CLEARY GOTTLIEB Alert Memo

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European Council Adopts New Rules on Credit Rating Agencies, Bank Capital Requirements, Cross-border Payments and E-money, and a Program to Support the Effectiveness of EU Policies

On July 27, 2009, the European Council adopted a number of new laws relating to the regulation of financial services in the European Union (the "EU").[1] The adoption of these measures represents an important step in the completion of the framework of new and updated EU measures regulating the European financial system, as laid out in the European Commission's Communication of March 4, 2009 (the "Spring Communication").[2]

The new measures include:

1. A regulation establishing the legal and regulatory framework for credit rating agencies (Council Regulation 3642/2009) (the "CRA Regulation");

2. A directive significantly amending credit institutions' capital requirements (Council Directive 3670/2009) (the "CRD Amendment Directive");

3. An updated regulation on cross-border payments (Council Regulation 3665/2009) (the "New Cross Border Payments Regulation");

4. A directive on electronic money (Council Directive 3666/2009) (the "New E-Money Directive"); and

5. A decision establishing the Community program to support activities in the area of financial services, financial reporting and auditing (Council Decision 3671/2009) (the "Community Financial Services Program Decision").

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1 12380/09 (Presse 234).

2 COM (2009) 252. These developments are discussed in the CGS&H Alert Memorandum, "Expanding EU Role in European Financial Regulation", March 27, 2009.

This memorandum briefly reviews each of these measures and discusses their relationship to previous initiatives.

I. THE CRA REGULATION

The CRA Regulation[3] establishes a mandatory system of registration and oversight for credit rating agencies ("CRAs") that issue ratings intended for regulatory purposes. It is intended that the new regime will improve the quality and transparency of ratings produced by CRAs.

The Commission proposed the regulation of CRAs on November 12, 2008 to restore confidence in CRAs and to improve transparency in the process by which ratings are determined. CRAs are not currently regulated directly by EU law or by the national law of most EU Member States. Accordingly, the CRA Regulation establishes a common framework for measures adopted at a national level and will create a common level of investor and consumer protection throughout the EU.

The CRA Regulation applies only to credit ratings issued by agencies registered within the Community and which are intended either to be disclosed publicly or distributed by subscription. It requires Member States to impose a legally binding registration and surveillance system for CRAs that issue ratings intended for regulatory purposes. Its key aims are as follows:

i. To ensure that CRAs avoid or manage conflicts of interest in the ratings process;

ii. To require CRAs to disclose rating methodologies, models and assumptions, thereby increasing transparency;

iii. To improve the quality of CRAs' methodologies and ratings by stipulating the allocation of adequate human and financial resources to the issuing, monitoring and updating of credit ratings; and

iv. To improve supervision of CRAs through the coordination of competent authorities in relevant Member States.

The CRA Regulation permits the use of credit ratings issued by CRAs established in non-EU states if these are "endorsed" by EU-established and registered CRAs that are members of the same corporate group (*e.g.*, the European subsidiary of a non-EU CRA). The endorsing EU CRA will have a number of obligations, including demonstrating to its home-Member State authority that the third-country CRA's activities fulfil

[3] Regulation of the European Parliament and of the Council on credit rating agencies available at: http://register.consilium.europa.eu/pdf/en/09/st03/st03642.en09.pdf

requirements that are at least as stringent as those of the CRA Regulation; providing its home-Member State regulator with ongoing information; and remaining responsible for the endorsed rating. The third-country CRA whose ratings are endorsed must be authorized and subject to supervision in that third country; the regulatory regime in that country must prevent interference by competent authorities with the content of credit ratings and methodologies; and there must be an appropriate cooperation agreement in place between the two countries. Credit ratings issued by third-country CRAs will not need to be endorsed by an EU-established and registered CRA if the Commission has adopted an equivalence decision recognizing the legal and supervisory framework of that third country as equivalent to the requirements of the CRD Regulation and the third-country CRA is certified by the CESR.

The CRA Regulation complements developments in the United States, where the Securities and Exchange Commission (the "SEC") has responsibility for the regulation of CRAs under the Credit Rating Agency Reform Act 2006 (the "CRA Reform Act"). The CRA Reform Act shares broadly similar policy goals to the CRA Regulation; namely, "to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry". The CRA Reform Act and the rules that the SEC adopted under its authority require CRAs to provide detailed information to the SEC at the time of registration and oblige them to update this information on a rolling basis, as well as to maintain effective conflict-of-interest management procedures. In June 2008, in response to the turmoil in the global financial markets, the SEC proposed a number of additions to their rules governing CRAs. Certain of the proposed rules were adopted in February 2009, including requirements that CRAs regulate or prohibit additional conflicts of interest and that they publicly disclose ratings methodologies and prescribed ratings performance statistics to facilitate comparisons and to improve competition in the industry. In July 2009, as part of its regulatory reform agenda, the Administration proposed modifications to the CRA Reform Act to further regulate conflicts of interest, require greater transparency and disclosure by CRAs, and strengthen the SEC's oversight of CRAs. At the same time, the Administration announced its support for some of the rules previously proposed but not adopted by the SEC, including a requirement that CRAs publicly disclose ratings histories for all issuer-paid credit ratings.

The new regime for CRAs will be effective on the twentieth day after its publication in the Official Journal of the European Union. There will, however, be a six-month transition period to allow Member States to designate a competent regulatory authority, and before which CRAs may not submit applications for registration. There will also be an 18-month transition period for certain of the requirements relating to endorsement of ratings from non-EU CRAs.

II. THE CRD AMENDMENT DIRECTIVE

The CRD Amendment Directive[4] amends the 2006 Capital Requirements Directive.[5] The CRD Amendment Directive contains a range of provisions that aim to strengthen the rules on capital requirements for credit institutions in a manner that addresses weaknesses highlighted by the economic crisis. It represents an important step in addressing shortcomings identified by the crisis ahead of further initiatives designed to mitigate the effects of "excessive" procyclicality in the CRD, as announced by the Commission in the Spring Communication.

The amendments relate to five main areas:

i. *Strengthening the supervision of cross-border banking groups:*

   a. Close coordination will now be required between the supervisor of the Member State where the parent undertaking is located and the supervisors of its subsidiaries with respect to risk assessment and additional capital requirements;

   b. Reporting requirements will be fully harmonized at a European level in 2012;

   c. Colleges of supervisors will be established for all cross-border groups in order to conduct supervisory activities more effectively;

   d. The role of the Committee of European Banking Supervisors ("CEBS") is strengthened; and

   e. The mandates of national supervisory authorities are to be given a European dimension.

ii. *Improving the framework for securitization practices*: Due diligence and transparency obligations of the originators of securitization operations and of investors will be strengthened, so that investors may assess the risks involved in structured products by means other than the ratings provided by CRAs. To encourage better risk assessment, originators will be

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4 Directive of the European Parliament and of the Council amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management available at: http://register.consilium.europa.eu/pdf/en/09/st03/st03670.en09.pdf

5 Council Directive (EC) 2006/48 concerning the taking up and pursuit of the business of credit institutions and Council Directive (EC) 2006/49 concerning the capital adequacy of investment firms and credit institutions.

obliged to retain 5% of the risk transferred or sold to investors on their own balance sheets. The retention requirement must be applied to all new securitizations issued from December 31, 2010 and to existing securitizations from December 31, 2014. After consulting CEBS, the Commission will recommend by December 31, 2009 whether the 5% retention figure should be increased.

iii. *Harmonizing the classification of banks' 'tier 1' capital funds and hybrid instruments*: CEBS will play a central role in ensuring greater uniformity of supervisors' practices in each Member State.

iv. *Introducing rules on liquidity risk management*: The CRD Amendment Directive places particular emphasis on setting up liquid asset reserves, conducting liquidity stress tests and establishing contingency plans.

v. *Tightening the supervision of exposure to a single counterparty*: Under the current framework, concentration limits for bank counterparties are less restrictive than for "undertaking" counterparties. However, the financial crisis has shown that bank counterparties also present a risk of default. Accordingly, the extent of exposure to a single bank counterparty will be restricted.

III. THE CROSS-BORDER PAYMENTS REGULATION

Implementation of the single European payment area ("SEPA") initiative has been in progress since June 2002, when the banking industry established the European Payments Council (the "EPC"), with the aim of creating a harmonized payments market, and Regulation 2560/2001 on cross-border payments in Euros came into force.

SEPA is supported by the Payment Services Directive,[6] which comes into force in November 2009 and which aims to ensure that payments between Member States will be as cheap and effective as intra-Member State payments. The new Cross-Border Payments Regulation[7] updates and aligns the cross-border payments regime established under Regulation 2560/2001 with the Payment Services Directive.

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6 Council Directive (EC) 2007/64 on payment services in the internal market, [2007] OJ L319/1.

7 New regulation on cross-border payments available at: http://register.consilium.europa.eu/pdf/en/09/st03/st03665.en09.pdf

IV. THE NEW E-MONEY DIRECTIVE

The adoption of the New E-Money Directive[8] follows an assessment by the Commission of application of the Electronic Money Directive,[9] which concluded that electronic money is still far from delivering the benefits that were expected when the Electronic Money Directive was adopted in 2001. The number of newcomers to the market has been comparatively low, and in most Member States electronic money is not considered a realistic alternative to cash. The New E-Money Directive updates the Electronic Money Directive, with particular regard to the level of initial capital and the prudential supervision of electronic money institutions. The aim is to encourage the design of electronic money services that are both innovative and secure, whilst promoting competition in the market and ensuring access to new players. The New E-Money Directive is also aimed at ensuring consistency with the Payment Services Directive.

V. COMMUNITY FINANCIAL SERVICES PROGRAM DECISION

This decision[10] is intended to enable the Community to participate in the funding of certain bodies, both European and international, so as to ensure the effectiveness of EU policies in the financial services sector and in the fields of financial reporting and statutory audits. Beneficiaries include: with respect to regulation and supervision, the "Lamfalussy level 3 Committees" (the Committee of European Securities Regulators ("CESR"), the Committee of European Banking Supervisors ("CEBS"), and the Committee of European Insurance and Occupational Pensions Supervisors ("CEIOPS")); with respect to financial reporting, the International Accounting Standards Committee Foundation and the European Financial Reporting Advisory Group; and with respect to auditing, the Public Interest Oversight Board.

In June 2009, the European Council endorsed a Commission Communication regarding the establishment of a European System of Financial Supervisors, which will be constituted by a network of national financial supervisors working in tandem with three new European supervisory authorities: the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities

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8 New directive on electronic money available at: http://register.consilium.europa.eu/pdf/en/09/st03/st03666.en09.pdf

9 Council Directive (EC) 2000/46 on the taking up, pursuit of and prudential supervision of the business of electronic money institutions.

10 Decision establishing a Community program to support specific activities in the field of financial services, financial reporting and auditing available at: http://register.consilium.europa.eu/pdf/en/09/st03/st03671.en09.pdf

Authority which will ultimately replace three of the bodies funded by the Decision: CESR, CEBS and CEIOPS.[11]

VI. CONCLUSION

The Council's adoption of a package of financial services regulatory reforms follows the endorsement at the Spring European Council meeting of the European Commission's program for greatly expanding the EU's role in regulating the European financial system, as laid out in the Spring Communication. Although the legislative provisions are heterogeneous, they illustrate the determination of the Council and the Commission to ensure that a new European supervisory framework will be put in place by the end of 2009 and will become operational during 2010.

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For additional information on issues regarding the financial crisis, please visit Cleary Gottlieb's Financial Crisis Resource Center at http://www.cgsh.com/financial_crisis_resource_center/eu_resources.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

[11] These developments are discussed in the CGS&H Alert Memorandum, "Proposed New EU Financial Regulatory System," June 19, 2009.

CLEARY GOTTLIEB

Office Locations

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax