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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 four weeks.

EU and Supranational Regulatory Developments

European Commission Initiatives for 2011

The Commission published on 5 April 2011 an update on its agenda and timetable for legislative proposals and non-legislative acts that it expects to adopt between March and December 2011. Changes have been made to the expected adoption dates of a number of financial services measures since the Commission published the previous version of this document. These include:

- the revision of the Market Abuse Directive (2003/6/EC) ("MAD") and its three implementing directives, now expected to be adopted in July 2011 (rather than June 2011);
- the review of the Markets in Financial Instruments Directive (2004/39/EC) ("MiFID") (known as MiFID II), now expected to be adopted in July 2011 (rather than June 2011);
- the amendment of the UCITS IV Directive (2009/65/EC) (known as "UCITS V"), now expected to be adopted in July 2011 (rather than the Q2 of 2011); and
- level 2 measures for Solvency II (2009/138/EC), now expected to be adopted in the Q4 of 2011 (rather than Q3 of 2011).

IOSCO Report on Commodity Derivative Markets

The International Organization of Securities Commissions ("IOSCO") published a report on Commodity Futures Markets for the Financial Stability Board ("FSB") on 15 April 2011.

The report summarises IOSCO's work in this area to date, outlines its current workstreams, and describes its future plans and possible new areas of focus.

IOSCO is currently working on:

- the supervision of commodity derivative markets;
- physical market transparency; and
- the ongoing monitoring of developments in the OTC financial oil markets.

(As indicated above, the Hungarian Presidency of the Council of the EU has published a compromise proposal relating to EMIR. This will be considered at a meeting of the Council's working party on financial services, following which the Presidency will make further amendments, and which follows earlier compromise proposals previously published by this Presidency.)

The AIFMD – ESMA Discussion Paper

The European Securities and Markets Authority (“ESMA”) published on 15 April 2011 a paper on its policy on possible implementing measures under Article 3 of the Alternative Investment Fund Managers Directive (the “AIFMD”).

The discussion paper sets out ESMA’s proposed approach to AIFMD’s implementing measures and seeks views on:

how to identify the portfolios of alternative investment funds (“AIFs”) under management by a particular fund manager and the calculation of the value of assets under management;

- how leverage influences the assets under management;
- how to determine the value of the assets under management by an AIF for a given calendar year;
- how to treat potential cases of cross-holding among the AIFs managed by a fund manager;
- how to treat fund managers whose total assets under management occasionally exceed and/or fall below the relevant AIFMD threshold;
- what the registration requirements for entities falling below the threshold should be;
- how the obligation to register with national regulators should be implemented and establishing what the suitable mechanisms for gathering information might look like; and
- what the procedures should be for small managers to opt-in to the AIFMD.

Comments can be made on the discussion paper until 16 May 2011.

(This discussion paper follows the European Commission’s December 2010 request for technical advice on Level 2 measures and the related Committee of European Securities Regulators’ call for evidence.)

AIFMD: ESMA Consultation on Exemptions for Small Managers

ESMA has published a discussion paper on the exemptions under AIFMD for small managers, i.e., those whose AIF AUM do not exceed EUR 100m (including leveraged assets) or EUR 500m where the AIFs are unleveraged and are not redeemable within

the initial five years. In particular, ESMA’s discussion paper asks for views on:

- how to identify the portfolios of Alternative Investment Funds (AIFs) under management by a particular fund manager and the calculation of the total value of assets under management;
- how leverage influences the assets under management;
- how to determine the value of the assets under management by an AIF for a given calendar year;
- how to treat potential cases of cross-holding among the AIFs managed by a fund manager;
- how to treat AIFMs whose total assets under management occasionally exceed and/or fall below the relevant threshold;
- what the registration requirements for entities falling below the threshold should be;
- how the obligation to register with national competent authorities should be implemented and establishing what the suitable mechanisms for gathering information might look like; and
- what the procedure should be for small managers to ‘opt-in’ to the AIFMD.

The response date is 16 May 2011.

ESMA Final Report and Guidelines on Structured UCITS Risk Measurement and Global Exposure Calculation

ESMA published on 14 April 2011 a final report containing draft guidelines to competent authorities and UCITS management companies on risk measurement and the calculation of global exposure for certain types of structured UCITS.

(The report sets out ESMA’s agreed policy approach, a cost-benefit analysis and feedback from the November 2010 consultation on the guidelines.)

The guidelines propose, for certain types of structured UCITS, an optional regime for the calculation of the global exposure. More specifically, ESMA’s policy approach consists of the calculation, for each scenario to which investors can be exposed at any one time, of the global exposure using the commitment approach. Under this approach, each scenario must comply at all times with the 100 per

cent global exposure limit, using the general guidelines.

FSB Background Note on Financial Stability Issues Arising from Exchange-Traded Funds

The Financial Stability Board (the “FSB”) published on 12 April 2011 a note on potential financial stability issues arising from recent trends in exchange-traded funds (“ETFs”).

The note has been published by the FSB as part of its role of monitoring market developments relevant to financial stability and identifying the implications for regulatory policy. It details recent developments in the ETF market, including:

- the strong growth and rapid innovation experienced in the ETF market; and
- the increase in product variety and, in some segments of the ETF market, product complexity.

In particular, the FSB refers in the note to the impact of the current low interest rate environment in respect of investors’ search for yield in more complex, non-standard market segments which increase exposure to liquidity risks. In this respect, certain segments of the ETF market (in addition to the commodities and high-yield markets) merit closer surveillance by regulatory authorities, in the view of the FSB).

Work is ongoing at national and international level to determine both whether the ETF market developments referred to in the note increase financial stability risks and necessitate regulatory actions to address potential flaws in the management of counterparty, collateral and liquidity risks, and market transparency. The FSB suggests that imposing higher disclosure and reporting requirements, together with regulatory and other limits, could help to mitigate the risks emerging in complex ETFs and prevent conflicts of interest from emerging.

The aims of the note are to improve understanding of the potential emerging issues for financial stability and to encourage ETF providers (and, where relevant, ETF investors) to review risk management, disclosure and transparency practices and adapt such practices early in the product cycle to match the pace of market innovation.

Financial Service Board Proposals on Financial Regulatory Reforms

The Financial Stability Board (the “FSB”) published on 5 April 2011 a press release following its meeting on vulnerabilities affecting the financial system, and decisions to progress major initiatives to strengthen the resiliency of the financial system, which contains the following points of interest:

- systemically important financial institutions: the FSB agreed an accelerated timetable and processes (including a public consultation), to deliver recommendations about global systemically important financial institutions (“SIFIs”) to the G20 summit in November 2011;
- over-the-counter derivatives markets: the FSB has emphasised that in order to ensure the G20 commitments relating to over-the-counter (“OTC”) derivatives markets are implemented in an internationally consistent manner by the agreed date at the end of 2012, all jurisdictions need to take immediate and concrete steps and it notes the risk that the emergence of different models of trade repositories may lead to difficulties in cross-border sharing of data or aggregating data on a global basis;
- commodity markets: the FSB is to consider next steps relating to commodity markets in the light of the International Organization of Securities Commissions’ final report on commodity financial markets of September 2011;
- “shadow banking”: the FSB will publish a background note on its shadow banking project in April 2011 which will consider recommendations to strengthen the regulation and oversight of the shadow banking system;
- data gaps: the FSB has approved proposals and a consultation process on a consistent methodology for improving the collection, and sharing among regulators, of data on SIFIs;
- remuneration: the FSB finalised the terms of reference for its second thematic peer review of compensation practices which is to be published at the G20 summit in November 2011;
- international co-operation and information exchange initiative: the FSB is to publish a report on the status of evaluations and progress this month; and

- the banking system: the FSB has noted that pockets of weakness in the banking system remain and will use the results from its 2011 bank stress testing exercise to identify and address weaknesses.

The FSB published on 15 April 2011 a progress report on the work underway to implement the financial stability recommendations put forward by the G20 at its November 2010 Seoul summit.

The focus of the report is on the international policy development and implementation which has taken place since the G20 finance ministers and central bank governors met in February 2011.

G20 Finance Ministers and Central Bankers' April 2011 Meeting

The G20 finance ministers and central bank governors have published a communiqué following their meeting in Washington DC held on 14 and 15 April 2011.

At the meeting, in relation to financial services, among other things the ministers and central bank governors:

- stressed the need for participants on the commodity derivatives markets to be subject to appropriate regulation and supervision;
- called for enhanced transparency in cash and derivatives markets (as previously recommended by IOSCO) and asked IOSCO to finalise by September 2011 its recommendations on regulation and supervision in this area;
- welcomed the preliminary proposals put forward by the FSB to strengthen its capital, resources and governance, and asked the FSB to present formal proposals at its July 2011 meeting for review at the ministers and central bank governors' next meeting;
- noted the progress made to determine "a cohort of global SIFIs" (i.e., systemically important financial institutions) and confirmed that the FSB will make recommendations for a supervisory framework in this area;
- welcomed the FSB's work on shadow banking and the related recommendations on regulation and oversight which the FSB is to make;
- committed to set high, internationally consistent, co-ordinated and non-discriminatory requirements in legislation

and regulations implementing FSB recommendations on the OTC derivatives markets and stressed the need to avoid overlapping regulations;

- urged all jurisdictions to fully implement the FSB principles and standards on compensation, and requested that the FSB undertake ongoing monitoring in this area;
- welcomed ongoing work by the OECD, the FSB and other relevant international organisations to develop common principles on consumer protection in financial services; and
- agreed to maintain momentum for action to tackle non-cooperative jurisdictions and to fully implement the G20 anti-corruption action plan.

UK Regulatory Developments

Use of Non-EEA Rules in Calculating Group Capital Requirements

The FSA published on 31 March 2011 a consultation on proposals concerning the use of non-EEA regulators' rules when calculating the capital requirements of a UK banking or investment firm group (CP11/6).

Currently, under chapter 8 of the FSA's Prudential sourcebook for Banks, Building Societies and Investment Firms ("BIPRU"), a UK consolidation group can use non-EEA regulators' rules when calculating the standardised capital requirements of a non-EEA subsidiary. However, this is only permitted where the FSA has determined that the non-EEA regulators' standardised rules are equivalent to its rules. The FSA carried out equivalence assessments in 2006, at the time that it was implementing the Capital Requirements Directive (2006/48/EC and 2006/49/EC) (the "CRD").

The FSA is concerned that these assessments are no longer up to date and consequently there is an asymmetry of information between it and firms on capital levels. The FSA therefore intends to revoke the equivalence rules in BIPRU 8. This would mean that, for the purpose of aggregating the capital requirements of a non-EEA subsidiary into the consolidated capital requirements of a UK consolidation group, firms will be required to use the FSA rules to do so. This will bring the UK's approach to this issue in line with the approach taken by other EEA Member States.

A draft FSA instrument making the relevant changes, is set out in an Appendix to CP11/6. The FSA is proposing for these rule changes to come into force on 30 December 2011.

Comments can be made on the proposals however, until 30 June 2011 and the FSA intends to publish a policy statement on the proposals in Q3 of 2011.

Independent Commission on Banking Interim Report

The Independent Commission on Banking (the "ICB") published on 11 April 2011 for consultation an interim report on potential reforms to the UK banking sector to promote financial stability and competition.

The interim report follows an issues paper and call for evidence which was published by the ICB in September 2010. A high-level summary of responses to the issues paper was subsequently published by the ICB in January 2011.

This interim report stresses that the ICB has not yet reached final conclusions.

In setting out possible options for reform in respect of financial stability, the ICB indicates that it

believes a combination of capital and structural approaches "in moderate form" would be most appropriate. In this respect, the ICB suggests that systemically important banks should hold equity capital of at least 10 per cent together with holdings of genuinely loss-absorbing debt. It rejects the idea of entirely separating retail banking from wholesale and investment banking, but puts forward the concept of ring-fencing the UK retail banking operations of universal banks, to protect them from risks arising elsewhere in such banks or the wider financial system. In combination with higher capital standards, the ICB believes this could also limit taxpayer exposure and so help improve commercial risk-taking disciplines.

The closing date for responses to this report is 4 July 2011. The ICB is due to publish a final report setting out its recommendations to the Government in September 2011.

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