

# Insight: Financial Regulation

August 2012

## Financial Regulatory Update

This newsletter highlights some of the key financial regulatory reform measures affecting the UK and EU during the period from 1 May to 31 July 2012. For a copy of our previous newsletter, please [click here](#).

### Banking Regulation

#### Announcement of proposal for Banking Union in the EU

The European Commission has announced the proposal for Banking Union in the EU. The idea of Banking Union is a political one and the concept may ultimately encompass a variety of legal instruments designed to achieve closer EU integration of banking.

Measures which are likely to be considered further at EU level as part of Banking Union include: an integrated system for the supervision of cross-border banks, a bank supervisory role for the European Central Bank, a single deposit guarantee scheme, an EU resolution fund and a common regulator for EU cross border banks.

The Commission is working to produce proposals in these areas by early September. Meanwhile, the British government has indicated that Britain will not be part of any common deposit guarantees or under the jurisdiction of any single European financial supervisor.

#### Recovery and Resolution of Credit Institutions and Investment Firms

The European Commission has published its long awaited [proposal](#) for a Directive establishing a framework for the recovery and resolution of banks and investment firms in the EU. The proposed Directive delivers on the EU's commitments to the G20 to introduce legislative reform and can also be seen as a first step in the process of achieving Banking Union in the EU.

The recovery and resolution powers under the proposed Directive are divided into three main areas: prevention, early intervention and resolution. Intervention by the authorities will become more intrusive as a situation deteriorates.

The deadline for implementing most of the provisions in the Directive through national legislation is set at 1 January 2015. The provisions relating to the 'bail-in' of liabilities should be applied as of 1 January 2018.

For a copy of our client Insight on the proposed Directive, please [click here](#).

In May, the European Banking Authority (EBA) published a [discussion paper](#) on a template for recovery plans aimed at encouraging discussion and gathering stakeholders' opinions at an early stage of the process.



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### Basel III update

The Basel Committee on Banking Supervision and the European Banking Authority has published a consultative document on a framework for dealing with domestic systemically important banks (June 2012)

The [consultative document](#) sets out a framework of principles covering the assessment methodology and the higher loss absorbency requirement for domestic systemically important banks (D-SIBs). The D-SIB framework takes a complementary perspective of the global systemically important bank (G-SIB) [framework](#) published by the Basel Committee in November 2011. It focuses on the impact that the distress or failure of banks will have on the domestic economy. While not all D-SIBs are significant from a global perspective, the failure of such a bank could have an important impact on its domestic financial system and economy compared to non-systemic institutions. In order to accommodate the structural characteristics of individual jurisdictions, the assessment and application of policy tools are designed to allow for an appropriate degree of national discretion. The D-SIB framework is therefore proposed to be a principles-based approach, which contrasts with the prescriptive approach in the G-SIB framework.

The proposed D-SIB framework requires banks, which have been identified as D-SIBs by their national authorities, to comply with the principles beginning in January 2016. This is consistent with the phase-in arrangements for the G-SIB framework.

### Composition of capital disclosure requirements (June 2012)

The Basel Committee on Banking Supervision has published a set of [disclosure requirements](#) on the composition of banks' capital. During the financial crisis, market participants and supervisors experienced difficulties in undertaking detailed assessments of banks' capital positions and making cross-jurisdictional comparisons because of insufficiently detailed disclosure by banks and a lack of consistency in reporting between banks and across jurisdictions. This lack of clarity

may have contributed to uncertainty during the financial crisis. The disclosure requirements aim to improve market discipline through enhancing both transparency and comparability.

### CRD update

It is currently expected that the European Parliament will consider the legislative proposals on CRD IV in September of this year.

On 1 August, the FSA published a [statement](#) referring to the delay of the European Parliament's plenary vote and stated that "it does not appear feasible that the legislation can enter into force in line with the implementation date of 1 January 2013." It seems probable therefore that the implementation of CRD IV will be postponed to a date later in 2013 or possibly even 2014.

### European banking authority consultation papers on draft implementing technical standards

The European Banking Authority has launched consultation papers on the following areas:

- Draft Implementing Technical Standards (ITS) on [Supervisory reporting requirements for liquidity coverage and stable funding](#);
- Draft Implementing Technical Standards (ITS) on [Supervisory reporting requirements for the leverage ratio](#); and
- Draft Implementing Technical Standards (ITS) on [Disclosure for Own Funds](#).

### Investment funds regulation

#### Alternative Investment Funds

The European Securities and Markets Authority (ESMA) has published a [consultation paper](#) on proposed Guidelines on remuneration of alternative investment fund managers (AIFMs). ESMA's future guidelines will apply to managers managing alternative investment funds (AIFs) including hedge funds, private equity funds and real estate funds. These funds will be asked to introduce sound and prudent remuneration policies and structures with the aim of increasing investor protection and avoiding conflicts of interest that may lead to excessive risk taking.

### UCITS

On 3 July 2012, the Commission adopted a [proposal](#) for a directive amending the recast UCITS Directive as regards depositary functions, remuneration policies and sanctions.

The proposal addresses three areas:

- a precise definition of the tasks and liabilities of all depositaries acting on behalf of a UCITS fund;
- clear rules on the remuneration of UCITS managers: the way they are remunerated should not encourage excessive risk-taking. Remuneration policy will be better linked with the long-term interest of investors and the achievement of the investment objectives of the UCITS; and
- a common approach to how core breaches of the UCITS legal framework are sanctioned, introducing common standards on the levels of administrative fines so as to ensure they always exceed potential benefits derived from the violation of provisions.

The proposal of the Commission will go to the European Parliament and the Council for their consideration under the co-decision procedure. Once they reach agreement, Member States usually have two years to transpose the provisions into their national laws and regulations, meaning that the new rules could apply by the end of 2014. By this date, the necessary package of implementing measures should also be adopted.

On 26 July, the Commission launched a UCITS [consultation](#) that focuses on UCITS product rules, extraordinary liquidity management tools, depositary passports, money market funds, and long-term investments.

### Securities regulation

ESMA publishes MiFID guidelines to enhance investor protection

The European Securities and Markets Authority (ESMA) has published two final sets of guidelines, [here](#) and [here](#), aimed at enhancing the protection of investors in the EU. The guidelines relate to the provisions under the Markets in Financial Instruments Directive (MiFID) relating to the suitability of investment advice and the compliance function.

## ESMA Feedback Statement on Call for Evidence on Empty Voting

ESMA launched a [Call for Evidence on Empty Voting](#) in September 2011 to analyse the potential issues and concerns raised by the practice of empty voting and to examine whether there was a possible need for further action.

An analysis of the responses received to the consultation has led ESMA to conclude in its [feedback statement](#) that there is insufficient evidence to justify any regulatory action at the European level at present.

## Short Selling

The Regulation on Short Selling and Certain Aspects of Credit Default Swaps will become effective on 1 November 2012. Amongst other things, the Regulation prohibits dealings in naked sovereign CDS.

In July 2012, the European Commission adopted a [delegated act](#) which sets out technical rules needed to ensure the uniform application and enforcement of the Regulation. In particular, the delegated act specifies the cases in which sovereign credit default swaps are considered covered and therefore not banned in accordance with the Regulation.

Investors can demonstrate that the sovereign credit default swap contracts they have entered into are covered by demonstrating either a quantitative or a qualitative correlation between the hedged assets and liabilities and the sovereign credit default swap.

Other issues addressed in the delegated act include technical rules relating to the reporting of short positions in shares and sovereign debt and the thresholds which can trigger a short term suspension of short selling in illiquid shares and other financial instruments.

A related regulatory technical standard on short selling was also adopted by the Commission in June based on a draft submitted by the European Securities and Markets Authority (ESMA). This draft implementing [Regulation](#) lays down implementing technical standards with

regard to the means for public disclosure of net position in shares, the format of the information to be provided to the European Securities and Markets Authority in relation to net short positions, the types of agreements, arrangements and measures to adequately ensure that shares or sovereign debt instruments are available for settlement and the dates and period for the determination of the principal venue for a share according to Regulation (EU) No 236/2012 of the European Parliament and Council on short selling and certain aspects of credit default swaps.

Separately, in July 2012, regulators in Italy and Spain introduced temporary restrictions on certain short sales or the holding of short positions in certain stocks respectively. The Spanish restrictions are due to expire in October 2012.

## Market Abuse Directive

The European Commission has indicated that it will amend reforms to EU market abuse rules so that potential loopholes are closed and criminal sanctions specifically cover tampering with benchmarks or indices such as Libor and Euribor. [Proposals](#) effecting these changes were published in July.

## Prospectus Directive

The implementation date for changes to the Prospectus Directive occurred on 1 July 2012. For a link to our note on the impact of the changes to issuers of stand-alone debt, please [click here](#).

In June 2012 the European Commission published a delegated [Regulation](#) amending the Prospectus Regulation as regards information on the consent to use of the prospectus, information on underlying indexes and the requirement for a report prepared by independent accountants or auditors.

## European Markets Infrastructure Regulation (EMIR)

The European Securities and Markets Authority (ESMA) has launched a [consultation](#) on its technical standards under the Regulation on OTC derivatives, central counterparties and trade

repositories (EMIR), which is aimed at improving the functioning of OTC derivatives markets in the European Union (EU). EMIR aims to achieve this by reducing risks via the use of central clearing and risk mitigation techniques, increasing transparency via trade repositories (TR) and ensuring sound and resilient central counterparties (CCPs).

## Retail Investment Services

### Proposal for a regulation on a new Key Information Document for investment products

On 3 July 2012, the Commission adopted a [proposal](#) for a Regulation for a new Key Information Document (KID) to be produced by investment product manufacturers and provided to retail customers when they are considering buying investment products. The products for which a KID will be required include all types of investment funds, insurance-based investments and retail structured products, in addition to private pensions.

## Credit rating agencies

### Regulatory Technical Standards for Credit Ratings Agencies

On 30 May 2012, four Commission Delegated [Regulations](#) establishing regulatory technical standards for credit rating agencies were published in the Official Journal of the European Union. These technical standards set out: (i) the information to be provided by a credit rating agency in its application for registration to the European Securities and Markets Authority (ESMA) (available [here](#)); (ii) the presentation of the information to be disclosed by credit rating agencies in a central repository (CEREP) so investors can compare the performance of different CRAs in different rating segments (available [here](#)); (iii) how ESMA will assess rating methodologies (available [here](#)); and (iv) the information CRAs have to submit to ESMA and at what time intervals in order to supervise compliance (available [here](#)).

## Solvency II implementation date

In May 2012, the European Commission adopted a targeted [proposal](#) for a Directive that will move the implementation date of Solvency II by Member States to 30 June 2013 and the application date by companies to 1 January 2014.

## Insurance mediation

On 3 July 2012, the Commission adopted a [proposal](#) for a revision of the Insurance Mediation Directive (IMD 2). The entry into force of the proposal will most likely be in 2015.

Currently, only agents and brokers are covered by the IMD. Under the new proposal:

- The scope of the revised IMD will be extended to all sellers of insurance products, including insurance companies that sell directly to consumers. Other market players who sell insurance products on an ancillary basis (e.g., car rental companies) will be included in a proportionate manner in the scope of the revised IMD;
- Rules that address more effectively the risk of conflicts of interest, including rules mandating the disclosure of remuneration by intermediaries, will be introduced;
- Improved requirements would apply to life insurance products with investment elements, covering sales standards, conflicts of interest, and a ban on commission for independent advice;
- There would be mutual recognition of professional knowledge and ability, as evidenced by registration and proof of professional qualifications acquired in another Member State;
- Special information requirements would apply where suppliers adopt the practice of bundling products together by informing the customer that it is possible to buy the two products separately; and
- Effective, proportionate, and dissuasive administrative sanctions and measures by competent authorities in respect of breaches would be required by providing guidelines to Member States.

## UK Regulatory Reform

### HM Treasury consults on sanctions for directors of failed banks

On 3 July 2012, HM Treasury published a [consultation](#) paper on sanctions for directors of failed banks.

The government is proposing to introduce a rebuttable presumption that a director of a failed bank is not suitable to be approved by the regulator as someone who could hold a position as a senior executive in a bank. This would mean that a director of a failed bank who wished to take up a similar role in another institution would have to show the regulator that he or she was suitable, despite their connection with a failed bank.

The government is also considering introducing criminal sanctions for serious misconduct in the management of a bank. This would involve the creation of a new criminal offence that would not necessarily involve any element of dishonesty when it is committed.

### White paper on UK Banking Reform

On 14 June 2012, HM Treasury and the Department for Business, Innovation and Skills (BIS) published a [white paper](#) on banking reform, setting out the government's proposals for implementing the key recommendations of the Independent Commission on Banking (ICB) Chaired by Sir John Vickers.

The intention of the ICB's report proposals was to make banks better able to absorb losses, make it easier and less costly to sort out banks that still get into trouble and curb incentives for excessive risk taking.

The key areas in which the Committee made recommendations were:

- Structural reform and the introduction of a "ring fence" for UK retail banking;
- Improvement of the loss absorbency of UK headquartered banks and ring-fenced UK retail banks; and
- Measures to improve competition in the UK banking market.

A ring-fenced bank will be economically and legally separate from the rest of its group and run by an independent board. It is intended that the deposits of individuals and their overdrafts and the deposits and overdrafts of small and medium-sized businesses will, in general, be placed in ring-fenced banks. To minimise the risks that the ring-fenced bank is exposed to, the government proposals intend that ring-fenced banks will be prohibited from conducting the vast majority of international wholesale and investment banking. They will not be permitted to carry out activities through branches or subsidiaries outside the EEA, nor, except in limited circumstances, with financial institutions. Beyond this, and within certain constraints, firms may decide what to put inside the ring-fence.

The government also proposes to strengthen the ICB's recommendations by applying strict controls on the use of derivatives a ring-fenced bank uses to hedge its own balance sheet.

Smaller banks, with below £25bn of mandated deposits, will be exempt from these requirements.

In relation to bank capital, the largest UK ring-fenced banks should hold an additional 3% of equity on top of the Basel III minimum standards. The government also strongly endorsed the introduction of a binding minimum leverage ratio. Large ring fenced banks should hold a minimum amount of loss absorbing capacity – made up of equity or debt – of 17% of risk-weighted assets. Their overseas operations should be exempt from this requirement unless they pose a risk to financial stability. The minimum requirements are lower for smaller banks.

To deliver these proposals the authorities need a way to 'bail-in' bank liabilities so bondholders, not taxpayers, bear the losses. The government has stated that it will work with European partners to ensure that the ICB's recommendations on bail-in are credibly and consistently applied across Europe through the Recovery and Resolution Directive.

The government also intends to introduce the principle of depositor preference for insured deposits, stating that unsecured lenders to banks are better placed to monitor the risks that banks are taking on and should take losses ahead of ordinary depositors.

Draft legislation will follow in the autumn and the legislation is intended to be in place in 2015.

### Parliamentary Commission on Banking Standards

The Parliamentary Commission on Banking Standards was established, at the request of the leaders of all three main political parties, in July 2012.

The terms of reference of the Commission are to consider and report on:

- professional standards and culture of the UK banking sector, taking account of regulatory and competition investigations into the LIBOR rate-setting process;

- lessons to be learned about corporate governance, transparency and conflicts of interest, and their implications for regulation and for government policy; and
- to make recommendations for legislative and other action.

The Commission has been asked to report on proposals for legislative action no later than 18 December 2012 and on other matters as soon as possible thereafter.

### Setting the strategy for UK payments

On 19 July, HM Treasury published a [consultation](#) inviting views on three options for reforming the regulation and governance of payments networks (the payments process from payer to payee) in the UK. The government's preferred option proposes introducing a new public body to set strategy across the UK payments industry. The consultation closes on 10 October.

### FSA Guidance Consultation on the Remuneration Code

On 26 July, the FSA published a [guidance consultation](#) proposing to amend its *General Guidance on Proportionality*, which sets out the FSA's proportionate approach to implementing the Remuneration Code and the Pillar 3 remuneration disclosure rules.

The intention is to further clarify how firms may comply with the Code and disclosure rules in a manner that takes account of their size, internal organisation and the nature, scope and complexity of their activities.

The proposed new framework would replace the current four-tier structure (based on capital resources) with three new 'levels' (based on total assets).