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Financial Services Europe and International Update Regulatory Developments

This *DechertOnPoint* summarises current regulatory developments in the European Union and the UK and certain other EU member states in the investment funds and asset management sectors in the past fortnight.

EU and Supranational Regulatory Developments

Hungarian Presidency EMIR Compromise Proposal and ECON Committee Proceedings

It will be recalled that on 3 May 2011, the Hungarian Presidency of the Council of the EU published a compromise proposal dated 29 April 2011, relating to the proposed European Market Infrastructure Regulation ("EMIR") to be considered at a meeting of the Council's working party on financial services (see "[Financial Services Europe and International Update](#)", *DechertOnPoint*, Issue 7 (May 2011) (following earlier compromise proposals previously published by the Presidency).

In the ECON Committee meeting held on 24 May 2011, the following elements of the proposal were agreed:

- the scope of the proposal (e.g., for the clearing obligation) remains OTC derivatives whereas the reporting obligation will apply to all derivatives;
- a central role is envisaged for the European Securities and Markets Authority ("ESMA"), including involvement in the authorisation of new Central Counterparties ("CCPs") and in carrying out on-site inspections;
- the college structure will contain a maximum of seven members;

- inter-operability provisions will only be applied to cash equities, with a three-year period required during which CCPs must meet certain standards before they can apply for inter-operability;
- clearing obligations will only apply from the date of entry into force of the EMIR; however, ESMA is to be asked to consider whether a retroactive reporting obligation could be introduced;
- a special regime will apply for pension funds; and
- third country CCPs will be subject to a review by a process of similar rigour as that applicable to EU CCPs.

A plenary vote on EMIR is scheduled to take place during the July session of the European Parliament. Indications are that this will be the first of two readings unless agreement can be reached between Parliament and Council. The second reading in Parliament has to occur within three months of the Council agreeing its Common Position. In practice this means the proposal could easily be held up for a further six months.

The Regulation is expected to be agreed and in force before the end of 2011 however.

Revised AIFM Directive Text

The Council of the European Union (the "EU") published on 27 May 2011 a press release announcing it has adopted the text of the

Alternative Investment Fund Managers Directive (the "AIFM Directive"). This text is the 13 May 2011 version which had already been released.

An official version of the AIFM Directive will now be published in the Official Journal of the EU (the "OJ") and will enter into force twenty days after publication. Member states will then have two years to transpose the Directive's provisions into national law.

EU Supervision: ESMA Announces Members of Stakeholder Group

It will be recalled that the three new European Supervisory Authorities were officially established on 1 January 2011: the European Banking Authority in London ("EBA"), the European Securities and Markets Authority in Paris ("ESMA") and the European Insurance and Occupational Pensions Authority in Frankfurt ("EIOPA").

The European Securities and Markets Authority has now announced the membership of its market stakeholder group that will help draft regulatory technical standards. The group contains a number of market participants, users of financial services, consumers and academics. Each representative will serve for a two-and-a-half-year term, meaning they will be involved with developing the final standards for the Markets in Financial Instruments Directive ("MiFID") review and the EMIR. The group is mandated to meet at least four times a year.

Whilst representatives from each of Europe's three largest stock exchanges are all represented, the large universal banks have been allocated just one seat (held by JP Morgan). None of the industrial companies that use derivatives have been given a seat on the group, however.

Of the 29 members of the group only one - Sally Dewar, a former FSA official - is British. (Three are German, three are Belgian and four are French.)

IOSCO Report on Dark Liquidity Principles

On 20 May 2011, the International Organisation of Securities Commissions ("IOSCO") published a final report on principles for dark liquidity.

The report sets out six principles for regulators, trading venues and general users of dark liquidity,

to address regulatory concerns in the following areas:

- pre- and post-trade transparency;
- incentives for using transparent orders;
- reporting to regulators;
- information available to market participants about dark pools and dark orders; and
- regulation of the development of dark pools and dark orders.

The principles establish that pre- and post-trade transparency are central to promote the efficiency of the market and the integrity of the price formation process. The report recognises that a one-size-fits-all approach may not be appropriate for all types of trading. It also notes that a number of jurisdictions are currently reviewing their regulatory regimes, including regulation of trading in dark pools and the use of dark orders in transparent markets.

The report recommends that regulators consider the structure of their respective markets as a whole to determine how best to implement the principles. In particular, regulators should seek to ensure that the principles are implemented in a way which:

- aims to maintain the efficiency of the market and the integrity of the price formation process; and
- where appropriate, allows for the use of dark pools and dark orders for specified needs or trades.

The report acknowledges the various industry and regulatory developments in this area and recommends that regulators continue to monitor trends in trading conducted through dark pools and dark orders. IOSCO intends to review the principles in the light of market and regulatory developments.

Report on the Impact of MiFID

The City of London Corporation published on 23 May 2011 a report, prepared by London Economics, on understanding the impact of the Markets in Financial Instruments Directive (2004/39/EC) ("MiFID") in the context of global and national regulatory innovations.

The report sets out the findings of a European-wide (excluding the UK) consultation on the impact of MiFID's pre- and post-trade transparency requirements. It builds on an earlier City of London

research report, published in October 2010, outlining the findings of a UK consultation on the same subject.

The aim of the European consultation was to determine whether the views expressed by UK stakeholders can be generalised across the EU or are UK-specific. To enable a comparison, European stakeholders (that is, a sample of brokers, buy-side firms and trading venues) were asked the same questions as their UK counterparts had been asked in 2010.

The report notes that, in general, the responses of the European stakeholders were largely positive and reiterated the views expressed by their UK counterparts in 2010. However, there were some differences in perception regarding pre-trade transparency, including:

- waiver regime;
- price impacts; and
- liquidity impacts.

Following its MIFID review, the European Commission is expected to adopt a legislative proposal (known as “MiFID II”) amending the Level 1 MiFID Directive at the beginning of July 2011.

Commodity Markets: EU Council Conclusions

As long ago as November 2008, the European Commission presented a new integrated strategy for raw materials, suggesting three pillars for the EU’s policy response to global resource scarcity: better and undistorted access to raw materials on world markets; improved conditions for raw materials extraction within Europe; and reducing the EU’s consumption of raw materials by increasing resource efficiency and recycling. Since then, an EU expert group has identified 14 raw materials seen as “critical” for EU high-tech and eco-industries and suggested that the European Union’s global diplomacy should be geared up to ensure that companies gain easier access to them in future. As to prices in all major commodity markets (energy, metals and minerals, agriculture and food), the Commission notes an increasing trend since the summer of 2009. In autumn 2010, the EU executive said it was planning measures to regulate commodity exchanges and curb speculation.

In February 2011, the European Commission presented an integrated strategic vision to tackle challenges in commodity markets and on raw materials. The Communication included measures

to improve the transparency of financial and commodity markets. The European Commission also called for the swift implementation of the Raw Materials Initiative adopted in 2008.

In the last week of May, the EU Council issued a statement welcoming the EU Commission’s February 2011 Communication on commodity markets and raw materials, which set out proposals to improve the regulation, functioning and transparency of financial and commodity markets. The Council’s statement:

- notes the growing influence of financial actors in commodity markets, in particular the rise in financial investment flows into commodity derivative markets in recent years, including agricultural and oil markets;
- notes that the transparency of commodity derivatives markets needs to be improved without compromising the positive functioning of these markets, and stresses the need to ensure effective regulation and supervision of trading in commodity derivatives as well as an adequate regulatory and supervisory framework governing physical markets;
- encourages the Commission to come forward with proposals for better transparency and regulation on derivative commodity markets, within the framework of the revision of the Markets in Financial Instruments Directive (“MiFID”) and the Market Abuse Directive (“MAD”) and bearing in mind that the proposal for regulating over-the-counter (“OTC”) derivatives, central counterparties and trade repositories (i.e., EMIR) also has a bearing in this area;
- stresses the need to improve the quality and availability of data on physical markets and derivatives markets, in particular OTC, to extend position reporting, and to give sufficient powers and tools to the respective supervisors to ensure a better coverage of physical and commodity derivatives markets, notably OTC, whilst preserving market liquidity;
- emphasises the need for an effective regime to identify and prevent market abuse, in particular cross-market manipulation between the physical markets and the derivatives markets; and
- stresses the need to ensure that financial market participants are subject to adequate and proportionate regulation and supervision, especially when trading in commodity derivatives.

In the same week, European Commissioner Barnier announced that the Commission will propose powers to cap trading by big investors to control speculation in commodities. Speaking in the European Parliament, Commissioner Barnier said that the Commission wants to know who is doing what, when they are engaged in speculation.

The Commission noted, however, in its Communication that further work is necessary to understand fully the links between the physical and financial markets.

ESMA Announcements

Steven Maijor, Chairman of the European Securities and Markets Authority (“ESMA”), gave a speech on 26 May 2011 about the objectives underlying regulatory initiatives and how ESMA will promote these objectives. Mr Maijor discussed the objectives of transparency, stability and international co-ordination and indicated that:

- ESMA will launch a consultation in July 2011 on the technical advice it is providing to the European Commission on the AIFM Directive; and
- ESMA will publish its views on possible policy options concerning exchange traded funds (“ETFs”) in the next few months. (This follows the April 2011 Financial Stability Board report on ETFs).

Stress Tests in the Banking Sector: ECOFIN Council Sets Out Guiding Principles on Backstop Measures

The European Union authorities undertook a first round of stress-tests on European financial institutions in the summer of 2010 to assess the resilience of the EU banking system to hypothetical stress events under certain restrictive conditions. The results of these initial tests were widely criticised as lacking credibility. Indeed, the Irish banks passed the tests only to go bankrupt a few months later. The European Banking Authority (the “EBA”) launched a new round of stress tests in March 2011 with the aim of restoring credibility to the process and confidence in the EU banking sector.

The Economic and Financial Affairs Council (“ECOFIN”) on 17 May 2011 set out guiding principles on backstop measures to support financial institutions identified as vulnerable by the 2011 EU-wide stress tests. It agreed that all member states would have in place credible

backstop mechanisms at the time of the publication of the results, expected in June 2011, and set deadlines for addressing any vulnerability identified by the stress tests, with a stated preference for private sector solutions.

Depending on each institution and country, backstop mechanisms may cover a broad range of measures, including both private and public elements, such as for example, external audits, additional reporting requirements, reinforced monitoring, plans for capital conservation, capital increases, risk mitigating actions, liability management exercises, restructuring, sale of assets, transfers of assets to asset management companies, splitting of core and non-core activities and, where appropriate, merging of institutions to more viable units, orderly resolution, with the aim to accelerate the strengthening of the banking sector while preserving financial stability.

The EBA will publish the results of the most recent stress tests later this month.

UK Regulatory Developments

FSA Guidance Consultation on Transaction Reporting

The FSA published a guidance consultation (GC11/11) on 18 May 2011 proposing a change to its guidance on reporting of on-exchange derivative transactions conducted through exchange platforms.

The FSA has reviewed its current guidance (which relates to the transaction reporting requirements in Chapter 17 of the Supervision manual (SUP)) and, following consultation with firms, trade bodies and exchanges, proposes to revise it to:

- provide clearer and simpler guidance that removes the need to distinguish between transactions for fungible and non-fungible derivative instruments conducted through exchange platforms;
- provide guidance that reflects more accurately the status of transactions and is easier for firms to integrate into their transaction reporting systems; and
- extend the guidance from Alternative Instrument Identifier (Aii) derivative transactions to all derivative transactions (that is, Aii and International Securities Identification Number (ISIN) conducted through EEA derivative exchange platforms.

The guidance consultation sets out the proposed revised guidance, with examples of transaction reporting made in line with it. The FSA acknowledges that firms may have to make system changes to accommodate the revised guidance, which will be effective from 13 November 2011. This is also the implementation date of the FSA's new surveillance and monitoring system, Zen. However, firms may elect to report transactions in ISIN derivative instruments, and fungible and non-fungible transactions in Aii derivative instruments, conducted through exchange platforms, prior to this date.

Investment Trusts: Draft Regulations Published by HMRC

HMRC published on 25 May 2011 draft regulations introducing a new regime for the taxation of investment trusts, to supplement the provisions in clauses 49 and 50 of the Finance Bill 2011. The draft regulations provide for:

- an approval process;

- the conditions to be met while approved; and
- a “white list” of transactions not treated as trading.

The detail of these regulations is largely unsurprising, however, reflecting the contents of the consultation and feedback. The new rules will be welcomed as they remove certain unattractive features of the current rules, such as the need to seek annual approval, and add attractive new features, such as a “white list” of non-trading transactions, which should, in turn, improve the attractiveness of investment trusts as investments.

Comments on the draft regulations are invited by 24 June 2011.



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