

New EU Financial Supervisory Framework Approved

On September 22, the European Parliament (the “Parliament”) approved legislation (the “Core Regulations”) creating a new European System of Financial Supervision (the “ESFS”) consisting of a European Systemic Risk Board (the “ESRB”) and three European Supervisory Authorities (the “ESAs”).¹ The Council of Ministers had previously approved the Core Regulations on September 7.² The new system is intended to be operational in January 2011.

Within the ESFS, the ESRB will be responsible for macro-prudential oversight of the financial system. The ESAs, which comprise the European Banking Authority (the “EBA”), the European Securities and Markets Authority (the “ESMA”), and the European Insurance and Occupational Pensions Authority (the “EIOPA”), will each provide micro-prudential oversight of financial institutions and products. The ESFS will also include a Joint Committee including the ESAs and the financial supervisory authorities of each Member State (the “Joint Committee”), with the aim of ensuring appropriate and reliable information flow between each party to the ESFS.³

In addition to the responsibilities set out in the Core Regulations, a number of proposed sector-specific measures would give the ESAs further direct regulatory powers in certain areas. Current proposals of note include the following draft legislation:

- The Commission’s proposed regulation on over-the-counter derivatives, central counterparties and trade depositories, published on September 15, 2010.⁴
- The Commission’s proposed regulation on short selling and certain aspects of credit default swaps, published on September 15, 2010.⁵

¹ See the text adopted by the Parliament at: <http://tinyurl.com/EP-adoption-22Sep2010>

² See the announcement by the Council of Ministers here: <http://tinyurl.com/Council-Approval>

³ Agreement has also been reached agreement on the outstanding substantial issues on the Omnibus Directive (which amends certain financial services directives to reflect the establishment of the ESAs). The text of the Omnibus Directive is included in the text adopted by Parliament: <http://tinyurl.com/EP-adoption-22Sep2010>.

⁴ See *COD 2010/0250*: <http://tinyurl.com/OTCRRegulation>. See also the CGSH Alert Memorandum on the topic: <http://tinyurl.com/GGSH-OTC-Derivs-Draft-Proposal>

⁵ See *COD 2010/0251*: <http://tinyurl.com/Commission-Prop-Short-Selling>

- The Commission's legislative proposal for amendments to Regulation (EC) No 1060/2009 on credit rating agencies (the "CRA Regulation"), published on June 2, 2010.⁶
- The Belgian Presidency's proposal for a directive regulating alternative investment fund managers published on September 30, 2010.⁷

With the introduction of the ESFS, for the first time the supervision of EU financial institutions will be carried out to a significant extent at an EU level, with the ESAs in particular having strong supervisory powers and in certain circumstances rule-making powers and the ability to take direct action against national authorities and financial institutions. It is likely that, over time, the supervisory role of the ESAs and ESRB will increase along with greater EU harmonization of financial regulatory rules, possibly at the expense of Member State authorities.

I. THE ESRB

The ESRB will be responsible for macro-prudential oversight; specifically monitoring and assessing potential threats to financial stability that arise from macro-economic developments and from developments within the financial system as a whole. The ESRB is intended to address one of the fundamental weaknesses highlighted by the financial crisis, the vulnerability of the financial system to interconnected, complex, sectoral and cross-sectoral systemic risks.

The ESRB's function will be:

1. To collect and analyze information relevant and necessary for monitoring and assessing potential threats to financial stability that arise from macro-economic developments, as well as developments within the financial system as a whole;
2. To identify and prioritize systemic risks;
3. To issue warnings where risks are deemed to be significant and, where appropriate, make them public;
4. To issue recommendations for remedial action in response to identified risks and, where appropriate, make them public;
5. To issue a confidential warning to the Council when the ESRB deems an emergency situation may arise, together with an assessment of the situation;

⁶ See *COD 2010/0160*: http://ec.europa.eu/internal_market/securities/docs/agencies/100602_proposal_en.pdf

⁷ See *COD 2009/0064*: <http://register.consilium.europa.eu/pdf/en/10/st14/st14265.en10.pdf>

6. To monitor the follow-up to warnings and recommendations;
7. To cooperate with other parties to the ESFS and, where appropriate, provide the ESAs with information on systemic risks;
8. To participate, where appropriate, in the Joint Committee; and
9. To liaise with the International Monetary Fund, the Financial Stability Board and other non-EU counterparts.

The ESRB will have no independent regulatory authority. It will provide an early warning of systemic risks that may be building up and, where necessary, issue recommendations to deal with these risks, including, where appropriate, legislative initiatives. The warnings and recommendations may be either general or specific in nature and can be addressed to the EU as a whole; to one or more Member States; to one or more of the ESAs or national supervisory authorities; and (in respect of legislative initiatives) to the Commission. All warnings and recommendations shall also be transmitted on a confidential basis to the Council and the Commission and, where addressed to one or more national supervisory authorities, to the ESAs.

Each warning and recommendation will indicate, on a case-by-case basis, what priority and category classification applies to it, based on a colour-coded system that will be developed by the ESRB in consultation with the other parties to the ESFS.

Whilst the ESRB will possess no legally binding powers, compliance with the ESRB's recommendations will be encouraged by means of an "act or explain" mechanism: a requirement that the addressees explain the actions taken in response to a recommendation or justify their inaction, as applicable. If the ESRB feels that the explanations are not convincing, it shall inform the addressees, the Council, and, where relevant, the ESAs concerned. The ESRB may decide whether a warning or recommendation should be made public, taking account of the possible implications on the wider financial markets. Addressees of warnings or recommendations that are made public shall have the right to respond in public with their views.

The ESRB shall have a General Board, a Steering Committee, a Secretariat, an Advisory Technical Committee (the "ATC") and an Advisory Scientific Committee (the "ASC"). The General Board will be responsible for the major decisions of the ESRB and will be composed of the President and Vice-President of the European Central Bank (the "ECB"), the Governors of the 27 national Member State banks, a member of the European Commission, the chairpersons of the ESAs, the chairperson and two vice-chairpersons of the ASC, and the chairperson of the ATC. A representative of each national supervisory authority will also attend as an observer.

The Steering Committee will assist in the ESRB's decision-making process by preparing meetings of the General Board and monitoring the ESRB's work. The Secretariat will be responsible for the ESRB's day-to-day business, whilst the ATC and ASC will provide detailed technical advice, assistance and analysis on financial stability issues.

The President of the ECB will chair the ESRB for a term of five years from its establishment. For subsequent terms the ESRB's chair will be chosen following the review process described below.

The chairperson of the ESRB shall attend a hearing in the Parliament at least annually, to coincide with the publication of the ESRB's annual report, and the ESRB may attend hearings of Parliament Committees when requested. The ESRB will also examine specific issues at the invitation of the Parliament, Council or Commission.

The Parliament, Council and Commission will examine the regulation establishing the ESRB three years after its entry into force and determine whether the objectives and organization of the ESRB need to be revised, following discussions with the ECB and the ESAs. In particular, the process for designating or electing the ESRB's chairperson shall be reviewed.

II. THE ESAS

The ESAs will be responsible for overseeing micro-prudential regulation, safeguarding financial soundness at the level of individual financial firms and protecting consumers of financial services. The separation of EU wide micro-prudential regulation between the EBA, ESMA and EIOPA preserves the existing separate supervision of the banking, insurance and securities markets by the Committees of Supervisors, known as Level 3 committees, that advise the Commission within the Lamfalussy process and will be replaced by the ESAs. However, the new ESFS structure also encourages cross-sectoral cooperation and allows for convergence and the identification of common regulatory principles, in particular through the Joint Committee.

A. THE CORE REGULATIONS

The ESAs shall have the following key tasks:

1. To help establish high-quality common regulatory and supervisory standards and practices, by providing opinions to the EU institutions and developing guidelines, recommendations, and draft regulatory technical standards;

2. Contributing to the consistent application of legally binding EU acts, preventing regulatory arbitrage, mediating disagreements between competent authorities, ensuring effective supervision of financial institutions, and taking actions in emergency situations;
3. Facilitating the delegation of responsibilities among competent authorities;
4. Cooperating closely with the ESRB, in particular by ensuring a proper follow up to the warnings and recommendations of the ESRB;
5. Organizing and conducting peer review of competent authorities;
6. Monitoring and assessing market developments in the area of its competence;
7. Fostering and providing a high level of: depositor and investor protection (EBA); investor protection (ESMA); and policyholder and beneficiary protection (EIOPA); and
8. Contributing to the consistent and coherent functioning of supervisory colleges, monitoring systemic risk, and developing methods for the resolution of failing: financial institutions (EBA and EIOPA); and financial market participants (ESMA), and an assessment of the need for appropriate financial instruments.

To achieve the tasks set out above, the ESAs shall have the following key powers:

1. To develop draft regulatory technical standards following public consultations, and draft implementing technical standards in specific situations, that it can then submit to the Commission for endorsement;
2. Issuing guidelines and recommendations addressed to financial institutions or competent authorities to ensure the consistent application of EU legislation;
3. Carrying out investigations and issuing recommendations following a breach of EU law by a competent authority, setting out the action necessary for the competent authority concerned to comply with the relevant EU law (in the event that the competent authority fails to follow the EBA recommendation, the Commission may issue a formal opinion requiring the recommendation to be followed);
4. Taking individual decisions addressed to competent authorities requiring specific actions in emergency situations (as determined by the Council) or when there is a disagreement between competent authorities in cross-border situations;

5. In cases concerning directly applicable EU law, taking individual decisions addressed to financial institutions in the following situations: (i) where a competent authority has failed to implement an ESA recommendation and related Commission formal opinion in respect of a breach of EU law (see 3 above); (ii) where there is an emergency situation and a competent authority does not comply with an ESA decision (see 4 above); and (iii) when there is a disagreement between competent authorities in cross border situations and a competent authority has not acted in accordance with an ESA direction (see 4 above);
6. Issuing opinions to the Parliament, Council or Commission on issues related to its area of competence;
7. Collecting information concerning: financial institutions (EBA and EIOPA); and financial market participants (ESMA), including from national authorities, either on a one-off basis or at recurring intervals in specified formats; and
8. Developing common methodologies to assess the effect of product characteristics and distribution processes on consumer protection and on the financial position of financial institutions (EBA and EIOPA) and financial market participants (ESMA).

The following safeguards shall apply in relation to the powers of each ESA:

1. The ESAs shall ensure that no decision adopted under paragraph 4 above impinges on the fiscal responsibilities of Member States; and
2. A Member State may appeal to the applicable ESA and the Commission where it believes its fiscal responsibilities have been impinged, and the Council will ultimately decide whether the applicable ESA's decision is maintained or revoked.

In addition, any person may appeal against any decision taken by an ESA, such appeal to be heard by the applicable ESA's Board of Appeal and if necessary by the European Court of Justice.

Decisions taken by an ESA pursuant to the above powers will be made public and will identify the competent authority, financial institution or financial market participant concerned and the main content of the decision, unless such publication conflicts with the legitimate interests of relevant financial institutions or financial market participants in the protection of their business secrets or could seriously jeopardize the stability of the EU financial system and markets.

Each ESA shall comprise a Board of Supervisors, a Management Board, and a Board of Appeal. The Board of Supervisors shall be responsible for the key decisions of an ESA and shall be composed of the heads of: the national public authorities supervising credit institutions (EBA); the national public authorities supervising financial market participants (ESMA); and the national public authorities supervising financial institutions (EIOPA), together with the following non-voting persons: a Chairperson; and one representative of each of the Commission, the ECB, the ESRB, and the other ESAs. The Management Board will ensure that the ESA carries out its mission and performs the tasks assigned to it in accordance with all applicable regulations. The seats of the ESAs shall be located as follows: EBA in London; ESMA in Paris; and EIOPA in Frankfurt.

The Commission, Parliament and Council will examine the regulations establishing each ESA three years after their entry into force and determine whether the objectives and organization of each ESA need to be revised, in particular whether it is appropriate to continue to separate the supervision of banking, insurance, occupational pensions, securities and financial markets.

III. ADDITIONAL SECTOR-SPECIFIC PROPOSALS

Even before agreement was reached on the ESFS, the Commission, the European Parliament and the Council were proposing to grant new powers to the ESFS institutions, in particular ESMA, in proposed sector-specific legislation. The following proposed legislation would give significant additional direct regulatory powers to ESMA:

1. The Commission's proposed regulation on over-the-counter ("OTC") derivatives, central counterparties ("CCPs") and trade depositories. Under the proposed regulation, standardised OTC derivatives will have to be cleared through CCPs. ESMA will be responsible for the identification of contracts subject to the clearing obligation. ESMA will also be responsible for the registration and surveillance of trade repositories that will collect detailed information on each OTC derivatives contract entered into, modified or terminated by a financial counterparty or non-financial counterparty with large positions.
2. The Commission's proposed regulation on short selling and certain aspects of credit default swaps. The proposal regulation lays down a harmonised framework relating to short selling and credit default swaps, in particular in relation to increased disclosure, and to ensure greater coordination and consistency between Member States where measures have to be taken in an emergency situation. ESMA would be responsible for coordinating measures taken by competent authorities and to have power to restrict short selling activities where competent authorities have not taken adequate measures.

3. The Commission's proposal for amendments to the CRA Regulation. The core aim of the proposal is to transfer to ESMA certain powers that were previously delegated to national supervisors under the CRA Regulation, so that ESMA has exclusive supervisory powers over credit rating agencies based in the EU ("EU CRAs"). ESMA would be responsible for the registration and day-to-day supervision of EU CRAs. The proposal gives ESMA powers to perform these functions, including the right to carry on inspections at EU CRAs' premises and to request information from EU CRAs and national supervisors. ESMA would also have enforcement powers against EU CRAs that have breached the CRA Regulation, including the withdrawal of EU CRAs' registrations and the suspension of the use of their credit ratings for regulatory purposes.

4. The Belgian Presidency's proposal for a directive regulating alternative investment fund managers. ESMA would issue guidelines to national regulators on how to monitor conformity with the proposed directive, settle disagreements between national regulators, and be entitled to adopt draft implementing technical standards to ensure the effective implementation of the directive. ESMA would keep a central public register identifying each alternative investment fund manager authorised under the directive. National regulators would be required to provide to ESMA various information to ensure the effective functioning of the directive.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under antitrust, banking and finance or private equity in the "Practices" section of our website <http://www.clearygottlieb.com>.

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