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ClientAlert

Financial Regulation

December 2012

Financial Regulatory Update

This newsletter highlights some of the key financial regulatory measures affecting the UK and EU during the period from 1 August to 14 December 2012. For a copy of our previous newsletter, please click here.

Regulation of Banks and Investment Firms

Banking Union

On 13 December 2012, EU leaders agreed on a process that will deepen integration of the EU financial framework and strengthen economic governance to complete Economic and Monetary Union.

The Roadmap adopted by the European Council follows the report "Towards a genuine Economic and Monetary Union" prepared by the President of the European Council Herman Van Rompuy together with the Presidents of the European Commission, the European Central Bank and the Eurogroup.

Single Supervisory Mechanism

A key plank in the Banking Union proposals is the setting up of a Single Supervisory Mechanism ("SSM"), covering Eurozone banks and open to all member states. The deal struck by EU ministers on 13 December 2012 allows the Council Presidency to negotiate with the European Parliament with the aim of reaching a final agreement rapidly so that the SSM can be implemented as soon as possible.

The SSM will be composed of the European Central Bank and national competent authorities. The European Banking Authority will retain its role of developing standards and ensuring consistency.

Once an effective SSM is established, the European Stability Mechanism will be able to recapitalise banks directly. An agreement on the operational framework supporting this possibility, including the definition of legacy assets, is to be agreed as soon as possible in 2013.

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This publication is prepared for the general information of our clients and other interested persons. It is not, and does not attempt to be, comprehensive in nature. Due to the general nature of its content, it should not be regarded as legal advice.

The SSM will start supervising the largest Eurozone banks (it is estimated approximately 200 banks) in March 2014, or 12 months after the entry into force of the legislation, whichever is later.

Bank Resolution and Deposit Guarantee Schemes

The Roadmap contemplates that legislative proposals on more harmonised national bank resolution and deposit guarantee frameworks should be agreed by June 2013. Click here for a copy of our client note on the bank resolution proposals.

A Single Resolution Mechanism

The European Commission will propose a single resolution mechanism for member states participating in the SSM. The objective is to reach agreement on this mechanism by summer 2014.

Basel III and CRD IV Update

On 14 December, the European Council called for the rapid adoption of the legislative proposals for a new Capital Requirements Directive and Regulation (the "CRD IV package") implementing Basel III in the EU. A firm date for implementation is not yet known.

Meanwhile, the Basel Committee on Banking Supervision issued a press release in December 2012, identifying member jurisdictions that will be ready to implement Basel III on 1 January 2013 and indicating that almost all member jurisdictions will have implemented Basel III in accordance with the agreed timetable by the end of 2013.

Structural Banking Reform in the EU and UK

EU Banking Reform

The High Level expert group appointed by European Commissioner Michel Barnier and chaired by Erkki Liikanen to consider structural banking reforms published its final report in October 2012. Amongst other things, the report proposed that there should be a legal separation of certain activities from deposit-taking banks within the banking group. The activities to be separated would include proprietary trading of securities and derivatives and certain other activities closely linked with securities and derivatives markets. According to the report, such a separation should only be mandatory if the activities to be separated amount to a significant share of a bank's business, or if the volume of these activities could be considered significant from the viewpoint of financial stability.

In addition, the report proposed that:

- provision of hedging services to non-banking clients (e.g. using forex and interest rate options and swaps) which fall within narrow position risk limits in relation to own funds and securities underwriting do not have to be separated;
- the legally-separate deposit bank and trading entity can operate within a bank holding company structure;
- transfer of risks or funds intra-group between the deposit bank and trading entity should be on market-based terms and restricted according to the normal large exposure rules; and
- within a group, both the deposit bank and the trading entity would each individually be subject to all the regulatory requirements, such as the CRD IV package and consolidated supervision, which pertain to EU financial institutions.

The High Level expert group also endorsed the EU's proposals relating to recovery and resolution plans. It considered that producing an effective and credible recovery and resolution plan may require the scope of the separable activities to be wider than under the mandatory separation proposed by the group.

The group also looked at the issue of bail-inable debt, proposing that further work is done in relation to the issue, and that consideration be given to restricting the holdings of bail-inable debt to non-bank financial institutions such as investment funds and life assurance companies.

UK Banking Reform

In October 2012, the UK Treasury published a paper entitled "Sound Banking – delivering reform" and draft legislation, the main aim of which is to establish the UK ring fence separating deposit taking from individuals and small and medium sized enterprises ("SMEs") from wholesale and investment banking activities, as considered by the Independent Commission on Banking.

Much of the detail of the new regime is yet to be seen and is to be specified in secondary legislation or under powers to be given to the new UK Prudential Regulatory Authority ("PRA"), which is set to become operational in April 2013.

Under the proposals:

- The only UK banks which may accept deposits from individuals and SMEs will be ring-fenced banks. Exemptions for deposit taking firms which take deposits below a certain threshold (as yet to be specified) are envisaged.
- Additional relaxations are envisaged to allow larger companies to opt to place their deposits with non-ring fenced banks if they choose, and similarly to allow high net worth individuals to decide to place deposits outside ring-fenced banks. Again, the thresholds are still to be determined.
- Limitations will be placed on the ability of ring-fenced banks to deal as principal, so derivatives and trading activity will be curtailed, but some – to be specified in secondary legislation – will be permitted.
- The PRA will be required to make rules governing the relationship between the ring-fenced banks and members of its group.

Separately, the draft legislation amends the Insolvency Act 1986 and related Scottish and Northern Irish legislation to provide that deposits which are eligible for protection under the financial services compensation scheme are to be preferential debts. This will ensure that such deposits rank ahead of other unsecured claims in the event of a bank insolvency.

The proposals also give the UK Treasury the power to specify requirements or conditions to which the PRA must have regard when setting primary loss absorbency capacity requirements for UK-headquartered global systemically important banks and in relation to ring-fenced banks.

UK Review of LIBOR

Wheatley Review

In September 2012, the UK Treasury published the Wheatley Review containing final recommendations to the Government, the British Bankers Association, banks and the regulatory authorities, both in the UK and internationally for the reform of the London Inter-Bank Offered Rate ("LIBOR").

The Wheatley proposals were, in summary, that:

1. The new Financial Conduct Authority ("FCA") should regulate the submission to, and administration of, LIBOR – and there should be criminal sanctions for any attempted manipulation.
2. The British Bankers' Association should make an orderly transfer of responsibility for LIBOR to a new administrator, selected by an independent committee.
3. The new administrator should scrutinise submissions and regularly review the effectiveness of LIBOR.
4. There should be a new code of conduct for submitters, approved by the FCA.
5. LIBOR should, as far as possible, be corroborated by transaction data in line with the guidelines in the Review.
6. To improve this ability to corroborate submissions, the number of currencies and maturities for which submissions are made should be cut substantially to achieve a sharper focus on the more heavily-used benchmarks.
7. Individual submissions should be published, but after 3 months to avoid the incentive for banks to try to flatter their perceived credit standing and reduce the opportunity for collusion.
8. The Government should provide the Financial Services Authority ("FSA") with a reserve power to compel banks to submit to LIBOR.
9. All market participants should consider whether LIBOR is the most appropriate rate for their needs and to ensure that their contracts have workable contingency provisions.
10. The UK, European and International Authorities should establish clear principles for global benchmarks.

The Wheatley proposals have been fully endorsed by the Treasury which published draft legislative changes to give effect to the Wheatley Report in November 2012.

We note in particular that the draft legislative changes propose amendments to and replacement of what is currently section 397 (*Misleading Statements and Practices*) of the Financial Services and Markets Act 2000, introducing a new offence relating to benchmark manipulation and making changes to the existing section 397 offences.

FSA Consultation Paper on Benchmarks

In December 2012, the FSA issued an additional Consultation Paper entitled "The regulation and supervision of benchmarks". The first part of the Consultation Paper deals with the future regulation of benchmark setting, whilst the second part discusses how best to broaden participation in the setting of LIBOR. The Consultation Paper draws upon both the Wheatley Review recommendations and the Treasury's proposed legislative amendments in designing an FCA approach to regulating the setting of benchmarks.

The new approach to regulating the setting of LIBOR will centre on rules and guidance set out in the Market Conduct section of the FSA Handbook. The key proposals set out in part one of the Consultation Paper are as follows:

- benchmark administrators have to corroborate LIBOR submissions and monitor for any suspicious activity;
- institutions making benchmark submissions must have a clear conflicts of interest policy in place, as well as appropriate systems and controls; and
- in relation to both of the above, all regulated entities will be required to have FCA approved persons in key positions relating to benchmark activity.

Part two of the Consultation Paper deals with firms' future participation in LIBOR and proposes a number of objective criteria to determine which firms can be expected to make submissions to the LIBOR benchmark. While this paper is a relatively formal consultation as regards part one, it is looking for a more broad ranging set of views as to part two. The FSA intends for LIBOR to remain industry-led at this stage, but points out that it is reserving the right to require firms to contribute, should it be deemed necessary, to preserve the accuracy and integrity of the benchmark.

Related Developments

It is anticipated that the new legislation will take effect in early 2013. The legislation has been drafted in such a way that manipulation of additional benchmarks can be included in the new criminal regime if thought appropriate.

Separately, further revisions to the proposed new Market Abuse Regulation and Directive currently under discussion at European level have included benchmark manipulation as a criminal offence. When implemented, the Market Abuse Regulation and Directive changes will have effect throughout the EU.

At international level, the Financial Stability Board is coordinating a number of initiatives considering benchmark reform, including task forces of the International Organisation of Securities Commissions, the Bank for International Settlements, the European Commission and the European Securities and Markets Authority.

Other UK Regulatory Developments

FSA Consultation Paper on Non-EEA National Depositor Preference Schemes

The FSA Consultation Paper "Addressing the implications of non-EEA national depositor preference regimes" dated September 2012 proposes that firms from non-EEA countries which operate national depositor preference regimes should be required to accept deposits in the UK using a UK-incorporated subsidiary or else must implement an alternative arrangement that ensures UK depositors are no worse off than the depositors in the home country if the firm fails.

FSA Consultation Paper on Client Assets Regime

The FSA Consultation Paper "Client assets regime: EMIR, multiple pools and the wider review" dated September 2012 covers, among other things, a proposal to give investment firms the discretion to create specific client money sub-pools based, for example, on a class of clients or business lines. The FSA is also consulting on whether, in addition to, or in the place of, this discretion to create sub-pools, it should require firms to have separate client money sub-pools, for example, for retail and non-retail clients or for margined and non-margined business.

Investment Funds Regulation

Alternative Investment Funds

In November 2012, the FSA published a Consultation Paper on the "Implementation of the Alternative Investment Fund Managers Directive". The FSA is expected to publish a second Consultation Paper on the implementation of the Alternative Investment Fund Managers Directive in early 2013.

Other FSA Publications

In November 2012, the FSA also published a paper on "Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks". Firms that received this paper in the form of a hard copy "Dear CEO letter" must attest to the FSA by 28 February 2013 that their arrangements are sufficient for managing conflicts of interest effectively and in compliance with FSA rules. Other firms are also expected to consider the paper and review their operations against its findings.

The FSA is also consulting on "Restrictions on the retail distribution of unregulated collective investment schemes and close substitutes". The Consultation Paper covers proposals to restrict the promotion of unregulated collective investment schemes and close substitutes to ordinary retail investors in the UK.

Securities Regulation

Short Selling Regulation

The Regulation on Short Selling and Certain Aspects of Credit Default Swaps became effective on 1 November 2012. Click here for a copy of our client note on the Regulation.

Proposed New Market Abuse Regulation and Directive

In December 2012, the Council of the European Union agreed a general approach on the market abuse directive. The general approach will constitute the basis for negotiations with the European Parliament in order to agree the final text of the directive.

Proposed New Markets in Financial Instruments Directive and Regulation

In December 2012, the Presidency of the Council of the EU published its latest compromise proposals concerning the draft new Markets in Financial Instruments Directive (recast) and Markets in Financial Instruments Regulation.

A progress report by the Council of the European Union provides background information.

UK Regulatory Reform

The UK's Financial Services Bill, which, amongst other things, establishes the UK's new "twin peaks" model of regulation, is progressing through Parliament. It is expected to become effective in April 2013.

Meanwhile, the FSA and Bank of England have been consulting on how the new regime will operate. Further details can be found in the following publications:

- "Regulatory Reform: PRA and FCA regimes relating to aspects of authorisation and supervision";
- "The Prudential Regulation Authority";
- "Journey to the FCA";
- "Designation of investment firms for prudential supervision by the PRA: consultation on a draft policy statement";
- "The PRA's approach to banking supervision";
- "The PRA's approach to insurance supervision";
- "Regulatory reform: the PRA and FCA regimes for Approved Persons";
- "Regulatory reform: FCA Handbook updates relating to supervision and threshold conditions and statement on the FCA's new power of direction over qualifying parent undertakings"; and
- "The FCA's use of temporary product intervention rules".

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