Insight: Financial Regulation

December 2011

Financial Regulatory Update

The last few years have seen a very significant number of proposals for global financial regulatory reform. Our Summer newsletter (please click *here*) gave an update of where the main reform proposals stood. As we head towards 2012, this newsletter looks at more recent developments and highlights those areas where we expect to see further movement in the coming year.

Banking regulation

Basel III update

Frequently asked questions on the Basel III definition of capital

In October 2011, the Basel Committee responded to a set of frequently asked questions on the Basel III definitions of capital.[1] In November, the Basel Committee published answers to frequently asked questions on the treatment of counterparty credit risk under Basel III.[2] These documents provide clarification to firms and their advisers on the main Basel III rules texts published in December 2010 and January 2011.

Enhanced requirements for global systemically important banks

The Basel Committee has developed enhanced requirements for global systemically important banks (G-SIBs). In November 2011, the Committee published an assessment methodology for identifying G-SIBs along with additional loss absorbency requirements for such institutions of between 1% and 2.5% (with the possibility of rising to up to 3.5%) of risk-weighted assets depending on their systemic importance.[3] G-SIBs will be required to meet their additional loss absorbency requirement with Common Equity Tier 1 capital, although the Basel Committee will continue to review the use of contingent capital for meeting other loss absorbency requirements on a going concern basis. The G-SIB surcharge will initially apply to G-SIBs formally identified in November 2014 on the basis of the Basel Committee's methodology.

Timing – The Basel Committee envisages that the G-SIB proposals should be introduced along with the Basel III capital conservation and countercyclical buffers, i.e. between 1 January 2016 and year end 2018, becoming fully effective on 1 January 2019.

1 Available at http://www.bis.org/publ/bcbs204.htm.

2 Available at http://www.bis.org/publ/bcbs209.htm.

3 Available at http://www.bis.org/publ/bcbs207.htm.

Trade finance

In October 2011, the Basel Committee adopted two technical changes to the Basel regulatory capital adequacy framework related to the treatment of trade finance.[4]

The first of these is a waiver of the one-year maturity floor for certain trade finance instruments under the advanced internal ratings-based approach for credit risk. The second is a waiver of the so-called sovereign floor for certain trade-finance related claims on banks using the standardised approach for credit risk.

Timing – The Basel Committee does not set out a timeline for the implementation of these changes by national banking supervisors.

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.

Financial Stability Board (FSB) report on shadow banking

In October 2011, the FSB published a report on strengthening the oversight and regulation of shadow banking, i.e. any credit intermediation involving entities and activities outside the regular banking system.[5]

The FSB recommends an enhanced framework for monitoring shadow banking. The FSB also sets out high-level principles for designing regulation to mitigate the risks identified as a result of better monitoring. Workstreams to assess potential policy measures are in progress.

CRD update

European Banking Authority (EBA) publishes questions and answers on the guidelines on Article 122a of the CRD

In September 2011, the EBA published questions and answers[6] in relation to the guidelines issued by the Committee of European Banking Supervisors (CEBS) in December 2010 on Article 122a of the CRD.[7] As well as the original CEBS guidelines, the questions and answers will be a key reference document for practitioners seeking to apply Article 122a of the CRD in practice.

CRD 3 elements to come into force by 1 January 2012

The CRD 3 provisions on remuneration came into force on 1 January 2011. However, other provisions relating to, for example, capital requirements for the trading book, capital requirements for re-securitisations and disclosure of securitisation risks are due to take effect on 31 December 2011.

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

Additional capital buffers for EU banks and EBA estimates of capital shortfalls

In the wake of the sovereign debt crisis, an agreement was reached in the EU to require banks to build up additional capital buffers. The details were set out by the EBA in October 2011 and December 2011.[8]

Two buffers are envisaged. First, EU banks will have to hold a buffer against their sovereign debt exposures, with those exposures being valued on a marked to market basis as at 30 September 2011. Second, EU banks will have to build up a buffer to reach a Core Tier 1 capital ratio of 9% of risk-weighted assets. The EBA has indicated that these new requirements will have to be met from Core Tier 1 capital but including contingent capital instruments with the features set out in a common term sheet designed by the EBA. The additional capital banks will need to build up will be based on their capital position as at 30 September 2011 and sales of sovereign bonds will not reduce the sovereign debt buffer. Further, not all actions to reduce risk-weighted assets will be permissible to help to build up the new buffers.

Using September 2011 data, the EBA estimates that the aggregate capital shortfall of EU banks amounts to €114.7 billion. The EBA also provides a breakdown of this figure by country and, for countries other than Greece, on a bank-by-bank basis.

Timing – The EBA has stated that the buffers will have to be built up by the end of June 2012. Banks will have to submit plans on how to comply with the new buffer requirements by 20 January 2011.

EU bank crisis resolution

The European Commission was understood to be planning to publish legislative proposals on an EU framework for crisis management in the financial sector in 2011. However, at the time of writing, these are still awaited.

4 Available at http://www.bis.org/press/p111025.htm.

5 Available at http://www.financialstabilityboard.org/publications/r_111027a.pdf

6 Available at http://www.eba.europa.eu/News--Communications/Year/2011/The-EBA-has-published-today-a-Q-A-report-on-the-Gu.aspx.

7 Available at http://www.eba.europa.eu/Publications/Standards-Guidelines/CEBS-Guidelines-on-the-application-of-Article-122a.aspx.

8 Available at http://www.eba.europa.eu/News--Communications/Year/2011/The-EBA-publishes-Recommendations-and-final-results.aspx.

Investment funds regulation

ESMA advice on implementing the Alternative Investment Fund Managers Directive (AIFMD)

In November 2011, ESMA published its final advice to the European Commission concerning the detailed rules to apply to Alternative Investment Fund Managers (AIFMs) under the AIFMD.[9] This comprises 499 pages, consistent with the scale of changes AIFMs within the scope of the AIFMD are facing. ESMA's advice covers:

- general provisions for managers, authorisation and operating conditions;
- depositaries;
- transparency requirements and leverage; and
- supervision.

For further information on the AIFMD, please click *here* and *here* to see our previous client alerts.

Timing – The AIFMD is due to be implemented in July 2013. The European Commission will now commence work on drafting implementing measures in light of the ESMA advice.

Securities regulation

Financial transactions tax

In September 2011, the European Commission published a legislative proposal for a Council Directive on a financial transactions tax in the EU.[10]

Broadly speaking, the financial transactions tax would apply to financial transactions in financial instruments, provided that a financial institution established in the territory of a Member State is party to the transaction. In relation to financial transactions other than those related to derivatives agreements, the taxable amount would be either the sum payable in return for the transfer or, if higher and in certain other circumstances, the market price; and the tax would be set at a minimum level of 0.1%. In relation to financial transactions related to derivatives agreements, the taxable amount would be the notional amount of the derivatives agreement at the time of the financial transaction; and the tax would be set at a minimum of 0.01%. The financial transactions tax would generally be payable by each financial institution which is a party to a relevant transaction, whether in the EU or outside the EU. If a financial institution failed to pay the financial transaction tax it owes within the applicable time limit, each party to the transaction would become jointly and severally liable for the payment of the tax.

For further information on the European Commission's legislative proposal, please click *here* to see our previous alert on this topic.

Timing – The European Commission proposed that the financial transaction tax should come into force on 1 January 2014. However, as drafted, it would require unanimous agreement by Member States in the EU Council of Ministers after the European Parliament has given its opinion. The UK has expressed its opposition to the financial transaction tax.

Review of the Markets in Financial Instruments Directive

In October 2011 the European Commission published legislative proposals for amending the Markets in Financial Instruments Directive ("MiFID"), which consist of a new Directive ("MiFID II") and a Regulation ("MiFIR").[11]

MiFID II would introduce a wide range of changes, including extensions to the scope of MiFID, a revised framework for the regulation of trading venues, additional requirements for algorithmic and high-frequency trading and enhancements to the organisational and conduct of business obligations of investment firms. MiFIR establishes harmonised requirements for the disclosure and publication of pre- and post-trade data (including in equities, bonds and derivatives) and the transmission of transaction data to competent authorities, the re-location of trading in standardised derivatives to organised markets and non-discriminatory access to clearing services. The proposed new regime for access to EU markets for third country firms is split between MiFID II and MiFIR as are enhancements to the supervisory and enforcement powers of competent authorities and ESMA. We discuss these legislative proposals in detail in our previous alert, which you can access *here*.

Timing – The legislative proposals will now pass to the European Parliament and the Council for negotiation. There remains scope for changes to MiFID II and MiFIR. Our current best estimate is that the combined proposals will not become fully effective in Member States until early in 2015.

9 Available at http://www.esma.europa.eu/page/AIFMD

10 Available at http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/index_en.htm.

11 Available at http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm.

Review of the Market Abuse Directive

In October 2011 the European Commission published legislative proposals for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (the "Regulation") and a Directive of the European Parliament and of the Council on criminal sanctions for insider dealing and market manipulation ("MAD 2"),[12] which would replace the existing Market Abuse Directive.

The proposed Regulation sets out a revised and harmonised civil market abuse regime and ancillary requirements. It would broaden the scope of the existing civil market abuse framework, adjust the insider dealing and market manipulation offences as well as the requirements for the protection and disclosure of inside information and enhance the powers available to competent authorities. MAD 2 would additionally introduce criminal market abuse offences. For a detailed discussion of the European Commission's legislative proposals, please click *here* to see our previous alert on this topic.

Timing – The proposed Regulation and MAD 2 would pass into law if approved by the European Parliament and the Council, which might be achieved by late 2012. However, it would take another two years if not longer for the Regulation to become applicable and for MAD 2 to be implemented by Member States.

Regulation on Short Selling and Certain Aspects of Credit Default Swaps

The European Parliament voted in favour of a Regulation on Short Selling and Certain Aspects of Credit Default Swaps in November 2011.[13]

The Regulation defines short positions broadly, recognising that they can result from both short sales and transactions with equivalent effect. The Regulation would require significant net short positions in shares to be notified to competent authorities and to be publicly disclosed at specified thresholds. Significant net short positions in sovereign debt would only have to be notified to competent authorities. In order to mitigate the potential risk of settlement failure and volatility, the Regulation also imposes restrictions on uncovered short sales in shares as well as uncovered short sales and uncovered credit default swaps in sovereign debt. Finally, it grants powers to competent authorities and the European Securities and Markets Authority to add to these transparency requirements and restrictions on short selling and related practices in exceptional circumstances. Exemptions to some provisions of the Regulation are available where the principal trading venue for the trading of shares is outside the EU as well as for market making and primary market operations.

Timing – The Regulation still needs to be formally approved by the Council. We expect it to enter into force in November 2012.

Amendments to the Transparency Directive

In October 2011, the European Commission proposed a Directive[14] which would amend the Transparency Directive.

The proposed Directive would impose disclosure requirements in relation to holdings in financial instruments which have the same economic effect as holdings of shares. Voting rights relating to relevant financial instruments would have to be aggregated with those arising from holdings of shares to determine whether notification thresholds are reached or crossed. These proposals would have limited impact in the UK, which has already adopted rules of this kind. Further, the proposed Directive would discontinue the quarterly reporting requirement for EU listed companies but require certain firms that are active in the extractive or logging of primary forest industries to disclose annually the payments they made to governments. Competent authorities' sanctioning powers in respect of breaches of the Transparency Directive would be enhanced.

Timing – The legislative proposal will now pass to the European Parliament and the Council. The legislative proposal does not specify when the changes would have to be implemented in Member States. However, we would not expect this to be before 2014, given that certain draft regulatory technical standards in connection with the proposed Directive are to be submitted by ESMA only by 31 December 2013.

12 Available at http://ec.europa.eu/internal_market/securities/abuse/index_en.htm.

13 Available at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P7-TA-2011-0486+0+DOC+XML+V0//EN&language=EN.

14 Available at http://ec.europa.eu/internal_market/securities/transparency/index_en.htm.

European Markets Infrastructure Regulation (EMIR)

In September 2010, the European Commission published its legislative proposal for EMIR.[15]

The legislative proposal aims to address regulatory concerns in respect of OTC derivatives markets. EMIR would introduce a reporting obligation for OTC derivatives and a clearing obligation for eligible OTC derivatives, along with measures to mitigate counterparty credit risk and operational risk for bilaterally cleared OTC derivatives. In addition, EMIR would include common rules for central counterparties (CCPs) and for trade repositories and provisions governing the establishment of interoperability between CCPs.

Timing – The draft EMIR is currently being negotiated between the European Parliament and Council as part of the EU legislative process. It is envisaged that the Regulation should come into force by the end of 2012. Existing CCPs would have 2 years from that date to apply for recognition.

UK-specific regulatory developments

UK regulatory reform

The UK Government has published policy proposals and draft legislation that will fundamentally reform the structure of financial regulation.[16] This will involve the creation of a new prudential supervisor for banking organisations and insurance companies, the Prudential Regulation Authority, that 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 – Legislation to bring about these changes is still to be introduced to Parliament although the Government has indicated its intention to implement new legislation during the first quarter of 2013. A joint committee of the House of Commons and House of Lords has been applying pre-legislative scrutiny to the draft legislation and there has also been recent parliamentary focus on the accountability of the Bank of England.

Final Report of the UK Independent Commission on Banking (ICB)

The ICB published its Final Report in September 2011.[17] This sets out recommendations to the UK Government on reforming the UK banking sector in three main areas.

First, the ICB proposes to ring-fence the retail operations of UK banks. Ring-fenced banks would be allowed to carry on only a limited range of activities as legally separate corporate entities. Second, the ICB envisages a range of measures designed to (i) increase the minimum common equity capital ratio and leverage ratio for UK ring-fenced banks, (ii) enhance the loss absorbency of capital instruments held by certain UK banks and ring-fenced banks and (iii) introduce a form of depositor preference. These requirements would be in addition to those imposed on banks under CRD 4. Third, the ICB recommends improving competition in the UK banking market by (i) enhancing the planned divestiture by the Lloyds Banking Group and (ii) facilitating current account switching and improving transparency about the costs of retail banking services. For further information on the ICB's proposals, please click *here* to see our previous alert on this topic.

Timing – The Government has promised a response to the ICB Final Report by the end of 2011. It is expected that the Government will legislate in this Parliament and hence before 2015, though the implementation of some of the changes to the UK banking sector may take until 2019. It remains to be seen how this legislative process will interact with that for CRD 4, which would limit national discretions in relation to the prudential regulation of banks.

Increase in the UK Bank Levy

The UK Bank Levy was introduced by the Finance Act 2011 and applies with retrospective effect to periods of account ending on or after 1 January 2011. It is essentially a tax on the value of non-exempt debts of UK banks. The UK Government has recently announced that the Bank Levy will rise from the current 0.078% to 0.088% from 1 January 2012. The aim is to offset a forecast shortfall in receipts from the Bank Levy for 2011 and future years and to raise the £2.6 billion per year originally envisaged in Budget 2011.

UK implements certain amendments to the Prospectus Directive

A Directive[18] 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.

15 Available at http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm

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

17 Available at http://bankingcommission.independent.gov.uk

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

Change in the FSA's planning assumptions about Solvency II implementation

In October 2011, the FSA revised its planning assumptions about Solvency II implementation.[19] In view of discussions at EU level about a potential bifurcation of the implementation dates, the FSA's current assumptions are that:

- transposition of the Directive would have to be complete by 1 January 2013 and this is when the responsibilities of supervisors and European Insurance and Occupational Pensions Authority (EIOPA) would be switched on;
- firms would have to comply with Solvency II requirements from 1 January 2014.

These assumptions will need to be revisited again in light of developments at EU level.

Miscellaneous

Credit rating agencies

In November 2011, the European Commission published legislative proposals[20] for (i) a Regulation on credit ratings agencies amending the existing Credit Ratings Regulation (as amended in May 2011) and (ii) a Directive amending the Undertakings for Collective Investment in Transferable Securities Directive in respect of the excessive reliance on credit ratings.

The main goals of the legislative proposals are to reduce financial institutions' reliance on credit ratings, to introduce more transparent and frequent sovereign debt ratings, to enhance the diversity and independence of credit rating agencies and to make them more accountable for their ratings.

Timing – The legislative proposals now pass to the European Parliament and Council. No firm timeline for the legislative process has been published yet.

Sanctions against Iran and Syria

In December 2011, a further 180 parties were added to the EU's Iran sanctions list. Please click *here* to see our previous alerts on this topic.

In October, November and December 2011, the Council of the European Union considerably expanded its existing regime for economic sanctions against Syria. For further information, please click *here* to see our previous alert.

Using powers under Schedule 7 to the Counter Terrorism Act 2008, the UK Government imposed banking sanctions against Iran as set out in the Financial Restrictions (Iran) Order 2011.[21] These are in addition to the EU sanctions. For further details, please click *here* to see our previous alert.

19 Further information is available at http://www.fsa.gov.uk/pages/About/What/International/solvency/implementation/index.shtml.

20 Available at http://ec.europa.eu/internal_market/securities/agencies/index_en.htm.

21 See http://www.hm-treasury.gov.uk/d/fin_restrictions_iran_order2011.pdf and http://www.hm-treasury.gov.uk/d/fin_restrictions_iran_notice2011.pdf.

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