EU countries (that is, the US, Switzerland, Andorra, Liechtenstein, Monaco and San Marino) will apply similar measures from the same date, in accordance with agreements entered into by them with the EU.

Jurisdictions such as Belgium, Austria and Luxembourg, which tend to be concerned about banking secrecy, will not apply this system of information exchange immediately however. They

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<sup>76</sup> The Treaty of Rome of 1957 which set up the European Economic Community (EEC) which aimed to extend the common market of the ECSC to create a single European market with no barriers to the movement of goods, people and capital in Western Europe. The Treaty of Maastricht changed its name to "the European Community" in 1992.

<sup>77</sup> 2003/48/EC

<sup>78</sup> (Council Decision

2004/587/EC) [europa.eu.int/comm/taxation\\_customs/taxation/personal\\_tax/savings\\_tax/index\\_en.htm](http://europa.eu.int/comm/taxation_customs/taxation/personal_tax/savings_tax/index_en.htm)

may instead apply, for a transitional period only, a withholding tax<sup>79</sup> on savings income at rates rising over time to 35%.<sup>80</sup>

## 7. Money Laundering

The EU is zealously battling money laundering by regulating the entry of huge sums of money into the region. Under existing money laundering rules as established by the 1<sup>st</sup> and 2<sup>nd</sup> Money Laundering Directives (“ML Directives”), financial institutions must verify the identity of their clients and notify the relevant authorities of any transactions in which money laundering is suspected<sup>81</sup> - for example HM Treasury, the FSA and HM Revenue and Customs.

The EU recently expanded the scope of its efforts, in order to try and apply the verification process to legal professionals, accountants and estate agents, and ordered Member States to revise their legislation accordingly. Pursuant to this objective, in June 2004 the Commission proposed a 3<sup>rd</sup> ML Directive which was intended to be ready for implementation one year later. The 3<sup>rd</sup> directive is set to come into force by the end of 2005, and Member States will have two years to implement it.

This proposed 3<sup>rd</sup> Directive aims to amend and consolidate the previous two ML Directives. Besides the proposal for a new definition of money laundering predicate offences (i.e. offences, the proceeds of which are subsequently laundered) as required by the 2<sup>nd</sup> ML Directive, the 3<sup>rd</sup> Directive is meant to ensure a coherent application in all Member States of the revised forty recommendations adopted by the Financial Action Task Force (“FATF”)<sup>82</sup> in June 2003.

### The 1<sup>st</sup> Money Laundering Directive

The 1<sup>st</sup> Money Laundering Directive<sup>83</sup> required Member States to ensure money laundering is prohibited (though what sanctions were to be used to do this, and how to fulfill the objectives was left to the Member States themselves).

The 1<sup>st</sup> Directive required the imposition of an obligation on financial and credit institutions (including insurance companies) to establish customers’ identity and report any suspicion of money laundering. Money laundering includes converting, transferring, concealing, disguising or acquiring property which is known to be derived from criminal activity. The offence likewise covers participation, attempts to commit or facilitating the commission of all of the above. Financial and credit institutions covered by the Directive are subject to the following obligations:-

<sup>79</sup> i.e. Personal income tax paid on wages, salaries, dividends, or other income received by a non-resident of a country. Withholding tax is deducted at source to ensure that the income does not leave the country without being taxed.

<sup>80</sup> [www.legalmediagroup.com/internationaltaxreview/default.asp](http://www.legalmediagroup.com/internationaltaxreview/default.asp)

<sup>81</sup> Council Directive 91/308/EEG (10 June 1991) on the prevention of the use of the financial system for the purpose of money laundering (1<sup>st</sup> AML Directive) and Directive 2001/97/EC of the European Parliament and of the Council of 4 December 2001, amending Council Directive 91/308/EEC, on the prevention of the use of the financial system for the purpose of money laundering – Commission Declaration (2<sup>nd</sup> AML Directive).

<sup>82</sup> The leading international body in the fight against money laundering and the financing of terrorism.

<sup>83</sup> 91/308/EEC

- the identification of customers and retention of records;
- the reporting of suspicious transactions; and
- the establishment of internal procedures to train employees in identifying and dealing with money laundering, and to prevent the relevant institution from being used by money launderers.

### The 2<sup>nd</sup> Money Laundering Directive

The 2<sup>nd</sup> Money Laundering Directive<sup>84</sup> was presented in October 2001, following the identification of certain weaknesses in the 1<sup>st</sup> Directive. Changes brought about by the 2<sup>nd</sup> Directive include:-

- a wider definition of money laundering to include serious fraud and corruption;
- the express inclusion of investment firms in the definition of financial institution;
- extends the scope of the 1<sup>st</sup> Directive to cover collective investment undertakings and professionals such as auditors, accountants, lawyers and dealers in high value goods; and
- the express inclusion of bureaux de change and money remittance offices.

The Directive aims to strengthen the ability of Member States to fight financial crime and terrorism. It also brings law in the rest of Europe closer to the tough rules which already applied in the UK. It thus relieves the UK banking sector of some of the competitive disadvantages which they previously faced as a result of the relatively stringent UK money laundering regime. This legislation extended the application of the provision to greater number of crimes and a greater variety of professions. In addition it required the establishment of financial intelligence units in each Member State to which Suspicious Transactions Reports (“SRT”s) are to be made.

### The 3<sup>rd</sup> Money Laundering Directive

The proposed 3<sup>rd</sup> Money Laundering Directive is intended to incorporate into EU law revisions made to the FATF recommendations in June 2003, and was proposed in the wake of the September 11<sup>th</sup> attacks.

The new Directive:

1. Extends obligations to notify suspicious transactions to certain non-financial professions and sectors;
2. Widens the definition of laundering to the proceeds of all serious crime (including terrorism).<sup>85</sup>
3. Introduces further measures to tackle the financing of terrorism with either criminally or legally acquired money.
4. Obliges financial institutions to identify the owner of a business organization or transaction. This will prevent people from being able to hide behind certain legal facades;
5. Introduces a risk-based approach, under which institutions affected by the Directive will have to undertake their own risk-assessments to decide what client identification needs to be carried out.
6. Covers all traders who accept cash payments of more than €15,000.

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<sup>84</sup> 2001/97/EC

<sup>85</sup> From [http://europa-eu-un.org/articles/cs/article\\_1425\\_cs.htm](http://europa-eu-un.org/articles/cs/article_1425_cs.htm)

Member State authorities will also be obliged to ensure compliance with the Directive. Lawyers across the EU have sought amendments to the Directive in order to make ‘tipping off’ offences optional for Member States. Particularly vocal on this issue were British lawyers who sought to maintain their defence to proposed ‘tipping off’ offences<sup>86</sup> subject to legal professional privilege, as covered by the Proceeds of Crime Act 2002. However, pressure to get the Directive through the legislative process has meant that MEPs have ditched vital amendments in this respect. This means that tipping off penalties are likely to be mandatory for all Member States in future. The Directive is expected to be adopted in June 2005.<sup>87</sup>

Agreement on the Directive was reached in the EU Council for Economic and Financial Affairs (“ECOFIN”) on December 7. In Parliament, the Civil Liberties, Justice and Home Affairs Committee is leading on the issue. Its draft report has now been published and was discussed in committee on 21<sup>st</sup> February 2005.

Some of the states pushing hardest for the Third ML Directive (such as France) have not yet implemented the Second ML Directive<sup>88</sup> - a fact pointed out by the Commission. The Commission is considering legal action on the countries which have not yet implemented it and has accordingly sent formal requests to Italy, Portugal, Greece, Sweden, Luxembourg and France. Uneven implementation has increased the competitive disadvantage to which the UK's strict money laundering regime already subjects firms.

UK legislation is reflective of the 1<sup>st</sup> and 2<sup>nd</sup> ML Directives in the form of the Money Laundering Regulations 1993 and 2003 respectively. These form part of a greater raft of money laundering legislation in the UK including the Criminal Justice Act 1988, Drug Trafficking Act 1994, Terrorism Act 2000, Proceeds of Crime Act 2002 and associated secondary legislation.

## 8. Credit Rating Agencies

The International Organization of Securities Commissions<sup>89</sup> (“IOSCO”) Code of Fundamentals for Credit Rating Agencies defines Credit Rating Agencies (“CRA”)s as:

- Those entities whose primary business is the issuance of credit ratings for the purposes of evaluating the credit risk of issuers or debt and debt-like securities; or
- Any organization whose ratings are recognized for regulatory purposes by a financial regulatory authority.

<sup>86</sup> i.e. where a lawyer might ‘tip-off’ a client that they may have to make a report to authorities.

<sup>87</sup> Rachel Rothwell, ‘MEPs Deal Blow on Money Laundering’, The Gazette 5<sup>th</sup> May 2005

<sup>88</sup> Member States were obliged to transpose this Directive into their respective national laws by mid-June 2003.

<sup>89</sup> IOSCO was created in 1983 when 11 securities regulatory agencies from North and South America, already organized since 1974 as the inter-American regional association, formed a truly international cooperative body. IOSCO has some 180 members from around the world who regulate more than 90% of the world's securities markets. IOSCO promotes cooperation, mutual assistance, information sharing and the development of standards to improve the Regulation of securities markets internationally. IOSCO is a key international standard setting body.

Bankers, industry executives and politicians on the continent have complained about Europe's dependence on the American dominated rating system. This has placed pressure on the EU to regulate the rating system, and there is a lot of support for establishing a European rating agency. Europe does not currently have a major rating agency that takes into account the special characteristics of European accounting, or the prevailing differences in financial ratios which evolved as a result of a bank-based financial system. This is a situation that some feel demands remedy.

As a result, the EU is currently assessing credit rating agencies, the research methods they use and potential conflicts of interest. In February 2004, the European Parliament adopted a Resolution on the role and methods of rating agencies, following an 'own-initiative' report from its Committee on Economic and Monetary Affairs. In March 2004, following the Parmalat scandal and adoption by an overwhelming majority of the European Parliament resolution, the Commission presented the four core issues which it considers need to be addressed in relation to credit rating agencies:

1. Potential conflicts of interests within rating agencies;
2. Transparency of rating agencies' methodologies;
3. Legal treatment of rating agencies' access to inside information; and
4. Concerns about lack of competition in the market for provision of credit ratings.

The Committee of European Securities Regulators subsequently released a Consultation Paper considering the potential Regulation of Credit Rating Agencies. The Committee is halfway through its process of evaluating the role of CRAs, and will not be issuing advice for some time. Even then, if legislation is required, the legislative process thereafter will lengthen the whole process as it will involve Parliament and Council. The Committee has noted that any initiative on rating agencies must follow this global perspective and, to this end, has contacted the following bodies in relation to the review:

- Committee of European Banking Supervisors ("CEBS");
- The US Securities and Exchange Commission ("SEC")<sup>90</sup>; and
- International Organization of Securities Commissions ("IOSCO").<sup>91</sup>

It appears that amongst banks at least, such proposed regulation is not entirely welcome. "*Rating agencies provide a judgment and banks decide if they use their judgment or not. Self-regulation with the use of a code of conduct is the best choice to address conflicts of interests,*" says Caitriona O'Kelly of the European Banking Federation.<sup>92</sup>

The market is already self-regulating in this area. In April 2005 for example, the Association Française des Trésoriers d'Entreprise released a draft of a "*Code of Standard Practices for Participants in the Credit Rating Process*". The standard allows each of the CRAs to use its own

<sup>90</sup> Since 1975, the SEC has relied on credit ratings from "*market-recognised credible*" rating agencies in order to distinguish between grades of creditworthiness in various Regulations under the federal securities laws.

<sup>91</sup> In September 2003, IOSCO released a report from its Technical Committee on the activities of credit rating agencies. The final section of this report consists of a Statement of Principles. This Statement of Principles covers the manner in which credit rating agencies activities should be conducted in order to reinforce the integrity of the rating process and to assist credit rating agencies in providing investors with informed and independent opinions.

<sup>92</sup> www.thebanker.com – "*EU's Plan to Regulate is Fiercely Opposed*" 1<sup>st</sup> September 2004

methodology but requires them to stick to it and document it. Although this is already a step towards what EU legislators want, market participants are still averse to the idea of a harmonised methodology. While the EU is still far from implementing any legislation, rating agencies are already making clear their concerns about the possibility of tighter regulation in this area.

## 9. Miscellaneous

This section is further divided into the following sections:

- a) Civil Liability for Nuclear Damage;
- b) Environmental Liability;
- c) EU Data Protection and Cyber-Security in the EU; and
- d) Gender Neutrality.

### a) Civil Liability For Nuclear Damage

Nuclear liabilities can generally be split into two types; the costs of decommissioning nuclear reactors and managing radioactive waste after a power plant has stopped generating electricity, and the costs of dealing with accidents during the active life of such reactors. The first type, which is expected typically to extend over a period of up to 100 years or more, should generally be funded by cash reserves built-up from income during the operating life of the plant. However, circumstances vary widely across Europe, leading to distortions in competition and an increasing amount of state subsidies to the nuclear sector when firms get into difficulty. Currently there are 140 nuclear reactors operating at 64 locations in 13 states by around 18 companies. In the UK at least, it is likely that the number of nuclear reactors in operation will increase over the coming decades. Total combined long-term liabilities amount to many hundreds of billions of euro.

In terms of the second type of liability, ever since the first commercial nuclear power reactors were built, there has been concern about the possible effects of a severe nuclear accident, coupled with the question of who would be liable.

As the accident at Chernobyl disastrously illustrated, the consequences of nuclear accidents are not necessarily confined to national boundaries. As a result, it is important that the protection accorded to victims by a third party liability regime be distributed equitably among affected countries. Likewise, the potential magnitude of damage from a nuclear accident is such that coverage of liability requires international collaboration between national insurance pools. Furthermore, there is a significant amount of transboundary transport of nuclear materials – which is not necessarily well dealt with by disparate national liability regimes. All of these were considered good reasons for the development of an international regime to deal with the possible consequences of such accidents.<sup>93</sup>

The international liability regime which has come about as a result is primarily embodied in two instruments:

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<sup>93</sup> <http://www.nea.fr/html/general/press/press-kits/nuclear-law.html>

1. The Vienna Convention on Civil Liability for Nuclear Damage 1963 which was established under the auspices of the International Atomic Energy Agency and is worldwide in character; and
2. The Paris Convention on Third Party Liability in the Field of Nuclear Energy 1960 which was established under the auspices of the Nuclear Energy Agency and covers most west European states.<sup>94</sup> Coverage under the Paris Convention was expanded by the Brussels Supplementary Convention 1963<sup>95</sup>. Various amendments have been made subsequently.

Furthermore, the Paris and Vienna Conventions have been linked by a Joint Protocol<sup>96</sup> in 1992. The Paris and the Vienna Conventions are further supplemented, in relation to maritime transport, by the Brussels Convention 1971.<sup>97</sup> The Conventions are based on the civil law and share the following central principles:

- Operators of nuclear facilities are strictly liable, i.e. the operator is held liable irrespective of fault, except for "acts of armed conflict, hostilities, civil war or insurrection";
- Liability of the operator is limited in amount and time; there is an effective time limit of 10 years for claims;
- The operator must maintain insurance or other financial security for an amount corresponding to his liability or the limit set by the relevant state, beyond which public funds are to be used;
- Jurisdiction over actions lies exclusively with the courts of the contracting state in whose territory the accident occurred; and
- There is to be no discrimination of victims on grounds of nationality, domicile or residence.

These Conventions were linked by the Joint Protocol in 1988. For nuclear power station operators, the minimum level of third party liability cover is set at US\$890 million, for accidents in transporting nuclear material US\$102 million and for "low risk" installations US\$89 million.

In March 2004 the European Council passed a Decision authorising Member States to ratify a Protocol amending the Paris Convention. In approving of this Protocol<sup>98</sup>, the Commission explained that the protocol introduces several notable changes by:

- Extending coverage of the convention to the territory and coastal waters of non-nuclear states;
- Widening definitions of "*indemnifiable damage*";

<sup>94</sup> These include Belgium, Greece, Slovenia, Denmark, Italy, Spain, Finland, Netherlands, Sweden, France, Norway, Turkey, Germany, Portugal and the United Kingdom

<sup>95</sup> As signed up to by Belgium, Germany, Slovenia, Denmark, Italy, Spain, Finland, Netherlands, Sweden, France, Norway, and the United Kingdom

<sup>96</sup> Joint Protocol Relating to the Application of the Vienna Convention and the Paris Convention of 21 September 1988

<sup>97</sup> Convention Relating to Civil Liability in the Field of Maritime Carriage of Nuclear Material of 17 December 1971

<sup>98</sup> The original Paris Convention set requirements expressed in Special Drawing Rights (SDRs) at SDR 15 million (\$22 million at the current exchange rate), SDR 5 million (\$7 million), and SDR 5 million (\$7 million), respectively. However, parties to the Paris Convention later signed an additional NEA-brokered treaty, the 1963 Brussels Supplementary Convention, under which states promised additional payments from public funds.

- Increasing the minimum levels of liability that signatory states must specify in national legislation. The limits are; Operators (insured) €700m, signatory State (public funds) €500m, collective state contribution €300m, thus with a total maximum level of cover of €1.5bn; and
- Extending the scope of the Convention to include environmental damage. The Vienna Convention already covers environmental damage, but the 32 parties to the Vienna Convention include only two EU states, Spain and the UK.

The current EU member states that are party to the Paris Convention are expected to ratify the Protocol "by the end of 2006," according to a report from the EU Parliament's Legal Affairs Committee.<sup>99</sup>

### b) Environmental Liability Directive

The Environmental Liability Directive came into force in April 2004. It is aimed at preventing environmental damage by forcing industrial polluters ("Operators") to pay prevention and remediation costs. The Directive is one of the most controversial, and potentially far-reaching, pieces of environmental legislation negotiated by the EU to date.

The Directive aims to establish a framework that would prevent "*significant environmental damage*" or rectify damage after it has occurred. "*Significant environmental damage*" will be defined by reference to:

1. Biodiversity, whether protected at EU or national levels;
2. Waters covered by the Water Framework Directive; and
3. Human health (including land contamination when it is a threat to human health).

Annex I of the Directive provides specific criteria to assess when damage is "*significant*".<sup>100</sup> For example, significant adverse changes to the baseline condition should be determined by means of measurable data such as:

- The number of individuals, their density or the area covered;
- The role of the particular individuals or of the damaged area in relation to the species or to the habitat conservation, the rarity of the species or habitat (assessed at local, regional and higher level including at Community level; and
- The species' capacity for propagation (according to the dynamics specific to that species or to that population), its viability or the habitat's capacity for natural regeneration (according to the dynamics specific to its characteristic species or to their populations, etc).

Member States will be under a duty to ensure that the necessary preventive or restorative measures are actually taken.

Operators carrying out "*hazardous*" activities will be held strictly liable (i.e. no need to show fault or negligence) for preventing or restoring any damage caused by those activities to land, water and protected habitats and species. In addition, Operators carrying out other, less harmful,

<sup>99</sup> Report A5-0036/2004, of Jan. 29, 2004

<sup>100</sup> Article 2 (1) (a).

activities will be held liable when damage to protected habitats and species has been caused by their fault or negligence.

Member States may exempt Operators from clean-up costs if the damage:

- Is caused by pollution released within the terms of emission permits; or
- Occurred despite the use of best practice.

Operators will automatically be exempt from having to compensate for damage caused:

- By war or an act of God; or
- By a third party, despite having taken all safety measures.

Damage from nuclear and maritime accidents fall outside the environmental regime's scope and remains subject to existing treaties as described above. Member States have until 30th April 2007 to incorporate the Directive's provisions into national law. It is likely that these measures will have a significant effect on the demand for environmental liability and pollution cover, with significant opportunities for non-marine insurers operating in this area.

### c) EU Data Protection and Cyber-Security

The main overarching legal instruments in EC law on data protection is the 1995 Data Protection Directive<sup>101</sup> which protects individuals with regard to the processing of personal data and on its free movement. The Directive makes provisions for direct marketers in particular to inform subjects that their data may be collected and used for direct marketing - and to give them the right to object to this.

This Directive embodies two objectives of the European integration project: (i) the achievement of an Internal Market (in this case the free, though controlled movement of personal information); and (ii) the protection of the rights and freedoms of individuals.

However, delays in implementation by Member States and differences in the ways the Directive has been applied at national level have caused concern. A uniform interpretation and application of the Directive in national provisions is still missing. Amongst the major problems identified in the Directive's implementation and operationality is the long-term retention of data such as passengers' records and other data.<sup>102</sup> This is because there is risk of such data influencing employment decisions or granting of government and welfare benefits.<sup>103</sup> For instance on 21<sup>st</sup> April 2004 the European Parliament took the Commission to Court over the agreement with the US Department of Homeland Security on the transfer of air passenger's personal data (PNR) to US authorities.

Apparently as a response to technological developments, in December 1997 the European Parliament and the Council translated the principles set out in Directive 95/46/EC into specific rules for the telecommunications sector. These rules were adopted via the Directive on Privacy

<sup>101</sup> Directive 95/46/EC of the European Parliament and of the Council of 24<sup>th</sup> October 1995.

<sup>102</sup> Data Protection in Justice and Home Affairs: An Opportunity for Transatlantic Dialogue Friday 11 July 2003. From [www.euractiv.com/Article](http://www.euractiv.com/Article)

<sup>103</sup> [www.europa.eu.int/information\\_society/topics/ecom/highlights/current\\_spotlights/spam/index\\_en.htm](http://www.europa.eu.int/information_society/topics/ecom/highlights/current_spotlights/spam/index_en.htm)

and Electronic Communications (“DPEC”)<sup>104</sup> which dealt with the processing of personal data and the protection of privacy in the telecommunications sector. The subsequent Universal Service Directive<sup>105</sup> on privacy and electronic communications updated DPEC to reflect developments in the markets and technologies for electronic communications services – particularly the internet. These measures are intended to provide an equal level of protection to personal data and privacy, regardless of the technologies used.

The Commission presented its first report on the implementation of the Data Protection Directive in May 2003. In 2005 Working Party 29<sup>106</sup> adopted two working documents:

- The first is on data protection issues related to intellectual property rights (Working Document 104) adopted on 18th January, 2005; and
- The second is on data protection issue related to Radio Frequency Identification (“RFID”) technology (Working document 105) adopted on 19th January, 2005. The party has launched public consultations on these papers

The results of the working party are to be reviewed by the Commission in 2005 after which proposals are to be submitted which may amend, if required, the current Data Protection Directive.

Although the Member States should have implemented the Data Protection Directive by October 1998, many failed to do so on time. The Commission is now following this up, and has initiated infringement proceedings against some states. In December 1999, for example, the Commission decided to take France, Germany, Ireland, Luxembourg and the Netherlands to the ECJ for failure to inform the Commission of necessary measures taken to implement the Directive.<sup>107</sup>

France was the first member of the EU to enact data protection legislation in 1978.<sup>108</sup> This French data protection law of 1978 was amended in July 2004 in order to bring it in line with the requirements of the Data Protection Directive which entered into force in August 2004.<sup>109</sup>

In Germany the Federal Data Protection Act was adopted 18 May 2001. The German Federal legislation applies to both the federal public sector and the private sector. It entered into force on 23<sup>rd</sup> May 2001.

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<sup>104</sup> Directive 97/66/EC

<sup>105</sup> 2002/58/EC

<sup>106</sup> Article 29 of the Directive 95/46/EC Data Protection establishes a Working Party which is an independent and advisory body meant to bring together ‘Data Protection authorities’ in the EU.

<sup>107</sup> Subsequently when Netherlands and Germany in 2001 notified; the Commission closed the cases against them. France notified the data protection law of 1978 so that the proceedings for non notification against it were also dropped. France announced at the same time its intention to pass a new law. The Commission action against Luxembourg, has led to this State being condemned by the Court of Justice for failure to fulfil its obligations. The Directive was then implemented with a new law that entered into force in 2002. Ireland in 2001 notified a partial implementation; which was later passed as a complete Bill.

From [http://europa.eu.int/eur-lex/en/com/rpt/2003/com2003\\_0265en01.pdf](http://europa.eu.int/eur-lex/en/com/rpt/2003/com2003_0265en01.pdf)

<sup>108</sup> The French Data Protection Act makes stricter provisions than its founding law, the EC Directive of 95 to deal with the data storage issue faced by the Commission in the recent past. The French law provides that personal data cannot be stored over a certain period of time and ensures that the storage time reflected in the declaration is not disproportionate to the purpose of the database.

<sup>109</sup> From <http://www.mofo.com/tools/print.asp>

The UK law implementing the 1995 Directive<sup>110</sup> is the Data Protection Act (“DPA”) passed on 16<sup>th</sup> July 1998. Under the DPA, Principle 1 of Schedule 1 notes that the processing of personal data must be fair and lawful; the best practice is to obtain a data subject’s consent before collecting electronic contact details and processing this data. Whilst what amounts to consent is not defined in the DPA, the original EU Data Protection Directive refers to effective consent being “*specific and informed*” and emphasis is placed on users giving some sort of positive sign that consent has been given.

#### d) Gender Neutrality

The existence of discrimination between women and men in the area of goods and services has prompted the EU to consider providing a Directive in this area – known as the Gender Equality Directive. The proposed Directive gives concrete form to the Commission's intention to present a proposal to prohibit discrimination based on sex outside the labour market.<sup>111</sup>

The prohibition of discrimination between women and men should apply to the access to and supply of goods and services which are available to the public. Under the proposed Directive all direct and indirect discrimination between women and men is prohibited, including unfavourable treatment for reasons of pregnancy and maternity.

The Directive establishes minimum requirements - while the Member States can introduce or maintain provisions which are more favourable than those laid down in the Directive, they cannot reduce the level of protection granted by the Directive.

There has been widespread debate in the EU over this Directive. The Comité Européen des Assurances (“CEA”), the European federation for the insurance and reinsurance industry believes that in order to allow insurers to fulfill all of their commitments, pricing would have to be biased. Only such a bias on pricing would provide insurers with cover against potential liabilities where members of a pension scheme, for example, were mainly women, and if men primarily purchased motor insurance. As such, they oppose the proposals, as does the Association of British Insurers.

The controversy became more heated recently, when the FSA spoke out against the likely effects of the proposed legislation. Callum McCarthy, chairman of the FSA, notes that although the regulator opposed any form of gender discrimination, it was concerned “*....whether the wholly laudable aim of preventing gender discrimination can be practically achieved by a statement which overrides realities, and second whether the implications of what has been proposed have been thought through.*”<sup>112</sup> The FSA assesses that with regard to annuities, the result of overriding the reality of different life expectancies for men and women would be an increase in the annuity a woman would be able to purchase at the age of 60 by 2 per cent, and a 3 per cent reduction in the annuity that a man could purchase at the age of 60.

For the same reason of differing life expectancy, life insurance premiums for a woman aged 40 would likely increase in cost by 16 per cent, while the premiums payable for a man of the same age would fall by 8 per cent.

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<sup>110</sup> (95/46/EC)

<sup>111</sup> As expressed in the presentation of a Community framework strategy for gender equality (2001-2005) and in its social policy agenda published in June 2000.

<sup>112</sup> <http://www.telegraph.co.uk/money/main.jhtm>

There are further cost implications. "*The proposed Directive would increase the overall cost for consumers of buying insurance cover. This is because firms will not know in advance the proportions of men and women who might in the future buy their non-differentiated products*" says McCarthy.<sup>113</sup> This is likely to result in insurers including margins in their product pricing to cover the risk of their assumptions being incorrect, and they may also have to hold more capital to cover this risk.

Although the Gender Equality Directive relates to all sectors, the insurance industry will be particularly hard hit, as insurers will have to apply a policy of gender neutrality in the setting of premiums. The use of statistical criteria on the differences between men and women on issues like life expectancy or driving records would be banned. Insurers would also be unable to develop women-only products, such as low-cost motor insurance for women drivers.

The proposal was recently discussed by the EC working group, and was to put before ministers from all Member States on 1 June 2005. If adopted, the Directive will become law next year. Insurers would be given a transitional period of up to six years to adapt, while banks would have a two-year timescale to remove gender discrimination in their business practices. The Member States which decide to make use of this transitional period will notify the Commission and must compile, publish and update detailed life expectancy tables for men and women, so that the market is sufficiently transparent for the consumer.

The content of this paper does not constitute legal advice and should not be relied on as such. Specific advice should be sought about your specific circumstances.

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<sup>113</sup> <http://www.goodinsurance.co.uk/term-life-insurance-articles/eu-gender-debate-hots-up.html>