

European Commission Update on the EU's Financial Regulatory Reform Program

On June 2, 2010, the European Commission (the “Commission”) published a Communication outlining its plans for adoption of financial reform measures through the end of 2011 (the “Communication”)¹ and reviewing the status of its wide-ranging reform program published on March 4, 2009 (the “2009 Program”).² In the Communication, the Commission stresses the need to advance swiftly to complete remaining reforms from the 2009 Program, while introducing a number of new proposals and amendments to existing measures. In the Commission's view, the next six to nine months will be critical to the future of financial regulatory reform in the EU.

This Memorandum summarizes the Communication, discussing each of the key areas addressed, and notes changes from the 2009 Program.

I. SUPERVISORY AUTHORITIES

In 2009, the Commission proposed a major restructuring of the EU supervisory architecture for financial services firms. The Commission proposed the creation of a European Systemic Risk Board (“ESRB”), designed to ensure that macro-prudential and macro-economic risks are detected sufficiently early, and three European Supervisory Authorities: the European Banking Authority (“ERB”), the European Securities and Markets Authority (“ESMA”) and the European Insurance and Occupational Pensions Authority (“EIOPA”).³

In the Commission's view, the proposed new supervisory architecture will provide the backbone for a more harmonized European supervision, and will be instrumental in developing a real “Single Rule Book” for financial services firms. However, the Communication recognizes that the proposed reforms - under which the

¹ <http://tinyurl.com/2010Communication>

² Please see the CGS&H Alert Memorandum “Expanding EU Role in European Financial Regulation”, March 27, 2009 for further details. <http://tinyurl.com/CGS-HAlertMarch2009>

³ Please see the CGS&H Alert Memorandum “Commission Adopts Proposals for New EU Financial Regulatory System”, October 19, 2009 for further details. <http://tinyurl.com/CGS-HAlertOctober2009>

new bodies were to have been operational by the end of 2010 - has stalled. Talks are currently under way between the European Parliament and the European Council to reach a compromise position that can be adopted by both institutions. The Communication indicates that it is urgent to reach agreement so the proposal can be put to a vote at the Parliament's June plenary session. If the Parliament can vote in June, then ERB, ESMA and EIOPA can be set up in 2011.

II. ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE

The proposed Alternative Investment Fund Managers Directive (“AIFM”) is intended to provide a framework at European level for the regulation of fund managers, with the aim of increasing transparency towards investors. In accordance with the 2009 Program, the Commission produced a draft in April 2009, but it has been the subject of much criticism and debate and has undergone many amendments. In May 2010, the European Parliament’s Economic and Monetary Affairs Committee (“ECON”) and the Council of Ministers (the “Council”) both adopted amended versions of the AIFM Directive. “Triologue” negotiations are now taking place between the Commission, the Council and the European Parliament with the aim of adopting the AIFM Directive by July 2010, but adoption may be delayed until fall 2010 or even later.⁴

III. CAPITAL REQUIREMENTS

The Communication highlights the measures already taken under the 2009 Program to revise the Capital Requirements Directive (“CRD”) and notes that the Commission is currently working on a third revision of the CRD, which would introduce binding rules on remuneration and enhanced capital requirements for trading book positions.⁵ The Commission expects agreement on these proposals prior to the summer break.

In addition, the Commission plans to propose in the second half of 2010 a fourth revision to the CRD to improve the quality and quantity of capital held by banks, introduce capital buffers and promote counter-cyclical capital requirements, so that banks will build capital reserves during times of economic growth. The amendments will

⁴ Please see the CGS&H Alert Memorandum “EU Directive on Alternative Investment Fund Managers: ECON Committee and Council Drafts Adopted”, May 28, 2010 for further details. <http://tinyurl.com/CGS-HAlertMay2010>

⁵ Please see the CGS&H Alert Memorandum “European Council Adopts New Rules on Credit Rating Agencies, Bank Capital Requirements, Cross-border Payments and E-money, and a Program to Support the Effectiveness of EU Policies”, August 10, 2009 <http://tinyurl.com/CGS-HAlertAugust2009> and the CGS&H Alert Memorandum “EU Initiatives Regarding Remuneration Policies for the Financial Services Sector”, May 4, 2009 for further details. <http://tinyurl.com/CGS-HAlertMay2009>

also address banks' perceived excessive reliance on leverage and introduce an effective liquidity regime. The Communication envisages that these measures will become law by the end of 2011.

IV. CREDIT RATING AGENCIES

The Credit Rating Agencies Regulation (the “CRA Regulation”) was adopted in 2009 as part of the 2009 Program, and regulators and credit ratings agencies (“CRAs”) are currently preparing for implementation of these rules by September 7, 2010.⁶ The CRA Regulation provides for mandatory registration for all CRAs operating in the EU and sets out requirements to improve oversight and regulatory standards, and to reduce conflicts of interest.

The Communication envisages a number of measures not included in the 2009 Program (although some were contemplated in the de Larosière Report of February 25, 2009). On June 2, 2010, the Commission proposed amendments to the CRA Regulation, in particular to introduce centralized EU oversight of CRAs, entrusting ESMA with powers over EU CRAs that the CRA Regulation granted to national supervisors.⁷ ESMA would have powers to request information, launch investigations and perform on-site inspections. The proposed revisions would also require issuers of structured finance instruments to provide all interested CRAs with access to the information they give to their own CRA, in order to facilitate publication of unsolicited ratings. In addition, to align the CRA Regulation with the proposed AIFM Directive, alternative investment funds using credit ratings for regulatory purposes would have to use a CRA registered or certified in the EU.

These proposals have now passed to the European Council and the European Parliament for consideration, and if adopted, should come into force in 2011.

V. DERIVATIVES MARKETS

The Commission published communications on derivatives markets in July and October 2009⁸ as part of the 2009 Program. In June 2010, the European Parliament's ECON committee adopted a report entitled “efficient, safe and sound derivatives markets: future policy actions” (the “Langen Report”), which broadly adopts the

⁶ Please see the CGS&H Alert Memorandum “European Council Adopts New Rules on Credit Rating Agencies, Bank Capital Requirements, Cross-border Payments and E-money, and a Program to Support the Effectiveness of EU Policies”, August 10, 2009 for further details. <http://tinyurl.com/CGS-HAlertAugust2009>

⁷ <http://tinyurl.com/EC-CRA-initiatives>

⁸ COM(2009)0563 and COM(2009)0332.

Commission proposals.⁹ The European Parliament is expected to vote on these proposals in June 2010.

The Commission intends to propose further legislation to improve the transparency of the derivatives markets in the summer of 2010. The legislation will provide European supervisory authorities access to derivatives information in trade repositories. The legislation will also promote the standardization of derivatives contracts and develop central clearing parties for derivatives contracts to reduce risk. These proposals appear largely based on principles for reform set out in the 2009 Program.

In addition, the Commission plans to propose measures on short selling and credit default swaps based on its findings in the ongoing investigation into the functioning of financial markets, in particular focusing on sovereign debt and the circumstances in which “naked” credit default swaps should be prohibited. The Commission proposes that national regulators, in coordination with ESMA, be given emergency powers to deal with issues such as the speculative use of the credit default swap market. The Market Abuse Directive (“MAD”) will be extended to include derivatives markets, and the Commission will also propose amendments to the Markets in Financial Instruments Directive (“MiFID”) in order to bring more derivatives onto organized trading venues. These derivatives-related measures were generally not part of the 2009 Program. The Communication envisages that these measures will become law by the end of 2011.

VI. CORPORATE GOVERNANCE AND REMUNERATION

As part of the 2009 Program, the Commission presented two Recommendations on remuneration principles in April 2009.¹⁰

In the Communication, the Commission now goes well beyond the reforms contemplated in the 2009 Program, proposing further measures aimed at improving internal controls and governance inside companies. On June 2, 2010, the Commission adopted a Green Paper on “Corporate Governance in financial institutions and remuneration policies,” launching a consultation on a wide range of corporate governance and remuneration issues (the “Green Paper”).¹¹ The Green Paper solicits comments by September 1, 2010, with a view to establishing a broad consensus to be followed by an impact assessment.

⁹ <http://tinyurl.com/FinalLangenReport>

¹⁰ COM(2009)3159 and COM(2009)3177. Please see the CGS&H Alert Memorandum “EU Initiatives Regarding Remuneration Policies for the Financial Services Sector”, May 4, 2009 for further details. <http://tinyurl.com/CGS-HAlertMay2009>

¹¹ <http://tinyurl.com/EC-GreenPaper>

VII. CRISIS MANAGEMENT

The 2009 Program contemplated a White Paper on tools for early intervention to prevent a banking crisis by the end of June 2009, but this White Paper was never published. Instead, on October 20, 2009, the Commission published a Communication on cross-border crisis management in the banking sector¹² followed by a Communication on options for bank resolution funds on May 26, 2010.¹³

The Communication states that in October this year, the Commission will publish an action plan on crisis management leading to legislative proposals for a complete set of tools for prevention and resolution of failing banks.

VIII. OTHER PROVISIONS

The Communication refers to a number of additional proposals included in the Commission's legislative agenda for 2010/2011, as set out below.

- The Commission will propose improvements to **MiFID** to strengthen pre- and post-trade market transparency.
- The Commission made several revisions to the **Deposit Guarantee Schemes Directive** as part of the 2009 Program. To increase investor protection, the Commission now proposes additional revisions to the Deposit Guarantee Schemes Directive and revisions to the **Investor Compensation Schemes Directive**.
- The Commission will publish a proposal to address the divergence in practice across the EU regarding **sanctions in the financial sector**. The Commission proposes a thorough review of existing sanctioning powers and their practical implications. The 2009 Program anticipated that the Commission would have reviewed **MAD** and made proposals to better harmonize sanctions by Autumn 2009. Although the initiative appears to have been delayed, the Commission is holding a public hearing in Brussels on the review of MAD on July 2, 2010.¹⁴
- The Commission will continue work towards achieving one set of high quality **international accounting standards**, though no express timeline was specified.

¹² <http://tinyurl.com/EC-CrisisManagement>

¹³ <http://tinyurl.com/EC-BankResolutionFunds>

¹⁴ <http://tinyurl.com/EC-MADReview>

- The Commission will present legislative proposals on **packaged retail investment products** to further promote consumers' interests. In addition, in response to the Madoff fraud, changes to the legislation applicable to the functions of **UCITS** depositaries will be proposed. This is an agenda item included in the 2009 Program still to be addressed.

IX. NEXT STEPS

The Commission stresses that strong political commitment from the Council and the European Parliament is needed to ensure the effective prioritization, timing and delivery of these reform measures. The Commission also expects the financial services industry to continue to contribute actively. According to the Communication, the last piece of legislation should be adopted by the end of 2011 at the latest.

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For additional information, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under banking and finance in the "Practices" section of our website (www.clearygottlieb.com) if you have any questions.

For additional information on issues regarding the financial crisis, please visit Cleary Gottlieb's Financial Crisis Resource Center at:

http://www.cgsh.com/financial_crisis_resource_center/eu_resources/.

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