WHITE & CASE

Insight: Financial Regulation

May 2012

Financial Regulatory Update

The last three months have seen a relative slow-down in the rate of production of entirely new financial regulatory reform materials. Legislatures, regulators and industry are taking time to debate and revise the numerous significant measures which are already in train. Nevertheless, the ongoing legislative timetable for European financial regulatory reform remains ambitious. Key elements of many of the proposed new regulations are still unclear despite the stated aims of the regulators generally to adhere to pre-announced implementation dates.

This newsletter highlights some of the key financial regulatory reform measures affecting the UK and EU since December 2011. For a copy of our December newsletter, please **click here**.

Banking regulation

Basel III update

The Basel Committee on Banking Supervision and the European Banking Authority have published the results of their June 2011 Basel III implementation monitoring exercises (4 April 2012)[1]

A total of 212 banks participated in the Basel Committee study, including 103 Group 1 banks (that is, those that have Tier 1 capital in excess of €3 billion and are internationally active) and 109 Group 2 banks (all other banks).

The monitoring exercises assumed full implementation of the final Basel III package based on data as of 30 June 2011 without taking account of any transitional arrangements. No assumptions were made about bank profitability or behavioural responses, such as changes in bank capital or balance sheet composition. For that reason the results of the study are not comparable to industry estimates.

1 Available at http://www.eba.europa.eu/cebs/media/Publications/Other%20Publications/QIS/EBA-BS-2012-037-FINAL-Results-Basel-III-Monitoring-.pdf

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The Basel Committee study found that, based on data as of 30 June 2011 and applying the changes to the definition of capital and risk-weighted assets, the average common equity Tier 1 capital ratio (CET1) of Group 1 banks was 7.1%, as compared with the Basel III minimum requirement of 4.5%. In order for all Group 1 banks to reach the 4.5% minimum, an increase of €38.8 billion CET1 would be required. The overall shortfall increases to €485.6 billion to achieve a CET1 target level of 7.0% (including the capital conservation buffer); this amount includes the surcharge for global systemically important banks where applicable.

For background information on Basel III, please click here for our earlier client alert and here for an article on capital instruments that are loss-absorbent at the point of non-viability of a firm.

European Commission Green Paper on shadow banking (19 March 2012)[2]

The European Commission has published a discussion paper on shadow banking, broadly in order to engage in the debate regarding the possible future regulation and supervision of the shadow banking sector which is currently the focus of the Financial Stability Board. The European Commission has invited comments on the Green Paper by 1 June 2012. The FSB is expected to make recommendations regarding enhanced supervision of the sector by the end of the year.

CRD update

European Presidency compromise proposals of the draft Capital Requirements Directive and Capital Requirements Regulation (CRD4) were published on 2 April 2012[3]

European Banking Authority Consultation paper on Draft Regulatory Technical Standards on Own Funds (4 April 2012)[4]

The European Banking Authority has launched the first part of a consultation on draft Regulatory Technical Standards (RTS) on own funds. The consultation groups fourteen RTS covering, amongst others, areas such as Common Equity Tier 1, Additional Tier 1, deductions from Common Equity Tier 1 and from own funds in general and transitional provisions on grandfathering.

The consultation paper is based on the draft Capital Requirements Regulation (CRR) as proposed by the European Commission on 20th July 2011. As the text is still being discussed by the EU legislature, some of the mandates for the EBA to develop Binding Technical Standards (BTS) may be changed in the adopted Regulation. Therefore, the proposed RTS are likely to be amended after the consultation to take into account the final CRR text.

Timing - the RTS must be submitted to the EU Commission by 1 January 2013. Separate consultations on some remaining RTS on Own Funds will follow in the second half of 2012.

For further information on CRD 2 and 3 and the proposed CRD 4 package, please click here and here.

European Banking Authority survey on the implementation of the Guidelines on remuneration policies and practices (12 April)

The European Banking Authority has published the results of its survey on the implementation of the CEBS Guidelines on remuneration policies and practices. The survey findings indicate that, in most countries, the Guidelines came into force on 1 January 2011 and that supervisors have actively assessed remuneration policies requiring, where needed, interventions in the remuneration structures and payouts of the variable component. While considerable progress has been reported with respect to the governance of remuneration, some areas of concern are stated to remain.

Further supervisory guidance will be given in setting up the criteria for identifying risk takers as well as in the application of the proportionality principle and of the risk alignment practices.

Crisis management

The European Commission's widely trailed legislative proposals on an EU framework for crisis management in the financial sector are still awaited. As an interim measure, in March 2012, the Commission published a discussion paper on the debt write down (or bail-in) tool[5] which it regards as part of the final steps to prepare the proposal on the recovery and resolution of banks and investment firms. The Commission is discussing the proposals with stakeholders with a view to these enabling the swift adoption of the proposal once published, and to prepare the ground for its smooth negotiation during the legislative process.

Timing – it is expected that legislative proposals will be published before the G20 meeting in June.

2 Available at http://ec.europa.eu/internal_market/bank/docs/shadow/green-paper_en.pdf

3 Available at http://register.consilium.europa.eu/pdf/en/12/st08/st08467.en12.pdf and http://register.consilium.europa.eu/pdf/en/12/st08/st08468.en12.pdf

4 Available at http://eba.europa.eu/cebs/media/Publications/Consultation%20Papers/2012/CP02/EBA-BS-2012-059–CP-2012-02v2.pdf

5 Available at http://ec.europa.eu/internal_market/bank/docs/crisis-management/discussion_paper_bail_in_en.pdf

Investment funds regulation

ESMA discussion paper on Key concepts of the Alternative Investment Fund Managers Directive (AIFMD) and types of AIFM (23 February 2012)[6]

In February 2012 ESMA published a discussion document on various provisions under the AIFMD including the definitions of alternative investment fund managers, alternative investment funds, treatment of UCITS management companies and the treatment of MIFID Investment Firms and Credit Institutions under the Directive.

Timing – finalised draft proposals on the matters covered will be published for consultation in Q2 2012 and finalised draft regulatory technical standards are to be submitted to the Commission for adoption by the end of 2012. The Directive is due to be implemented in July 2013.

Securities regulation

Prospectus Directive

A Directive[7] amending the Prospectus Directive came into force on 31 December 2010 and should be implemented by EU member states by 1 July 2012, although they have discretion to do so earlier. In the UK, two changes already came into effect on 31 July 2011: a rise in the threshold for an offer of securities for which a prospectus is required from €2.5 million to €5 million; and an increase in the minimum number of investors for which a prospectus is required from 100 to 150. The remaining measures are to be implemented by the 1 July 2012 deadline.

On 30 March, the European Commission published a draft Delegated Regulation[8] amending certain aspects of the the Prospectus Regulation as follows: the format and the content of a prospectus, the base prospectus, the summary and the final terms and concerning disclosure requirements in certain circumstances (specifically, for rights issues, SMEs and credit institutions). The Delegated Regulation categorises the different items of the applicable Prospectus Regulation Annexes to determine which information should be included in the base prospectus at the time of approval, and which information should be included in the final terms at the time of an individual issue. Some additional information may be inserted in the final terms, on a voluntary basis. The Regulation also emphasises that Final Terms must not amend or replace any information in the base prospectus.

Timing - the delegated Regulation will enter into force on 1 July 2012. The European Parliament and the Council have the right to express objections to it prior to its taking effect.

Central Securities Depositaries – Commission acts to increase the safety and efficiency of securities settlement in Europe (7 March 2012)

As part of its ongoing efforts to create a sounder financial system, the European Commission has proposed a European common regulatory framework for Central Securities Depositories (CSDs),[9] the institutions responsible for securities settlement. The proposal seeks to enhance the safety and efficiency of securities settlement in Europe and shorten the time it takes for securities settlement.

Key elements of the proposals include:

- Settlement periods will be harmonised and set at a maximum of two days after the trading day for the securities traded on stock exchanges or other regulated markets
- Market participants that fail to deliver their securities on the agreed settlement date will be subject to penalties and will have to buy those securities in the market and deliver them to their counterparties
- Issuers and investors will be required to keep an electronic record for virtually all securities, and to record them in CSDs if they are traded on stock exchanges or other regulated markets
- CSDs will have to comply with strict organisational, conduct of business and prudential requirements to ensure their viability and the protection of their users. They will also have to be authorised and supervised by their national competent authorities
- Authorised CSDs will be granted a 'passport' to provide their services in other Member States
- Users will be able to choose between all 30 CSDs in Europe
- CSDs in the EU will have access to any other CSDs or other market infrastructures such as trading venues or Central Counterparties (CCPs), whichever country they are based in

Timing – the proposal will pass to the European Parliament and the Council (Member States) for negotiation and adoption. Implementation of certain provisions is stated to be in 2015 and 2020.

6 Available at http://www.esma.europa.eu/system/files/2012-117.pdf

7 Available at http://ec.europa.eu/internal_market/securities/prospectus/index_en.htm.

8 Available at http://ec.europa.eu/internal_market/securities/docs/prospectus/20120330-delegated-regulation_en.pdf

9 Available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52012PC0073:EN:PDF

Regulation on Short Selling and Certain Aspects of Credit Default Swaps

The Regulation on Short Selling and Certain Aspects of Credit Default Swaps[10] has been adopted. It will become effective on 1 November 2012.

The Regulation creates a two-tier model for the disclosure of significant net short positions for shares of companies listed in the EU. At a lower threshold, notification of a position must be made privately to the regulator, but at a higher threshold (0.5% of issued share capital and above), positions must be disclosed to the market.

For sovereign debt, significant net short positions relating to issuers in the EU will always require private disclosure to regulators. The proposed regime also provides for notification of significant positions in credit default swaps that relate to EU sovereign debt issuers.

The regulation generally requires that anyone entering into a short sale must at the time of the sale have borrowed the instruments, entered into an agreement to borrow them or made other arrangements to ensure they can be borrowed in time to settle the deal, although there are exceptions in certain circumstances.

In March 2012 the European Securities and Markets Authority (ESMA) published certain regulatory and implementing technical standards relating to provisions of the Regulation. The Commission has three months from the date of submission to decide whether to adopt these.

European Markets Infrastructure Regulation (EMIR)

The European Parliament adopted the European Market Infrastructure Regulation (EMIR) on 29 March 2012.[11] The objectives of the new rules are to increase transparency in the OTC derivatives market and to make the market safer by reducing counterparty credit risk and operational risk.

Key elements of the Regulation are as follows:

- detailed information on OTC derivative contracts entered into by EU financial and non-financial firms must be reported to trade repositories and made accessible to supervisory authorities. Trade repositories must publish aggregate positions by class of derivatives accessible to all market participants. In the course of the negotiations the scope of the proposal was widened to cover the reporting of both listed (i.e. non-OTC) and OTC derivatives.
- the new rules introduce prudential, organisational and conduct of business requirements for central counterparties. CCP-clearing for contracts that have been standardised (i.e. they have met predefined eligibility criteria) becomes mandatory and risk mitigation standards for contracts not cleared by a CCP (e.g. exchange of collateral) are introduced.
- electronic means must be used for the timely confirmation of the terms of OTC derivatives contracts.
- The obligation to clear OTC derivatives contracts through a CCP and report derivatives to trade repositories will apply to financial firms (banks – both universal banks and investment banks, insurance companies, funds etc.) and to non-financial firms (energy companies, airlines, manufacturers etc.) that have large positions in OTC derivatives.
- Contracts of non-financial firms below a 'clearing threshold' will not have to be cleared through a CCP. Commercial and treasury hedging activities will not count towards the threshold set for the clearing obligation. These thresholds are not set out in the proposal. ESMA, the European Securities and Markets Authority, together with ESRB, the European Systemic Risk Board and other relevant authorities will draft technical standards on what these thresholds should be.

Timing – Before the EMIR rules are implemented, the European Supervisory Authorities (ESAs) first need to develop technical standards. The ESAs must submit these standards to the Commission by 30 September 2012. In line with G20 commitments, these new standards should be fully adopted by the Commission by the end of 2012.

Central counterparties will have to apply for authorisation under the new European regime at the latest six months after the adoption of the technical standards by the Commission. In the meantime, CCPs must continue to comply with national rules on authorisation.

The date of application of the reporting obligation and clearing obligations will be determined in the new technical standards to be developed by 30 September 2012.

10 Available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:0024:en:PDF

11 Available at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+20120329+SIT-01+DOC+WORD+V0//EN&language=EN

Automated Trading (24 February 2012)

ESMA has published official translations of its final "Guidelines on systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities"[12] first published on 21 December 2011. High frequency trading is one form of automated trading.

The purpose of the guidelines is to ensure common, uniform and consistent application of The Markets in Financial Instruments Directive and the Market Abuse Directive as they apply to the systems and controls required of trading platforms and investment firms in an automated trading environment and trading platforms and investment firms in relation to the provision of Direct Market Access or Sponsored Access.

Timing – the publication triggers a transitional period of two months during which national supervisors must declare whether they intend to comply with the guidelines or otherwise explain the reasons for non-compliance. National supervisors are obliged to make every effort to comply with the Guidelines.

Credit rating agencies

On 15 March, ESMA announced that it considered the regulatory frameworks for credit rating agencies (CRAs) of the United States of America, Canada, Hong Kong and Singapore to be in line with European rules. This allows European financial institutions to continue using credit ratings issued in these countries for regulatory purposes after 30 April 2012.

UK regulatory reform

The UK Government has published policy proposals and draft legislation that will fundamentally reform the structure of financial regulation.[13] This will involve the creation of a new prudential supervisor for banking organisations and insurance companies, the Prudential Regulation Authority, which will be a subsidiary of the Bank of England. The supervision of markets and business conducted with consumers will be the responsibility of the Financial Conduct Authority. Both of these bodies will have new powers including a power to ban financial products. At the same time, a new committee of the Bank of England – the Financial Policy Committee, will be charged with powers of direction over both regulators in order to avoid instability of financial markets and systems.

Timing – the Government introduced the Financial Services Bill[14] into the House of Commons in January 2012 following pre-legislative scrutiny by a Joint Committee of the House of Commons and House of Lords. At the same time the Government published a written response to the Joint Committee's report. Subject to the parliamentary timetable, the Government's aim is for the Financial Services Bill to gain Royal Assent by the end of 2012, and for the new regulatory system to be operational in early 2013. The Government further intends that legislation relating to the retail ring fence which has been the subject of the Independent Commission on Banking's September 2011 Report should be finalised by May 2015 and implemented as soon as possible thereafter, although new provisions relating to loss absorbing capital would be implemented from 2019, commensurate with the Basel III timetable.

12 Available at http://www.esma.europa.eu/system/files/esma_2012_122_en.pdf

13 Available at http://www.hm-treasury.gov.uk/consult_finreg_blueprint.htm.

14 Available at http://services.parliament.uk/bills/2010-11/financialservices/documents.html