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# Financial Regulatory Reform in the European Union: State of Play and Prospects

The European Union (the "EU") is in the midst of a far-reaching program of financial regulatory reform launched in the wake of the financial crisis by the European Commission's communication of March 4, 2009.[1] The Commission's program was in turn based on the report of an independent high-level group chaired by the former International Monetary Fund Managing Director Jacques de Larosière.[2]

The centralization of financial regulatory policy at the EU level represents a seismic shift in an area traditionally characterized by regulation at the national Member State level. The shift away from national authority to central EU policy-making is reflected in the creation of a new European financial supervisory framework, consisting of a macro-prudential European Systemic Risk Board ("ESRB") and a European System of Financial Supervisors, comprising three micro-prudential sectoral European Supervisory Authorities ("ESAs"). Although these institutions were created with relatively modest powers, with every EU financial regulatory measure adopted they acquire more responsibilities.

To a large extent, EU financial regulatory developments in the last two years have followed the Commission's March 2009 program, though political pressures have resulted in significant changes to some proposals, while certain measures, such as the Alternative Investment Fund Managers Directive ("AIFM Directive"), were not part of the Commission's original program, but instead were the product of political initiatives by members of the European Parliament and Member State governments. While the EU has made significant progress in implementing the Commission's program, much remains to be done. This month, the Commission published draft legislation to implement the Basel III capital requirements and to reform the governance of EU financial institutions. Draft legislation to be published by the Commission in the coming months includes the following:[3]

- A new proposed framework for recovery and resolution of EU financial institutions

[1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0114:FIN:EN:PDF

[2] http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

[3] http://ec.europa.eu/atwork/programmes/docs/forward_programming_2011.pdf

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- Amendments to the Markets in Financial Instruments Directive ("MiFID"),[4] which came into force in November 2007 and harmonized the regulation of investment services;

- Amendments to the Market Abuse Directive ("MAD"),[5] including the extension of MAD to cover certain derivatives;

- A regulation on central securities depositaries;

- A communication on financial sector taxation;

- A new regime for venture capital fund managers; and

- Further amendments to the EU credit rating agency regulation.

This Memorandum reviews the status of the EU's financial regulatory reform program in seven key areas.

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[4] 2004/39/EC

[5] http://ec.europa.eu/internal_market/consultations/docs/2010/mad/consultation_paper.pdf

# I. EXECUTIVE SUMMARY

This section describes, in summary, the most important components of the EU reform program. Following the Executive Summary, this memorandum provides a more detailed analysis of these measures, organized by subject area.

- **Systemic Risk and Financial Stability.** The EU has implemented, from January 1, 2011, a new framework for financial supervision and the oversight of systemic risk. The ESRB has responsibility for macro-prudential supervision, with a primarily advisory role but with the ability to issue recommendations which, if not complied with by Member States, may be referred to the Council. Three ESAs have also been created: the European Securities and Markets Authority ("ESMA"), the European Banking Authority ("EBA") and the European Insurance and Occupational Pensions Authority ("EIOPA"), with responsibility for the oversight of micro-prudential supervision of financial institutions within their respective sectors. Their other functions include monitoring the application of EU rules, mediating between national supervisors, providing advice to the Commission in relation to the content of new legislation and licensing credit rating agencies.

- **Cross Border Crisis Management Framework**: The Commission is scheduled to adopt a cross-border crisis management framework in autumn 2011. The legislation will establish a framework within which the prudential supervisors of Member States will exercise and, where necessary, coordinate crisis management measures. Financial institutions within the scope of the framework will be required to produce recovery plans, while Member State resolution authorities will be required to produce resolution plans. The framework will provide the resolution authorities with a harmonized set of resolution tools and powers. A separate regime that will harmonize EU bank insolvency regimes is planned for 2012, and a single European Resolution Authority to manage cross-border bank failures may be adopted in 2014.

- **Derivatives Reforms**: A European Market Infrastructure Regulation ("EMIR") governing over the counter ("OTC") derivatives, central counterparties and trade repositories is likely to be adopted in autumn 2011. EMIR will introduce a reporting obligation for OTC derivatives (and possibly other derivatives), a clearing obligation for eligible OTC derivatives, measures to reduce counterparty credit risk and operational risk for bilaterally cleared OTC derivatives, common rules for CCPs and for trade repositories and rules on the establishment of interoperability between CCPs. The Commission has also consulted on amendments to MiFID, and is expected to public legislative proposals in October 2011. Those reforms related to derivatives include the extension of pre- and post-trade transparency obligations to new asset classes, including derivatives eligible for central clearing and reported to trade repositories under EMIR, enhanced transaction reporting requirements and the establishment of a mandatory consolidated tape for the reporting and consolidation of post trade data. Separately, a regulation on short selling and certain aspects of credit default swaps is expected to be adopted in autumn 2011 creating disclosure obligations on short positions held by investors in certain EU securities, limitations in relation to uncovered short sales, and

intervention powers by Member States, coordinated by ESMA. Finally, proposals to amend MAD are also expected in October 2011. It has been proposed that the market abuse regime be extended to cover not only regulated markets, but also multilateral trading facilities ("MTFs"), and that the definition of "financial instruments" covered by the regime be expanded to include additional categories of financial derivatives, including contracts for differences ("CFDs") and credit default swaps ("CDS").

- **Executive Compensation:** Remuneration of staff by credit institutions and investment firms by has been harmonized at an EU level through the Capital Requirements Directive III ("CRD III"). Similar requirements are to be imposed on alternative investment fund managers ("AIFMs") under the AIFM Directive, and on the insurance sector under the Solvency II directive. CRD III came into force on January 1, 2011, and applied retroactively to include remuneration due on the basis of contracts concluded before 2011 and awarded or paid after that date for service provided in 2010. Although the requirements apply generally to institutions, the more detailed obligations arise in relation to staff whose professional activities have a material impact on the institution's risk profile. The new rules include a requirement to set appropriate ratios balanced between fixed and variable components of total remuneration; that a substantial proportion, and in any event at least 50% of variable remuneration, should consist of shares or equivalent ownership instruments, which are subject to an appropriate retention policy; and that a substantial proportion, and in any event at least 40% of variable remuneration, or 60% in the case of a "particularly high amount," should be deferred over a period not less than three to five years and should vest no faster than on a pro-rata basis.

- **Credit Rating Agencies and Securitization**: The Regulation of the European Parliament and of the Council on Credit Rating Agencies (the "CRA Regulation") requires that a broad range of financial institutions may only use credit ratings for regulatory purposes if they are issued by credit rating agencies ("CRAs") established in the EU and registered in accordance with the CRA Regulation. However, the CRA Regulation permits credit ratings issued by non-EU CRAs to be used if they are endorsed by an EU CRA in its group, but only if various tests are met, including that the non-EU CRA is supervised to a level "at least as stringent" as the CRA Regulation. Alternatively, non-EU CRA ratings may be used if the CRA is regulated in a manner certified to be equivalent to CRAs registered in the EU. Article 122a of the CRD establishes a credit risk retention requirement which applies all new securitizations, broadly defined, from January 1, 2011 and to pre-existing securitizations where new assets are added or substituted after December 31, 2014. The obligation catches any EU-regulated credit institution investing in a securitization, which must ensure that the originator, sponsor or original lender has explicitly disclosed in the offering materials for the securitization that it will retain a material net economic interest of not less than 5%, and carry out thorough due diligence before investing, and periodic monitoring thereafter. Failure to comply with these obligations will result in a requirement to hold a higher level of capital against the securities.

- **Alternative Investment Fund Regulation:** When implemented in July 2013, the AIFM Directive will introduce a harmonized set of rules for the management and marketing of alternative investment funds ("AIFs"). AIFs will include hedge funds and private equity funds. The AIFM Directive mandates authorization of AIFMs and subjects them numerous requirements relating *inter alia* to remuneration, valuation, depositaries, disclosure, capital requirements, and leverage. Non-EU AIFMs from qualifying jurisdictions will be able to apply for authorization under the AIFM Directive from the second half of 2015. Authorized AIFMs will be entitled to market AIFs to professional investors throughout the EU, but existing national private placement regimes will continue until late 2018.

- **Consumer Protection:** EU consumer protection measures are set out in a variety of legislative measures. The EU is presently consulting on proposals to create a regime for standardized pre-contractual information on packaged retail investment products ("PRIPs"). Measures are also being taken to expand the scope of the Deposit Guarantee Schemes Directive (94/19/EC) (the "DGS Directive") and the Investor Compensation Schemes Directives (97/9/EC) (the "ICS Directive"). The EU is also proposing to introduce provisions that will regulate insurance guarantee schemes.

## II. SYSTEMIC RISK AND FINANCIAL STABILITY

Restructuring Financial Supervision within the European Union: Reasons for reform

- The financial crisis revealed important shortcomings in financial supervision within the EU, which failed to anticipate adverse macro-prudential developments and to prevent the accumulation of excessive risks. Surveillance and supervision were not sufficiently effective or responsive. When transnational financial institutions faced problems, the coordination between national authorities was far from optimal.

- In its Communication of May 27, 2009 entitled "European Financial Supervision," the Commission proposed reforms for safeguarding financial stability at the EU level, in particular including the creation of a systemic risk board responsible for macro-prudential oversight.

- Implementation of the new framework was delayed by disagreements between the European Parliament and the Council over the powers of the ESAs. The Parliament favored giving the ESAs the power to impose requirements on financial institutions that would strengthen the single market, while some Member States wished to preserve the powers of their national regulators. During the summer of 2010, a compromise was reached. The ESAs were given certain powers to instruct financial institutions to comply with EU law, to prohibit or restrict certain financial activities and products, and to overrule national supervisors where the Council has declared an "emergency". The framework legislation was adopted on November 17, 2010.

- The new system of financial oversight came into force on January 1, 2011. The new financial supervisory framework consists of the ESRB and three ESAs: ESMA, EBA and

EIOPA. The purpose of the ESRB is macro-prudential supervision: to detect and respond to systemic risks to the financial system. It monitors and assesses potential threats to financial stability that arise from macro-economic developments and from developments within the financial system as a whole. The function of the ESAs is micro-prudential supervision of financial institutions falling in the three financial sectors covered by the ESAs.

The European System of Financial Supervision

- With the introduction of the new European financial supervisory framework, the first steps have been taken towards the creation of true EU level regulatory authorities. In particular, the ESAs in certain circumstances have been invested with 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. Although the three ESAs are presently separate bodies, the Commission will report back every three years on whether it is desirable to combine the separate supervision of banking, securities, and insurance. The Commission will also consider whether the ESAs should be entrusted with further supervisory powers, notably over financial institutions with pan-European reach.

- The new EU authorities do not replace national authorities and their objective is not to transfer the regulatory oversight of financial institutions to the EU. National authorities are responsible for day-to-day supervision, while the European authorities are responsible for coordination, monitoring and if need be mediation between national authorities, and will contribute to the harmonization of technical rules applicable to financial institutions.

The European Systemic Risk Board

- The ESRB is responsible for macro-prudential oversight; specifically, monitoring and assessing potential threats to financial stability that arise from macro-economic developments, the prevention or mitigation of systemic risks to financial stability in the Union that arise from developments within the financial system and taking into account macro-economic developments. It is intended that it will address the vulnerability of the financial system to interconnected, complex, sectoral and cross-sectoral systemic risks arising within the EU.

- The ESRB's function is:
  - To collect and analyze information relevant 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;
  - To identify and prioritize such risks;
  - To issue warnings where risks appear to be significant;

  - To make recommendations on the measures to be taken in reaction to the risks identified;
  - To monitor the required follow-up to warnings and recommendations; and
  - To liaise with the International Monetary Fund, the Financial Stability Board ("FSB") and other non-EU counterparts.

- The role of the ESRB is predominantly advisory. It provides an early warning of systemic risks that may be building up and, where necessary, issues recommendations for action to deal with these risks. The warnings could be general and addressed to the Council, but they could also be directed at specific EU Member States or groups of States.

- Whilst the ESRB possesses no legally binding powers, compliance with the ESRB's recommendations is encouraged by means of an "act or explain" mechanism: a requirement that the addressees explain and justify their reasons for not acting upon ESRB proposals. When a national supervisory authority intends to deviate from an ESRB recommendation, it must first discuss and justify it with the competent European authority and will have to take into account that authority's view before answering the ESRB. If the ESRB concludes that the explanation is not convincing, it is required to report that conclusion to the Council. The ESRB has the discretion to publish its recommendations, but is not obliged to do so.

- The General Board of the ESRB is composed of the heads of the European Central Bank ("ECB") and the Governors of the 27 national Member State banks, a member of the European Commission, as well as the chairpersons of the three ESAs. A representative of each national supervisory authority also attends as an observer. The members of the General Council of the ECB elect the chair of the ESRB for a renewable term of five years. The current chair of the ESRB is Jean-Claude Trichet, President of the ECB. Trichet will be replaced by Mario Draghi as President of the ECB and of the ESRB in November 2011. The ESRB shall report bi-annually to both the European Council and the European Parliament. Direction is provided by a small steering committee composed of the ESRB chairperson and vice-chairperson, five additional central bank members of the ESRB, the chairpersons of the ESAs and the Commission member. The ESRB is also assisted by an advisory technical committee, which is tasked with providing detailed technical analysis of financial stability issues.

The European Supervisory Authorities

- The ESAs have replaced the prior "Level" 3 committees of EU Member State regulators, the Committee of European Securities Regulators ("CESR"), the Committee of European Banking Supervisors ("CEBS"), and the Committee of European Insurance and Occupational Pensions Supervisors. In cooperation and coordination with nationally based supervisors, the ESAs are in place to ensure that rules are applied in a rigorous and consistent fashion throughout the EU, to monitor developments within the financial system as well as to detect potential risks to financial stability.

- In the event of disagreements between national supervisors, ESAs are able to impose legally binding mediation and, if no agreement can be reached within the relevant college of supervisors, to impose supervisory decisions on the financial institution concerned ESAs are able to intervene as mediators at their own discretion, rather than only at the request of one of the national supervisors. The ESAs are able to monitor how national supervisors implement their obligations under EU law. If these obligations are implemented incorrectly, the ESAs may issue instructions to the national supervisor concerned and, if these go unheeded, directly instruct the financial institution to remedy any breach of EU law.

- The ESAs are 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 previous separate supervision of the banking, insurance and securities markets by the Level 3 committees. However, the new EU supervisory structure encourages cross-sectoral cooperation and allows for convergence and the identification of common regulatory principles, in particular through the Joint Committee made up of representatives from each of the ESAs and the ESRB.

<u>Key powers and functions of the ESAs</u>

- The ESAs have the following tasks:

  - Helping 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;

  - 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;

  - Cooperating closely with the ESRB, in particular by ensuring a proper follow-up to the warnings and recommendations of the ESRB;

  - Monitoring and assessing market developments in the relevant areas;

  - Fostering and providing a high level of: depositor and investor protection (EBA); investor protection (ESMA); and policyholder and beneficiary protection (EIOPA); and

  - 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 have the following powers:

  - To develop draft technical standards for submission to the Commission for endorsement;

- ○ Issuing guidelines and recommendations addressed to financial institutions or competent authorities to ensure the consistent application of EU legislation;

- ○ 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);

- ○ 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;

- ○ 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

- ○ 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).

- Decisions taken by an ESA pursuant to the above powers are made public and 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 comprises a Board of Supervisors, a Management Board, and a Board of Appeal. The Board of Supervisors are responsible for the key decisions of an ESA and are composed of the heads of: the national public authorities supervising credit institutions (in relation to the EBA); the national public authorities supervising financial market participants (in relation to ESMA); and the national public authorities supervising financial institutions (in relation to 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 ESAs are located as follows: the EBA in London; ESMA in Paris; and EIOPA in Frankfurt.

- **ESMA** contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection. In particular, ESMA fosters supervisory convergence both amongst securities regulators and across financial sectors by working closely with the other European Supervisory Authorities. ESMA's work on securities

legislation contributes to the development of a single rule book in Europe. This ensures the consistent treatment of investors across the Union, enabling an adequate level of protection of investors through effective regulation and supervision. ESMA also promotes equal conditions of competition for financial service providers, as well as ensuring the effectiveness and cost efficiency of supervision for supervised companies. ESMA also contributes to the financial stability of the European Union in the short, medium and long-term through its contribution to the work of the ESRB.

- The **EBA** is the hub of a network of EU and national bodies safeguarding the stability of the financial system, the transparency of markets and financial products and the protection of depositors and investors. The Committee advises the European Commission on banking policy issues, in particular in the preparation of draft "Level 2" measures for the implementation of European legislation.

- **EIOPA** is responsible for supporting the stability of the financial system, the transparency of markets and financial products as well as the protection of policyholders, pension scheme members and beneficiaries. EIOPA is commissioned to monitor and identify trends, potential risks and vulnerabilities stemming from the micro-prudential level, across borders and across sectors.

## III. CROSS BORDER CRISIS MANAGEMENT FRAMEWORK

- Unlike the United States, where the Federal Deposit Insurance Corporation ("FDIC") is involved in the resolution of large, interconnected financial firms when stability of the financial system is threatened, at present, the EU has no single central "Resolution Authority" with responsibility for cross-border bank insolvencies.

- In October 2009, the Commission published a communication setting out and requesting views from stakeholders on its preliminary proposals for an EU Framework for cross-border crisis management in the banking sector[6]. On October 20, 2010, the Commission published a further communication[7] outlining its proposals for an EU framework based on responses to and developing the proposals set out in its earlier communication. On January 6, 2011, the European Commission published a consultation paper on technical details of the proposed EU framework[8] (the "Crisis Management Consultation"). According to the Commission's most recent work program, the Commission intends to adopt proposed legislation by September 2011.

- In addition to the forthcoming legislation, the Commission is expected to report before the end of 2011 on possible further resolution measures for other types of financial institution, including insurers and central counterparties. However, detailed initiatives promoting the

[6] http://ec.europa.eu/internal_market/bank/docs/crisis-management/091020_communication_en.pdf

[7] http://ec.europa.eu/internal_market/bank/docs/crisis-management/framework/com2010_579_en.pdf

[8] http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf

harmonization of EU bank insolvency regimes and creating a single European Resolution Authority to manage cross-border bank failures has been deferred until 2012 and 2014, respectively.

- The EU framework for cross-border crisis management will have some or all of the following features:
  - **Scope**. The legislation would apply to all credit institutions, at least some investment firms and, to achieve effective group resolution, their holding companies ("Covered Institutions" or "Covered Group", as applicable).
  - **Authorities responsible**. Powers of early intervention would continue to be exercised by prudential supervisors under the CRD. The choice of authority responsible for resolution would be left to each Member State's discretion, subject to a requirement that the resolution authority be separate, at least functionally, from the relevant supervisory authority.
  - **Recovery plans**. Covered Institutions would be obliged to draw up "recovery plans" (or "living wills") highlighting the current and potential measures that are or could be deployed to address liquidity problems, raise capital or reduce risk.

It is not yet clear whether recovery plan requirements would be imposed at the level of both the group and individual entities. In its Consultation, the Commission favored application of the requirement at group and entity-specific level on the basis that neither should assume that they would have access to public financial support in the event of financial instability. Under the Commission's proposal, recovery plans would need to be approved at entity level by the national supervisor and, at group level, by a consolidated group of regulators responsible for the EU group entities. Most respondents to the Consultation favored application of the requirement solely at group level. If entity-specific plans are required, Member States considered that both host and consolidating supervisors should be able to require changes, while industry members believe that only the consolidating supervisor should have such powers.

- **Resolution plans**. Resolution authorities would be required, in consultation with supervisory authorities, to draw up "resolution plans" that would, for example, set out options for applying resolution tools in a range of scenarios and identify critical functions, the sudden withdrawal of which would cause financial instability, outlining the steps that could be taken to ensure their continuity. It is likely that resolution plan requirements would be imposed at both group and entity-specific level.

- **Restrictions on intra-group transfers**. Transfers within a Covered Group experiencing instability would be subject to a pre-approved shareholders agreement designed to preserve the stability of the group as a whole. The Commission has also proposed that Covered Institutions and their parent entities enter into framework agreements to provide financial support at the onset of financial difficulty and that national insolvency regimes be amended to bolster the effectiveness of such agreements by giving the provider of financial support

priority over other creditors in the event of insolvency (with clawback provisions in the event of the provider's insolvency). However, many respondents to the Consultation were skeptical of the proposals for framework agreements and it remains to be seen whether they are incorporated in the Commission's draft legislation.

- **Early intervention powers**. Authorities would be empowered to exercise various "early intervention powers" in relation to a Covered Institution suffering instability. The Commission proposed that these powers should be triggered when a Covered Institution is or is likely to fail to meet the requirements of the CRD; however, many respondents to the Consultation considered this test too vague. These early intervention powers could include powers to:

  - Require the Covered Institution to attempt to raise funds, direct it to use net profits to strengthen the capital base, and prohibit distributions;

  - Restrict or limit the business, operations or network of the Covered Institution; and

  - Impose additional or more frequent reporting requirements or replace board members or managing directors.

- **Special managers**. Supervisory authorities would be given the power to install "special managers" within unstable Covered Institutions. Such a power would be triggered when a Covered Institution fails or refuses to submit or implement a credible recovery plan or fails or refuses to implement additional recovery measures imposed by the national supervisor. The special manager would be obliged to restore the stability of the Covered Institution or prepare it for winding down. Special managers would initially be appointed for up to one year, extendable in exceptional circumstances.

- **Supervisory and resolution colleges**. Where there is instability within a Covered Group, the national supervisor of the parent institution (the "consolidating supervisor") would be required to assess whether a collaborative supervisory effort on behalf of all supervisory authorities of the EU group entities was necessary. Where it was considered necessary, agreement would then be sought amongst all supervisors responsible for each entity in the EU group (the "supervisory college") as to necessary recovery measures. Similarly, resolution colleges would be comprised of supervisors and authorities responsible for resolution and would aim to agree on common approaches to resolution on an entity-specific or group-wide basis (for example, development of resolution plans and application of resolution tools). It is not clear whether non-EU supervisors will be included in resolution colleges. Therefore, it is possible that an internationally coordinated approach to resolution will be pursued outside the scope of EU legislation.

- **Resolution Tools and Powers**. Authorities would be empowered to employ "resolution tools" to ensure the continuity of essential banking services and to manage a Covered Institution's failure in a coordinated way. The proposed legislation will likely incorporate some or all of the following:

- *Sale of business tool.* This would allow authorities to effect a sale of the Covered Institution in whole or part to a purchaser on commercial terms, without requiring the consent of the shareholders or complying with other ordinary procedural requirements;

- *Bridge bank tool.* This would enable resolution authorities to transfer all or part of the business of the credit institution to a public "bridge bank," which would inject capital into the distressed aspects of the business;

- *Asset separation tool.* This would allow resolution authorities to transfer certain assets of a Covered Institution to a publicly owned asset management vehicle for the purposes of facilitating the use or ensuring the effectiveness of another resolution tool; and

- *Debt conversion/write-down tool.* Referred to colloquially as "bail in" or "haircut", this would either: (i) empower regulators to write down by a discretionary amount or convert to equity some or all of the Covered Institution's senior debt; or (ii) require that the Covered Institution issue a fixed volume of "bail-in-able debt" governed by contractual provisions permitting the resolution authority to write down the debt. It is likely that the bail-in triggers would be the same as the resolution triggers (see below).

- The debt conversion/write down tool would be deployed as a last resort, *i.e.,* only where the first three tools proved insufficient. Commission officials have indicated that the tool would not apply to currently outstanding debt and have suggested informally that it would be introduced no sooner than 2015.

- The proposed legislation would confer on authorities a wide range of powers to facilitate use of these resolution tools. For example, to facilitate the use of the debt conversion tool, authorities would be empowered to issue new shares.

- **Resolution triggers**. The use of resolution powers and resolution tools would be contingent on the occurrence of certain triggering events designed to indicate that the Covered Institution is failing or is likely to fail. The Commission proposed three potential triggering events in their consultation, to be used separately or in combination:

  *Insolvency test:*

  - The Covered Institution has incurred losses or is likely to incur losses that will deplete its equity;

  - The assets of the credit institution are or are likely to be less than its obligations; or

  - It is or is likely to be unable to pay its obligations in the normal course of business.

  *Continued authorization test:*

  - The Covered Institution no longer fulfills, or is likely to fail to fulfill, the financial conditions for authorization under the national regulatory regime.

*Capital test:*

- ○ The credit institution no longer possesses, or is likely to fail to possess, sufficient capital to fulfill certain requirements of the CRD.

- These potential triggers could be supplemented by additional criteria, including a requirement that the application of resolution tools be considered necessary in the public interest.

- **Stakeholder protection**. The proposed legislation would include protections for stakeholders to ensure that where resolution authorities applied resolution tools, shareholders and creditors would suffer no greater loss that they would have suffered if the institution had been wound up under the normal insolvency procedures.

## IV. DERIVATIVES REFORMS

The European Market Infrastructure Regulation

- On September 25, 2009, the G-20 leaders agreed that standardized over-the-counter ("OTC") derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties ("CCPs"). OTC derivative contracts should also be reported to trade repositories. Additionally, it was agreed that non-centrally cleared contracts should be subject to higher capital requirements.

- **The European Commission's Proposal.** The European Commission published a draft regulation on OTC derivatives, central counterparties and trade repositories (also known as EMIR) on September 15, 2010.[9] EMIR focuses on creating a more centralized and transparent clearing and trading process.

- EMIR sets out to increase stability within OTC derivative markets. It introduces:
  - ○ A reporting obligation for OTC derivatives;
  - ○ A clearing obligation for eligible OTC derivatives;
  - ○ Measures to reduce counterparty credit risk and operational risk for bilaterally cleared OTC derivatives;
  - ○ Common rules for CCPs and for trade repositories; and
  - ○ Rules on the establishment of interoperability between CCPs.

[9] *See* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0484:FIN:EN:PDF.

- It is also intended that ESMA will be responsible for the oversight of the EU derivatives markets and will be tasked with liaising directly with national regulators on issues concerning derivatives.

- **Legislative Developments.** Since the Commission's proposal the Council of Ministers has put forward various compromise proposals and the European Parliament has proposed amendments. The main issues that have arisen include:

    - Whether EMIR should cover all derivatives or only OTC derivatives;

    - Exemptions for certain categories of transactions;

    - Whether trading venues should be required to furnish data to central counterparties;

    - How CCPs can meet liquidity requirements, in particular, whether they should have a banking license and access to central bank liquidity;

    - The role of the ESMA and the college of supervisors; and

    - The transition period for pension funds.

- **The European Parliament's Position.**[10] On May 24, 2011, the Economic and Monetary Affairs Committee of the European Parliament ("ECON") approved EMIR with amendments, including the following:

    - OTC derivative contracts need to be cleared through CCPs;

    - ECON rejected suggestions by some Member States that all derivatives should be governed by EMIR. Instead, ECON proposes that only OTC derivatives be subject to the clearing obligations (as proposed by the Commission and agreed by the G20), while reporting obligations apply to all derivatives to give the new ESMA a better understanding of the derivatives markets;

    - The interoperability requirement for CCPs, allowing traders to choose where their trades are cleared, should be limited to cash securities. Moreover, CCPs have to comply with the requisite standards for at least three years before requesting authorization for interoperability;

    - ECON accepts that clearing should only become mandatory for transactions entered into after EMIR enters into force. However, ECON has asked ESMA to assess how reporting retroactivity could be introduced for information deemed essential by supervisory authorities; and

[10] See http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+AMD+A7-2011-0223+001-001+DOC+PDF+V0//EN

  - ECON envisages a central role for ESMA, which would be involved in authorizing new CCPs, would work closely with national supervisory authorities, and could carry out on-site inspections.

- The full Parliament was scheduled to vote on EMIR on July 4, 2011, although such a vote would have resulted in a "second reading" of EMIR, delaying the adoption process by at least another six months. Instead, the European Parliament decided to delay the adoption of EMIR until September 2011 to enable the Parliament to reach an agreement with the Council.[11]

- **The Council's Position.** On June 20, 2011, the Hungarian Presidency of the Council of Ministers published a press release outlining its views with regards to EMIR.[12] The remaining issues under consideration include the following:

  - *Scope*: at present, a majority wishes to extend the scope of clearing obligations to all derivatives but it is faced with a large blocking minority.

  - *ESMA's powers*: the Presidency wishes to strike a compromise between two major camps, one, supporting national authorities to retain both authorization and registration of CCPs, and the other, maximizing ESMA's role in the process. The Presidency has sought political guidance on the issue and the voting modalities in the supervisory college.

  - *Third-country provisions*: the Presidency incorporated a suggestion by the Commission intended to mirror similar U.S. provisions.

- **Next steps.** The European Parliament is expected to vote on EMIR in September 2011.Until then, the European Parliament will be seeking agreement with the Council in order to adopt EMIR in a "first reading" in Fall 2011.

Extension of the Market Abuse Directive to certain derivatives

- MAD is the centerpiece of the European regulation of insider dealing and market manipulation. In November 2008, the European Commission began to consider the need for a revised MAD ("MAD II"), inter alia, to react to market developments since 2003, as well as to the issues raised by the financial crisis. A public consultation was released by the Commission in June 2010 (the "June 2010 Consultation").

- Among other issues, MAD II is expected to have implications on the regulation of derivatives in Europe. The June 2010 Consultation proposes to (i) extend the application of the market abuse regime to MTFs which do not qualify as regulated markets but which are commonly use as market places for derivatives, and (ii) align the definition of financial

[11] *See* http://www.europarl.europa.eu/en/pressroom/content/20110705IPR23303/html/Parliament-decides-stance-on-derivatives-short-selling-investor-compensation.

[12] *See* http://www.eu2011.hu/files/bveu/documents/HUPRES43_20062011_FinancialServices_EN.pdf.

instrument with the broader definition used in MiFID. The definition of financial instrument under MiFID covers certain derivatives that are not currently within the scope of MAD. These derivatives include, for example, CFD, CDS and climatic derivatives. In particular, the Commission seeks to clarify the definition of commodity derivatives (which are defined extensively under MiFID but not at all under MAD) and the treatment of CFDs under MAD.

- In addition to the overarching extension of MAD to certain derivatives and MTF trading, the June 2010 Consultation also proposes a number of detailed amendments that would affect derivatives:

    - MAD currently includes a specific definition of inside information in relation to commodity derivatives. This definition classifies inside information as "*information […] which users of commodity derivative markets would expect to receive in accordance with accepted market practices*" and has been criticized as unclear and difficult for regulators to apply. The Commission proposes to replace this vague definition with the general definition of inside information, *i.e.,* "*information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments*."

    - Under MAD, derivatives of financial instruments not admitted to trading on a regulated market, or for which a request for trading has been made, currently only fall within the scope of the inside information regime. The Commission also proposes to extend market manipulation rules to cover these derivatives.

    - Persons arranging transactions are currently required to report transactions suspected for inside trading or market manipulation to their regulator. The Commission proposes to include, inter alia, suspicious orders and OTC transactions as well as transactions in derivative instruments executed outside a regulated market or MTF under this regulation.

- Most respondents to the June 2010 Consultation concurred that the prohibition of market manipulation should be expanded to cover manipulative actions committed through derivatives. For example, the International Swaps and Derivatives Association, the Association for Financial Markets in Europe and the British Bankers Association were all in favor of the MAD II's application to transactions in OTC derivatives whose value depends on a financial instrument admitted to trading on a regulated market. With regards to the definition of inside information for commodity derivatives, respondents supported the proposal that it should be linked to price-sensitivity, but they were not in favor of altogether abandoning the existing definition, which is linked to the expectations of market users. On the point of extending the requirement to report suspicious orders in OTC transactions, the London Stock Exchange suggested it should be coordinated with other initiatives at the European level such as the establishment of trade repositories under EMIR.

Review of MiFID (focused on trading structures, transparency and commodity derivatives)

- MiFID came into force in November 2007 and regulates the operations of investment services firms. The European Commission began its review of MiFID in 2010 and published a consultation paper in December 2010, based on technical advice provided by the CESR.

- The MiFID review will have an effect on, inter alia, the regulation of derivatives in Europe. On a technical level, the revised directive ("MiFID II") will be aimed at controlling market structures and technology, including derivatives trading. On a more principles-oriented level, MiFID II is expected to improve oversight and transparency of commodity derivatives. The MiFID consultation addressed the following questions, which affect derivatives:

    - The Commission proposes to introduce a broad definition of an organized trading facility ("OTF") to suitably regulate all organized trading occurring outside regulated markets and MTFs, currently outside the scope of MiFID. The definition of an OTF would capture any facility or system operated by an investment firm or a market operator that on an organized basis brings together buying and selling interests or orders relating to financial instruments. This new definition would be broad but would still exclude "pure OTC trading" (*i.e.* bilateral trades carried out on an ad hoc basis between counterparties and not under any organized facility or system). Operating an OTF would require authorization.

    - The Commission proposes to enhance pre- and post-trade transparency for all trades, in particular, non-equity products, whether executed on regulated markets, MTFs, OTFs or OTC. These new requirements would be differentiated by asset class. The new transparency regime would be achieved through new obligations for investment firms and would apply to:

        - All bonds and structured products with a prospectus or which are admitted to trading either on a regulated market or MTF; and

        - All derivatives eligible for central clearing and reported to trade repositories under EMIR.

      As non-equity products are very different one from another, the Commission considers that the exact post-trade transparency regime would need to be defined for each asset class and in some cases for each type of instrument within this asset class. The Commission provided the following parameters for the contemplated post-trade disclosure regulation:

        - The post-trade transparency regime would be transaction-based. It would provide data on transactions in terms of price, volume, time of trade, and

the main reference characteristics of the traded instrument rather than aggregate data;

- The transparency regime would be properly calibrated to the class of financial instruments (bond, structured finance product, derivative) and to the type of instrument (option, swap, forward) as well as underlying variable, for instance a financial asset or a commodity, as appropriate; and
- The transparency regime would be predicated on a system of thresholds and delays, based on transaction size.

- The Commission proposes to establish a mandatory consolidated tape, an integrated reporting system regarding the essential characteristics of trades. A consolidated tape would provide comprehensive consolidation of post-trade data and offer market users a single point to access post-trade information about trading of instruments on each of the trading platforms and OTC, across Europe.
- Specifically in relation to commodity derivatives, the Commission proposes:
  - To introduce position reporting by categories of traders for contracts traded on all EU regulated markets, MTFs and OTFs which admit commodity derivatives to trading, and
  - To require regulated markets, MTFs and OTFs to design commodity derivatives contracts which they admit to trade and which can be physically settled in a way that ensures convergence between futures and spot prices.

  The Commission contemplates an exemption for commodity firms when they deal on own account in financial instruments or provide investment services in commodity derivatives on an ancillary basis as part of their main business, provided they are not subsidiaries of financial groups.

- The current transaction reporting requirements apply to financial instruments admitted to trading on a regulated market, including transactions in such an instrument executed outside a regulated market, notably on an MTF or OTC. The Commission's concerns, notably the need for transaction reporting to capture all relevant trades (including trading in financial instruments admitted to trading or trading only on MTFs or OTFs), will be dealt with under MAD II, which will also require amending the equivalent rules in MiFID to include:
  - All transactions in financial instruments that are admitted to trading or traded on a MTF or an OTF or that are related to the credit risk of a single issuer of such financial instruments;

- All financial instruments the value of which correlates with the value of a financial instrument traded on a regulated market, MTF or OTF;

- Depositary receipts that are related to a financial instrument that is admitted to trading or traded on a regulated market, a MTF or an OTF; and

- Commodity derivatives that are not admitted to trading or traded on a regulated market, a MTF or an OTF.

In order to align national reporting requirements, the Commission proposes further implementing acts to harmonize the format and content of European transaction reporting, including the reporting form, identification of the instrument traded, date and time, price against which the transaction took place, identification of the reporting parties, identification of the client, trading capacity, number of the report, technical format of transmission and means of transmission. To facilitate efficient information exchange between competent authorities, the Commission proposes to create a reporting mechanism at the EU level, *i.e.,* a database permanently accessible to competent authorities.

- The European Commission has announced that it will publish its legislative proposals on MAD II and MiFID II in October 2011. The revised MiFID proposal will also be accompanied by an impact assessment. Following publication of the proposals, the Council of Ministers and the European Parliament will review the proposals and seek to reach an agreement on a final text, which is expected in 2012.

Short selling and credit default swaps

- **The Commission proposal.** In response to the financial crisis, various EU Member State authorities adopted emergency measures to restrict or ban short selling.[13] On September 15, 2010, the European Commission published a proposal for a Regulation on short selling and certain aspects of credit default swaps (the "Short-selling/CDS Regulation")[14] with the aim to establish a coordinated EU-wide approach to restrictions on short selling and to limit regulatory arbitrage and instability of the European markets. The proposal provides for:

  - Increased transparency through disclosure obligations on short positions held by investors in certain EU securities and limitations to enter into uncovered short sales;

[13] Short selling of securities is a practice where a natural or legal person sells a security he does not own with the intention of buying back an identical security at a later point in time. The seller has a short position from the time when he agrees to sell the securities until the time he acquires them. Short sale transactions are described as "naked short sales" when the short position holder has not covered the transaction either by corresponding holdings in the underlying securities or by entering into an agreement or an arrangement to settle the short sale.

[14] http://tinyurl.com/Commission proposal.

- Clear powers for Member States to intervene in exceptional situations to reduce risks caused by short selling; and

- Enhanced coordination between Member States and ESMA in such situations.

- The Short-selling/CDS Regulation would apply to all financial instruments admitted to trading on a regulated market or a multilateral trading facility in the European Union. The Commission proposal would, however, provide exemptions for short sales in relation to, inter alia, shares with the principal trading venue outside the EU, market making activities, and stabilization activities.

- The Commission proposal would impose disclosure requirements on holders of short positions in (i) shares, (ii) debt instruments issued by the European Union or any Member State, including any ministry, department, central bank, agency or instrumentality, and (iii) CDS relating to such sovereign debt. These requirements would apply to investors established or residing either in or outside the EU.

- The Short-selling/CDS Regulation would require persons holding net short positions in relation to shares of an EU-listed company to notify the competent national authority if that position reaches or falls below 0.2% of the issuer's share capital and each 0.1% above that. Net short positions equal to 0.5% of an EU-listed company's share capital and each 0.1% above that would have to be disclosed to the public. Persons holding net short positions in debt instruments issued by an EU Member State or in CDSs relating to sovereign debt, over a threshold to be determined by the Commission, would have to notify the competent authority (but not the public).

- In addition to the disclosure obligations, the Commission proposes to restrict uncovered or naked short selling in EU shares and sovereign debt instruments. Under the proposal, short selling would only be allowed when the short seller has either borrowed or agreed to borrow the share or the sovereign debt instrument, or has arrangements with a third party under which that third party has confirmed that the share or sovereign debt instrument has been located and reserved for lending for the short seller so that settlement can be effected when it is due.

- The Commission would allow Member State authorities to impose additional disclosure requirements and/or conditions or limitations on short selling for limited periods where necessary to address a threat to financial stability. National authorities would be required to notify ESMA of such measures, and ESMA would play a facilitating and coordinating role, yet without the power to block actions by national authorities. Moreover, ESMA would have the ability to impose restrictions if the relevant national authorities would not have taken adequate measures. The Commission proposal also requires Member State authorities, whenever possible, to conclude cooperation agreements with non-EU authorities in relation to the enforcement of the Regulation.

- **Discussion in ECON and the Council of Ministers.** After its publication, various EU organs, including the Council of Ministers under the Hungarian Presidency and ECON, have discussed the Commission proposal.

- On March 7, 2011, ECON adopted proposed amendments to the Short-selling/CDS Regulation, according to which investors should be prohibited from engaging in naked short selling in relation to CDSs on sovereign debt.[15] Under that proposal, an investor would not be permitted to hold short positions in CDSs in relation to sovereign debt unless they already own either sovereign debt linked to that CDS or securities the pricing of which has a high correlation with the pricing of the given sovereign debt (such as shares in a major company based in that jurisdiction) or unless they acquire such assets by the end of the trading day on which they enter into the CDS. Further, according to ECON, investment firms' standard reporting requirements should be amended to allow short sale reporting at the end of the trading day and only to the regulator, rather than requiring separate disclosure of each short sale to the public, as proposed by the Commission.

- On May 17, 2011, the EU Council of Ministers reached agreement on the Short-selling/CDS Regulation.[16] The Council would clarify the definition of a "short sale" by excluding various types of transactions such as (i) repurchase agreements with a specific price and commitment agreed, (ii) transfers of securities under securities lending agreements, and (iii) futures or other derivative contracts with specific price and commitment agreed.

- The Council proposal would, in accordance with the ECON position, complement the restrictions on uncovered short sales in shares with similar restrictions on uncovered short sales in sovereign debt. These restrictions would, however, not apply if the short sale transaction served to hedge a long position in debt instruments of an issuer, the pricing of which had a high correlation with the pricing of the given sovereign debt.

- In relation to the disclosure obligations, the Council would not require trading venues to publish daily summaries of the volume of orders marked as short orders or allow trading venues to prohibit persons from entering into further short sales of shares or sovereign debt instruments as long as such persons would continue to fail to settle a previous shorting transaction.

- **Next steps.** On July 6, 2011, the European Parliament voted on the Short-selling/CDS Regulation largely in accordance with ECON's approach, and the Council published a summary of the Parliament's proceedings on July 14, 2011.[17] The Parliament vote was indicative only; the final vote was postponed with hopes of a first reading compromise in Fall 2011.

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[15] http://tinyurl.com/EP press release

[16] http://tinyurl.com/Council General Approach

[17] http://tinyurl.com/EP outcome

## V. EXECUTIVE COMPENSATION

Introduction

- There have been three separate but related developments in Europe relating to executive compensation in the past twelve months:
    - Developments applicable to credit institutions and certain investment firms pursuant to CRD III. CRD III is discussed in the remainder of this Part V;
    - Developments applicable to AIFM Directive. The AIFM Directive, including its remuneration aspects, are discussed below at Part VII; and
    - Developments applicable to the insurance sector pursuant to Directive 2009/138/EC ("Solvency II"). Solvency II will ultimately contain certain Level 2 implementing measures, which are expected to be finalized in 2012. Those implementing measures will contain provisions governing the remuneration of employees, which will mirror the approach in CRD III and the AIFM Directive. The proposed measures have been the subject of Advice published by the Committee of European Insurance and Occupational Pensions Supervisors.[18]

Legislative background to CRD III

- CRD III was adopted by the European Parliament and Council on November 24, 2010 and came into force on the day following its publication in the Official Journal of the European Union on December 14, 2010. CRD III amended Directives 2006/48/EC (relating to the taking up and pursuit of the business of credit institutions) and 2006/49/EC (on the capital adequacy of investment firms and credit institutions) and it made significant changes to the supervisory oversight in Europe of remuneration policies, practices and disclosure of "credit institutions"[19] and "investment firms"[20] within the meaning of MiFID (together, "Covered Firms").
- In its broadest formulation, CRD III mandates additional regulatory supervision of the remuneration policies and practices of Covered Firms, to assess whether they encourage excessive risk-taking or are consistent with and promote sound and effective risk management.

[18] https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/consultationpapers/CP59/CEIOPS-DOC-51-09%20L2-Advice-Remuneration-Issues.pdf

[19] Defined as "an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own accounts".

[20] Defined as "any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis".

- Members States were required to enact local legislation implementing CRD III's remuneration-related provisions by January 1, 2011, and to apply it retroactively to include remuneration due on the basis of contracts concluded before the effective date of implementation and awarded or paid after that date, including for service provided in 2010.

- In the United Kingdom, the few large banks subject to the Financial Services Authority's ("FSA") pre-existing remuneration code were required to comply with the UK implementation of CRD III from January 1, 2011, whilst the majority of Covered Firms, who were being brought within its scope for the first time, were given until July 1, 2011 to be fully compliant. To illustrate their compliance, Covered Firms in the United Kingdom are required to produce a written remuneration policy statement by September 1, 2011 and to have made their first public remuneration disclosure by December 31, 2011.

- In order to promote supervisory convergence across Europe, CEBS was required under CRD III to elaborate guidelines on sound remuneration policies in the banking sector and for MiFID investment firms. On October 8, 2010, CEBS published for consultation draft guidelines[21] for both Covered Firms and their supervisors, and these were released in final form[22] on December 10 2010 (the "CEBS Guidelines"), together with a summary of responses received.[23]

- The nature and extent of implementing measures and associated guidance across Member States varies widely. In the United Kingdom, the FSA consulted on draft implementing measures and guidelines in 2010,[24] published final rules[25] and guidelines[26] taking into account the CEBS Guidelines and has released further technical guidance.[27] Other Member State regulators have provided less extensive guidance.

- The European Commission is required under CRD III to review CRD III's principles on remuneration policies by April 1, 2013, with particular regard to their efficiency, implementation and enforcement and taking into account international developments (including any proposals from the FSB).

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[21] http://eba.europa.eu/documents/Publications/Consultation-papers/2010/CP42/CP42.aspx

[22] http://eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Remuneration/Guidelines.pdf

[23] http://eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Remuneration/Feedback-document.pdf

[24] http://www.fsa.gov.uk/pubs/cp/cp10_19.pdf and http://www.fsa.gov.uk/pubs/cp/cp10_27.pdf

[25] https://fsahandbook.info/FSA/html/handbook/SYSC/19A and https://fsahandbook.info/FSA/html/handbook/BIPRU/11/5

[26] http://www.fsa.gov.uk/pubs/policy/ps10_20.pdf and http://www.fsa.gov.uk/pubs/policy/ps10_21.pdf

[27] http://www.fsa.gov.uk/pages/library/policy/guidance_consultations/2011/11_09.shtml

Identified Staff

- Certain of CRD III's provisions, particularly those relating to governance and disclosure, are applicable to Covered Firms on an institution-wide basis. However, some of the more onerous requirements relating to remuneration structures apply only to those of a Covered Firm's employees "whose professional activities have a material impact on their risk profile" ("Identified Staff"). Identified Staff include, at least, "senior management, risk takers, staff engaged in control functions and any employee whose total remuneration, including discretionary pension benefit provisions, takes them into the same remuneration bracket as senior management and risk takers" An employee's compensation level alone cannot cause him to be designated Identified Staff.[28]

- It is primarily the responsibility of each Covered Firm to identify Identified Staff, and it must be able to demonstrate to its supervisor how it has assessed and selected its employees as Identified Staff.[29]

Application to groups

- CRD III provides that Covered Firms are required to comply with its remuneration-related rules at group, parent company and subsidiary levels, "including those [subsidiaries] established in offshore financial centers". In other words, Covered Firms are required to apply the rules on a group-wide basis to all firms within a consolidated group if their parent is located in the EEA (including to any non-EEA subsidiaries of that group) and also to any EEA subsidiaries of an otherwise non-EEA group.

Proportionality

- One of the key principles of CRD III's remuneration-related provisions is proportionality, namely, that the remuneration policies and practices of a Covered Firm should match with its risk profile and risk appetite. The practical impact of this is significant; not all Covered Firms are required to comply with CRD III in the same way and to the same extent. For example, the requirement to establish a remuneration committee is stated in CRD III to apply to firms that are "significant in terms of their size, internal organisation and the nature, the scope and the complexity of their activities".

- In the United Kingdom, the FSA has adopted a four-tiered system and has produced detailed guidance setting out the rules it generally considers can be disapplied by firms at each tier. For example, the FSA generally considers that limited license and limited activity investment firms in the lowest tier (tier 4) can disapply the rules around retained shares, deferral, performance adjustment and leverage, as well as the requirement to establish a remuneration committee.

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[28] CEBS Guidelines, paragraph 16.

[29] CEBS Guidelines, paragraph 15.

- Proportionality is also relevant to the way that Covered Firms are required to apply the rules to employees. For example, in relation to the deferral rule, CRD III provides that the 40 to 60% level should increase "significantly" with the level of seniority or responsibility of the person remunerated. Similarly, in the United Kingdom, the FSA does not generally consider it necessary for Covered Firms to apply the rules on guarantees, retained shares, deferral or performance adjustment to employees whose total remuneration is less than £500,000 and whose variable remuneration is no more than 33% of his total.

Governance

- As an integral part of ensuring a Covered Firm has robust corporate governance arrangements, the supervisory body/function of each Covered Firm at a local level is responsible for ensuring that its remuneration policies and procedures are consistent with and promote sound and effective risk management, do not encourage excessive risk taking and enable the Covered Firm to achieve and maintain a sound capital base.

- In brief, whilst not all Covered Firms are required by CRD III to establish a separate remuneration committee, its supervisory body (or, depending on local corporate structure, its management body exercising a supervisory function) is required to adopt and periodically review the Covered Firm's remuneration policy and is responsible for overseeing its implementation, including approving any material exemptions or changes. The implementation of the remuneration policy must also be reviewed for compliance at least annually.

- As to remuneration procedures, the CEBS Guidelines provide that these "should be clear, well-documented and internally transparent. For example, proper documentation should be provided on the decision-making process, the determination of the Identified Staff, the measures used to avoid conflicts of interest, the criteria used to determine the ratio between the fixed and variable remuneration components, the risk-adjustment mechanisms used, etc."[30]

Remuneration structures

- In addition to its various general principles, CRD III sets out a number of prescriptive rules relating to remuneration structures. These include:

  - *Guarantees*: guaranteed variable remuneration should be exceptional, occur only when hiring new staff and be limited to the first year of employment;

  - *Leverage*: Covered Firms should set appropriate ratios between fixed and variable components of total remuneration and ensure these are appropriately balanced so as to allow the operation of a fully flexible policy, including the possibility of paying no variable remuneration;

[30] CEBS Guidelines, paragraph 43.

- *Retained shares*: a substantial proportion, and in any event at least 50% of variable remuneration, should consist of shares or equivalent ownership instruments, which are subject to an appropriate retention policy;

- *Deferral*: a substantial proportion, and in any event at least 40% of variable remuneration (60% in the case of a particularly high amount),[31] should be deferred over a period not less than three to five years and should vest no faster than on a pro-rata basis; and

- *Performance adjustment*: variable remuneration (current and deferred) should be paid or vest only if it is sustainable according to the financial situation of the Covered Firm as a whole and justified according to the performance of the firm, the business unit and the Identified Staff.

Disclosure

- CRD III requires Covered Firms[32] at least annually to publicly disclose detailed information regarding their remuneration policies and practices applicable to Identified Staff. However, the proportionality principle applies also to this requirement, and in the United Kingdom for example, the requirement to make detailed quantitative disclosures applies only to tier 1 firms.

- Both qualitative and quantitative disclosures must be made:

  - Qualitative disclosures include: (i) information concerning the decision-making process used for determining the Covered Firm's remuneration policy; (ii) information on the link between pay and performance; and (iii) the most important design characteristics of the remuneration system, including information on the criteria used for performance measurement and risk adjustment, deferral policy and vesting criteria; and

  - Quantitative disclosures are required on an aggregate basis only by business area and category of Identified Staff and include: (i) amounts of fixed and variable remuneration and the number of beneficiaries; (ii) amounts of outstanding deferred remuneration, amounts of deferred remuneration awarded, paid out or reduced through performance adjustments; and (iii) details of sign-on and severance payments awarded.

- Covered Firms have discretion to decide when, how and where to make such disclosures, subject to these being easily accessible.

Anti-avoidance

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[31] That amount is £500,000 in the United Kingdom.

[32] Although note a slight difference in this definition in the United Kingdom, where third-country investment firms whilst subject to the rules on remuneration policies and practices in relation to activities carried on at a UK establishment, are not currently subject to the rules on remuneration disclosure.

- CRD III cautions against remuneration being paid through vehicles or methods that facilitate the avoidance of its remuneration-related requirements. For example, creating special group structures or offshore entities in order to circumvent the application of the remuneration policies to staff to which the remuneration principles should otherwise apply. In other words, staff will not be able to bypass CRD III's remuneration requirements by becoming employees of an offshore or non-regulated entity of the group while still performing services/duties for EU-based institutions.[33]

- In addition, the CEBS Guidelines include the following as examples of circumstances and situations that may be considered to have been employed to artificially evade the requirements of CRD III: "the conversion of parts of the variable remuneration into benefits that normally pose no incentive effect in respect of risk positions; the outsourcing of professional services to firms that fall outside the scope of the CRD III, or the use of off-shore centers; the use of tied agents or other figures not considered "employees" from a legal point of view; transactions between the institutions and third parties in which the risk takers have material interests; the setting up of structures or methods through which remuneration is paid in the form of dividends or similar pay outs (e.g. improper use of carried interest models) and non-monetary material benefits awarded as incentive mechanisms linked to the performance."[34]

- Firms must also require their staff to undertake not to use personal hedging strategies or insurance to undermine the risk alignment effects embedded in their remuneration arrangements.

<u>Corrective measures</u>

- CRD III contemplates the taking of "appropriate corrective measures" by supervisors against Covered Firms who fail to comply with its remuneration-related rules. Specifically, CRD III envisages requiring Covered Firms to reduce risk including by introducing changes to their remuneration structures or freezing the variable parts of remuneration to the extent inconsistent with effective risk management, or requiring them to hold additional own funds.

- In the United Kingdom, the FSA has been given the power to render void contractual provisions that contravene the rules on guarantees and deferral in certain circumstances, and such contravention is considered to be a significant breach notifiable to the FSA.

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[33] CEBS Guidelines, paragraph 28.

[34] CEBS Guidelines, paragraph 13.

## VI. CREDIT RATING AGENCIES AND SECURITIZATION

Scope of the CRA Regulation.

- The CRA Regulation applies to credit ratings issued by CRAs registered in the EU which are disclosed publicly or distributed by subscription. It does not apply to assessments that fall short of a credit rating, such as credit scores, or private credit ratings not intended for public disclosure, or the internal credit ratings produced by central banks. Neither does it apply to certain research recommendations, certain items of investment research and opinions about the value of a financial instrument or a financial obligation.

- Under the CRA Regulation, a "credit rating" is defined as an "opinion regarding the creditworthiness of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, or of an issuer of such a debt or financial obligation, debt security, preferred share or other financial instrument, issued using an established and defined ranking system of rating categories".

- The CRA Regulation came into force on December 7, 2009. On June 1, 2011, the Regulation of the European Parliament and of the Council amending the CRA Regulation (the "Amending Regulation") came into force. From July 1, 2011, the Amending Regulation transferred from national regulators to ESMA, the responsibility for the registration and supervision of CRAs.

Use of credit ratings

- Where a reference is made to credit ratings in a formal Prospectus Directive-compliant prospectus, it must also contain a clear and prominent statement as to whether the credit rating was issued by an EU-established CRA that is registered under the CRA Regulation.

- Credit institutions, investment firms, various types of insurance companies, and various types of funds, including AIFs and pension funds must only use credit ratings issued by EU-registered CRAs.

- Credit ratings issued by non-EU CRAs may be used if they meet the requirements of either of the following two exceptions:

    - *Endorsement*: An EU registered CRA may "endorse" credit ratings issued by a non-EU CRA that is in is a member of its group, if (i) the non-EU CRA is supervised to a level "at least as stringent" as the CRA Regulation, (ii) there is a co-operation arrangement between ESMA and the third country, and (iii) there is an "objective reason" for the credit rating to be produced outside the EU. ESMA has published guidance in relation to the "at least as stringent" requirement.

    - *Equivalence:* Alternatively, credit ratings may be used for regulatory purposes, where they (i) are issued by a non-EU CRA and (ii) relate to non-EU entity or non-EU issued financial instrument, if (iii) the non-EU CRA is certified to be regulated in an equivalent

manner to EU-registered CRAs. ESMA has made it clear that such a non-EU CRA must be subject to legally binding requirements that are "equivalent" to the provisions of the CRA Regulation. The Japanese regime for the regulation of CRAs was declared to be equivalent to the EU regime in September 2010. A non-EU CRA will be deemed ineligible for certification by equivalence if its activities are of systemic importance to the financial stability or financial markets of any Member State.

Conduct of business requirements

- **Methodologies**. CRAs must use rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience. Issued credit ratings must be based on a thorough analysis of all the information available to the issuing CRA and that is relevant to its analysis according to its methodologies. If a CRA changes its methodologies, models or key rating assumptions, it is obliged to disclose immediately the likely scope of credit ratings that are affected, to review the affected credit rating as soon as possible (and in any event within six months of the change) and, if the overall combined effect of the changes affects certain credit ratings, to re-rate those credit ratings.

- **Independence**. Subject to an exemption for small CRAs (who are exempt from some of the independence requirements), the CRA Regulation imposes a general duty on CRAs to ensure that the issuance of a credit rating is not affected by any actual or potential conflict of interest. CRAs are obliged to comply with various requirements to demonstrate their independence, including:

  - The establishment of a skilled and experienced management board to ensure conflicts of interest are properly identified, managed and disclosed in accordance with the CRA Regulation. The remuneration of the independent members of the board cannot be linked to the business performance of the CRA;

  - Limiting their activity to credit rating and connected operations, excluding consultancy or advisory services;

  - Conducting internal review processes to review the quality of the ratings produced by the CRA; and

  - Maintain records of all rating activities for at least five years.

- **Employees.** The CRA Regulation imposes obligations in relation to those involved in the issuing of credit ratings. For example, CRAs must ensure that:

  - Employees involved in rating activities have appropriate knowledge and experience and are not involved in any negotiations on fee arrangements between the CRA and the rated entity;

  - Employees directly involved in the credit rating process meet various independence requirements and are subject to a rotation mechanism;

- ○ Rating analysts do not make proposals or recommendations on the design of structured finance instruments on which the CRA is expected to issue a credit rating; and

- ○ Remuneration for employees involved in the rating process must not depend on the revenue received from the rated entity or affiliates.

- **Disclosure:** The CRA Regulation requires CRAs to make various periodic public disclosures. The key disclosures relate to methodologies, models and significant rating assumptions used in the rating process.

- **Transparency:** CRAs are also required to publish an annual "transparency report". The report must set out details of their internal systems and controls, ownership and certain specified financial information. Registered CRAs are also subject to a rolling public disclosure duty in relation to their policies on the publication of credit ratings, any services other than rating that they provide, and any actual and potential conflicts of interest.

- **Central repository:** The CRA Regulation provides for the establishment of a central repository that will store information on the past performance of CRAs and past credit rating issues. The date by which the central repository must be established has not been prescribed.

Enforcement

- Under the CRA Regulation, as amended, the ultimate responsibility for enforcement lies with ESMA. ESMA has broad powers to investigate and enforce not only against CRAs, staff involved in credit rating activities, individuals who are closely and substantially connected to CRAs or credit rating activities, and persons to whom CRAs outsource functions, but also in relation to rated entities themselves. It may require that information be provided to it, or that a person agree to an investigation or on-site inspection. ESMA may impose fines, capped at 20% of the CRA's turnover for the previous year, in respect of breaches of certain specified obligations of the CRA Regulation.

- ESMA is also empowered to:

  - ○ Withdraw the registration of the CRA;

  - ○ Prohibit the CRA from issuing credit ratings in the EU for a period of time;

  - ○ Suspend the use in the EU of the credit ratings issued by the CRA; and

  - ○ Require the CRA to end the infringement, which it may enforce by imposing penalty payments on the CRA until the infringement ceases.

- National authorities are empowered to enforce against infringements relating to the use of credit ratings, and are required to establish effective, proportionate and dissuasive penalties for such breaches of the CRA Regulation.

Credit risk retention for securitizations

- On January 1, 2011, Article 122a of the CRD came into force. It applies to all new securitisations coming into existence on or after January 1, 2011, and apples to any pre-existing securitizations where new assets are added or substituted after December 31, 2014. Article 122a places new requirements on European credit institutions both (i) when investing in securitisations and (ii) when acting as sponsor or originator on a securitization.

- **Investing**. An EU-regulated credit institution investing in a securitization must:

  - Ensure that the originator, sponsor or original lender has explicitly disclosed in the offering materials for the securitization that it will retain a material net economic interest of not less than 5%; and

  - Carry out thorough due diligence before investing, and periodic monitoring thereafter.

- Failure by an investing institution to comply with these requirements means that it will be required by its national regulator to hold more capital against the securities.

- **Sponsors and originators**. An EU-regulated credit institution acting as sponsor or originator of a securitization must:

  - Satisfy detailed disclosure requirements; and

  - Apply underwriting standards equivalent to the standards that apply to exposures they retain.

- The 5% retention is not a sponsor/originator requirement. Rather, it is the responsibility of the investing institution to ensure that the retention is complied with before making an investment.

- **What constitutes a securitization?** Any transaction which falls within the CRD definition of securitization will be subject to Article 122a. The key criteria for a transaction falling within the definition are:

  - Tranching; and

  - A transfer of credit risk.

- Note that it is not necessary that securities are issued. For example, junior and senior funding from multiple lenders to a warehouse SPV is considered to be tranching. Similarly, most asset-backed securities will be subject to Article 122a (e.g. CMBS, RMBS, auto-loan and credit card securitization).

- **Exceptions.** Covered bonds are not subject to Article 122a. The credit risk of third parties remains with the originator. Whole business securitizations are considered to be a form of structured corporate funding, but are not a securitization for the purposes of Article 122a.

- **CLOs.** There is a lack of clarity on the impact of Article 122a on CLOs. In a CLO structure there is no easily identifiable originator or sponsor. CEBS has suggested a possible solution would be the retention of a 5% interest by an intermediate originator SPV, to be owned by the portfolio manager. However, it isn't clear how such an originator SPV would be funded – CLO managers are not usually principal investors. Further guidance is expected later in 2011.

- **Retention of material net economic interest.** Article 122a sets out four ways in which the 5% retention of a material net economic interest may be satisfied:

  - *Vertical slice*: Retention of at least 5% of the nominal value of each of the tranches acquired by investors.

  - *Originator's share*: In the case of a securitization of revolving exposures (e.g. credit card receivables), the retention of at least 5% of the nominal value of securitized exposures.

  - *Random selection*: Retention from the pool of randomly selected exposures, constituting at least 5% of the nominal value of securitized exposures.

  - *First loss piece*: Retention of such amount of the first loss tranche that amounts to at least 5% of the nominal value of securitized exposures.

- Sponsors may satisfy the 5% retention requirement by providing a liquidity facility or letter of credit. Institutions must not hedge the retained material net economic interest.

- **Disclosure.** Originators must disclose loan level data if securities are to be held by an EU-regulated credit institution. Investors should have access to the information systems of the underlying loan or receivable – in practice this means access to every data field that the originator tracks in the ordinary course of business. Reporting should be based on observable events rather than a strict periodic reporting basis. The originator should also provide a clear explanation of how the transaction works. Such requirements apply for the life of the transaction.

- **Institutions subject to 122a.** Any credit institution which is EU-regulated is subject to the requirements. Unfortunately, it is unclear how the requirements apply to credit exposures to securitizations (whether by investment in securities or otherwise) by U.S. subsidiaries and other affiliates that, by way of being an affiliate of an EU-regulated credit institution, are subject to consolidated supervision.

  - In general, if a non-EU entity carries out activities that would be regulated in the EU, and the entity is (i) a subsidiary of an EU-regulated credit institution or (ii) a subsidiary of an EU-regulated parent financial holding company, then such non-EU entity is likely to be

subject to consolidated supervision for Article 122a purposes. The applicability of consolidated supervision is determined by the national banking regulator of the relevant EU-regulated entity.

- If a US subsidiary or other affiliate of an EU credit institution that is subject to consolidated supervision obtains a credit exposure to a securitisation, then it should comply with Article 122a in relation to such exposure. Such a credit exposure could include the provision of liquidity facilities and being party to swaps which have a risk of principal loss.

## VII. ALTERNATIVE INVESTMENT FUND REFORMS

- The AIFM Directive[35] entered into force on July 21, 2011 and must be implemented in Member State law by July 22, 2013. The AIFM Directive will regulate EU AIFMs of AIFs, in particular hedge funds and private equity funds, as well as non-EU managers of EU AIFs and non-EU AIFs marketed to EU professional investors. The Commission intends to propose a separate "light touch" regulatory regime for venture-capital fund managers and is currently consulting on the nature of this regime.

- The AIFM Directive was not part of the Commission's original work program drawn up in response to the financial crisis, but following a political campaign for the regulation of AIFs, was one of the first measures to be adopted by the Commission. It will fundamentally change the structure of the alternative investment sector in the EU, introducing for the first time a harmonized set of rules for the management and marketing of AIFs to EU professional investors. The AIFM Directive is long and complex, and it raises many questions. In addition, the AIFM Directive consists of high-level framework provisions and its practical implications will depend to a large extent on "Level 2" implementing measures that are required to be adopted by the Commission or by ESMA, which will have extensive powers under the AIFM Directive to design Level 2 measures on the Commission's behalf. ESMA is presently consulting on certain of those implementing measures.[36]

Scope and exemptions

- The AIFM Directive will apply to AIFMs established in the EU, regardless of the domicile or legal structure of the AIFs they manage. It does not apply (among other exemptions) to holding companies; financial vehicles in which the only investors are group companies; employee participation or saving schemes; and securitization special purpose entities. AIFMs would be exempt from parts (not all) of the AIFM Directive if the assets of the AIFs they manage do not exceed €100 million, or €500 million in the case of unleveraged funds that may not be redeemed for a period of five years following the date of initial investment in each AIF.

[35] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF

[36] http://www.esma.europa.eu/data/document/2011_209.pdf

Operating conditions

- The AIFM Directive will impose stringent requirements on the operation of AIFMs, including requirements relating to remuneration, independent valuations, independent depositaries, capital requirements, and leverage:[37]

  - *Remuneration:* The requirements relating to remuneration of AIFs are derived from the new EU rules on remuneration policies for credit institutions and investment firms, known as "CRD III."[38] AIFMs subject to the AIFM Directive will be required to have remuneration policies and practices for staff whose professional activities materially impact the risk profiles of the AIFs under management. AIFMs will also have to provide aggregate information on remuneration, split in various ways, under the disclosure provisions summarized below.

  - *Valuation*: AIFMs must establish "appropriate and consistent procedures" for the valuation of the assets of each AIF under management. The valuation procedures must require that assets be valued and net asset value per share or unit be calculated at least once a year. The valuation may be carried out by independent valuators or by the AIFM itself, subject to certain safeguards.

  - *Depositaries*: AIFMs must appoint an independent depositary for each AIF under management. Among other things, the depositary will receive payments from investors and keep them in segregated accounts, safe-keep AIFs' financial instruments and verify the ownership of other assets. Depositaries may be EU-based credit institutions, investment firms, or firms permitted to act as depositaries for a UCITS Directive governed retail fund. Depositaries must be established in the same Member State as the relevant AIF (subject to a possibility of derogation for four years). Non-EU AIFs may also appoint depositaries based in their home jurisdictions, subject to conditions.

  - *Capital requirements*: AIFMs will be required to maintain "own funds" of at least €125,000 plus 0.02% of the amount by which the value of the portfolio of the AIFM exceeds EUR 250 million, up to EUR 10 million. However, an AIFM's own funds may never be less than the amount required for investment firms under the Capital Adequacy Directive, i.e., one-quarter of annual operating expenses. AIFMs must invest these own funds in liquid assets or assets that are quickly convertible to cash; they may not take speculative positions.

  - *Leverage*: AIFMs must set leverage limits for the AIFs they manage, and they must demonstrate that the leverage limits for each AIF they manage are reasonable. AIFMs managing AIFs that use leverage on a "substantial basis" at the fund level are required to

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[37] Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitizations, and the supervisory review of remuneration policies

[38] See Section V, above.

provide information to their home Member State regulators about the leverage techniques they employ and the overall level of leverage employed by each AIF they manage. The home Member State regulator may impose limits to the level of leverage that an AIFM may employ in emergencies, and in consultation with ESMA and other regulatory authorities.

Disclosure and portfolio company requirements

- **General disclosure requirements.** AIFMs will be subject to extensive disclosure obligations, both before investors commit and on an ongoing basis thereafter. Matters to be disclosed relate to, for example: the particular features of the AIFs that it markets and manages; the AIFM's performance of its duties under the AIFM Directive and the AIFM's investment strategy, valuation procedures, liquidity and risk management policies and arrangements under which any investors receive preferential treatment. In addition, AIFMs must make available annual reports meeting certain requirements for each AIF they manage.

- AIFMs managing or marketing EU AIFs employing leverage must also disclose the total amount of leverage employed by that AIF, changes to the maximum permitted leverage, and whether under the leveraging arrangement, there is a right to re-use collateral.

- **Major holdings and control.** AIFMs must notify their home Member State regulators, target companies and other shareholders when AIFs managed by them increase or decrease their shareholdings in a non-listed company through the voting rights thresholds of 10%, 20%, 30%, 50% and 75%.

- In addition, AIFMs managing AIFs that acquire "control"[39] of EU companies will have to make certain disclosures to the company, its other shareholders, and the AIFM's home Member State regulator relating to the identity of the controlling AIF, its policy for managing conflicts of interest, and the policy for "communication relating to the company in particular as regards employees". AIFMs managing AIFs with control of non-listed companies will be subject to additional disclosure requirements. AIFMs will be obliged to use "best efforts" to ensure that the directors of controlled companies provide this information, in turn, to employee representatives.

Non-EU AIFMs.

- As from the second half of 2015, non-EU AIFMs from qualifying jurisdictions should be able to apply for authorization under the AIFM Directive. To qualify, non-EU jurisdictions must have appropriate cooperation agreements with Member State regulators, comply with

[39] For non-listed companies, "control" is defined as more than 50% of voting rights. For public companies, control is defined by reference to the threshold set by each Member State under the Takeover Directive.[39]

money-laundering and terrorist financing rules and have tax cooperation agreements complying with the OECD Model Tax Convention.

- Non-EU AIFMs registering under the AIFM Directive will be required to comply with all of the AIFM Directive's requirements and to have a "legal representative" in their Member State of reference. The choice of the Member State of reference depends on factors including the jurisdictions of any EU AIFs that are marketed, the jurisdiction of the AIF with the largest amount of assets, or – in the case of non-EU AIFs – the EU jurisdictions in which the AIFM intends to market AIF interests. ESMA is required to advise on the appropriateness of the choice of Member State of reference.

- If a non-EU AIFM would be subject, in its home jurisdiction, to a requirement that conflicts with an obligation under the AIFM Directive, the AIFM may be exempted from compliance with the AIFM Directive requirement if it can show that it is subject to an equivalent rule having the same regulatory purpose and offering the same level of protection to the investors of the relevant AIF. Again, ESMA is required to give advice on the appropriateness of exemption in case of incompatibility with an equivalent rule.

Marketing

- The AIFM Directive will create a "single internal market" for the marketing of AIF interests to professional investors. However, the applicable rules depend on whether or not the AIFM in question is established in the EU.

    - *EU AIF interests*: The AIFM Directive will allow an authorized AIFM to market to professional investors, interests in EU-based AIFs that it manages after notifying its home Member State regulator. The definition of a "professional investor" includes institutional and large corporate investors, as well as certain other persons (including individuals) who may "opt in" if they meet certain qualitative and quantitative tests. The regulator may only prevent marketing of interests in EU AIFs where the information provided in the notification demonstrates that the AIF concerned will not be managed in accordance with the AIFM Directive. Once the competent authorities in the AIFM's home Member State have granted marketing permission, an authorized AIFM may market EU AIF interests in other Member States under the EU "passport", subject to compliance with a similar notice procedure. Member State authorities may also allow marketing of AIFs to retail investors within their own territories and may impose stricter requirements on the AIF or AIFM than required by the AIFM Directive, provided that any additional requirements for marketing to retail investors may not discriminate against cross-border marketing.

    - *Non-EU AIF Interests:* Until late 2018, AIFMs will be able to market non-EU AIF interests without a passport subject to compliance with the AIFM Directive (in the case of EU AIFMs) or national private placement regimes and the AIFM Directive's disclosure requirements (in the case of non-EU AIFMs). In addition, cooperation arrangements must be in place between the AIF's home regulator and the supervisory authority in the jurisdiction where the non-EU AIF's interests are to be marketed.

From 2015, authorized AIFMs will be entitled to market interests in non-EU AIF they manage to EU professional investors, with the EU marketing passport, if the jurisdiction of the non-EU AIF meets certain conditions. The non-EU jurisdiction in question must (i) have appropriate cooperation arrangements in place with the AIFM's home Member State or Member State of reference, (ii) comply with money-laundering and terrorist-financing rules, and (iii) have tax agreements in place that comply with the OECD Model Tax Convention.

## VIII. CONSUMER PROTECTION

- There is no EU equivalent to the Bureau of Consumer Financial Protection. Instead, various consumer and financial protection measures are contained in a wide range of European legislation.

- The EU has consulted on proposals to create a legislative framework for standardizing PRIPs.[40] A PRIP is a product where the amount payable to the investor is exposed to fluctuations in the market value of assets or payouts from assets, through a combination or wrapping of those assets, or other mechanisms than a direct holding. The Commission has proposed requiring a standard pre-contractual disclosure document that will address the risk presented by confusing and deficient product information. It had previously been indicated that this initiative was to be adopted in the fourth quarter of 2011. However, the latest version of the Commission's agenda omits mention of this provision.

- Following the financial crisis, the Commission has been active in expanding the scope of the EU compensation schemes, which ensure compensation to depositors and investors upon the collapse of financial institutions. On July 12, 2010, the Commission published a package of proposals for reform comprising proposals to amend the existing DGS Directive and the ICS Directive, and a White Paper proposing legislation that would regulate insurance guarantee schemes. In an accompanying press release,[41] Internal Market and Services Commissioner Michel Barnier said that European consumers "need reassurance that their savings, investments or insurance policies are protected no matter where in Europe they are based".

- The DGS Directive is intended to ensure that if a bank is closed down, account holders of the bank would be reimbursed up to a certain coverage level. As part of the July 12, 2010 package, the Commission confirmed that the minimum level of deposit protection should be increased from €50,000 to €100,000 per depositor, per bank. Pursuant to an earlier revision of the DGS Directive in 2009, which provided that the minimum level of deposit protection should be increased to €100,000 unless the Commission confirmed that such increase and harmonization would be inappropriate and not financially viable, this amendment came into force on December 31, 2010.

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[40] http://ec.europa.eu/internal_market/consultations/docs/2010/prips/consultation_paper_en.pdf

[41] http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/918&format=HTML&aged=0&language=EN&guiLanguage=en

- The Commission's key proposals to further amend the DGS Directive[42] are as follows:
  - To reduce the period within which banks would be required to reimburse depositors from four-six weeks (reduced from three-months at the end of 2010 under a prior revision to the DGS Directive) to one week. To enable this reduced timeframe to be met, managers of deposit guarantee schemes would be required to inform the relevant supervisory authorities if it seemed likely that a bank would fail;
  - To provide investors with information about the deposit protection scheme to which they belong on their bank account statements;
  - To guarantee deposits in all currencies, including EU currencies, reflecting the increasingly global activities of investors;
  - To revise the rules relating to financing of deposit guarantee schemes.
- The Committee of Permanent Representatives of the Council of Ministers agreed a general approach to the DGS Directive on June 17, 2011.[43] The final legislation is still subject to further negotiations with the European Parliament, and it is expected that political agreement will be reached by October 2011. In addition to the proposed revisions of the DGS Directive, the European Commission is expected to publish a report on the possible creation of a pan-European deposit guarantee scheme by 2014.
- The European Commission published a proposal to amend the ICS Directive on July 12, 2010.[44] The ICS Directive is intended to protect investors who use investment services in Europe by providing compensation in cases where an investment firm is unable to return assets belonging to an investor. For example, this might occur where there is fraud or negligence at a firm or where there are errors or problems in the firm's systems. The Commission's key proposals to amend the ICS Directive are as follows:
  - To increase the minimum level of compensation per investor from €20,000 to €50,000. If there was uncertainty as to whether the DGS Directive or the ICS Directive applied, investors should be compensated under the DGS Directive, which provides greater protection;
  - To clarify that all investment services and activities covered under MiFID would be subject to the ICS Directive.

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[42] The Commission's proposed revisions to the DGS Directive may be accessed here: http://ec.europa.eu/internal_market/bank/docs/guarantee/20100712_proposal_en.pdf

[43] http://www.eu2011.hu/files/bveu/documents/HUPRES42_17062011_Deposit_Guarantee_EN.pdf

[44] The Commission's proposed revisions to the ICS Directive may be accessed here: http://ec.europa.eu/internal_market/securities/docs/isd/dir-97-9/proposal-modification_en.pdf

- ○ To reduce delays in the payout of claims to investors by requiring schemes to pay partial compensation to an investor within nine months of a firm being unable to meet its obligations.

- ○ To compensate investors where an investment firm is unable to return client assets as a result of failure of a third-party custodian, collective investment scheme depositary or sub-custodian.

- ○ To provide actual and potential investors with information about the investor protection scheme to which they belong.

- ○ To revise the rules relating to financing of investor guarantee schemes.

- The European Parliament adopted a legislative resolution on the ICS Directive on July 5, 2011.[45] The version of the ICS Directive adopted by the European Parliament provides for a minimum level of compensation per investor of €100,000, on the basis that a higher guarantee would facilitate cross-border competition and service the interest of investors. It is expected that political agreement with the Council of Ministers will be reached by November 2011.

- There is presently no EU Insurance Guarantee Scheme Directive. However, on July 12, 2010 the European Commission produced a White Paper[46] proposing a minimum harmonization Insurance Guarantee Scheme Directive, which would ensure that such insurance guarantee national schemes are created across the EU, covering both life and non-life insurance policies, but excluding pension funds and reinsurance. The Commission intends to publish a proposed Directive in December 2011.

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If you have any questions, please feel free to contact any of your regular contacts.

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[45] http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2011-0313

[46] http://ec.europa.eu/internal_market/consultations/docs/2010/whitepaper-on-igs/whitepaper_en.pdf

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