Regulatory Policy Newsletter

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Editor: Paul Richards

In this issue:

Question time for the retail bond markets

Foreword by Lachlan Burn, Partner, Linklaters LLP

Lawyers are normally paid to give answers, not to ask questions. However, let me turn tradition on its head and ask a few about the international retail bond markets – or, rather, why such markets currently don't really exist.

First, do we need them? What business have retail investors with corporate bonds? Shouldn't they be investing in safe things like bank deposits and government bonds?

I suspect that answers can be found by asking some other questions. For example, one doesn't need a crystal ball to know that there is a huge demographic shift going on in the world, particularly in the EU. We are getting older as populations and living longer. Older people need things like pension provision and increased health care. In many states, these things are currently provided from current revenues and we are fast reaching the point where the burden is going to be unsustainable. So, one would think, those who can save for their own needs in later life should do so. But where to put the money? Government bonds? UCITS? Shares? Corporate bonds? At least for those at the higher net worth end of the spectrum, who can invest directly and wish to diversify their portfolio, perhaps corporate bonds make good sense.

Or is an answer to be found in the recent market crisis? The bank lending market largely froze. The real economy was starved of funding. Would it not make sense to develop an alternative source of finance, by giving retail investors access to corporate bond markets?

Lachlan Burn

Or maybe the answer has to do simply with investor choice. Is it right that investors should be able to buy shares direct, but to be denied the opportunity to diversify by buying an (arguably) less risky bond issued by the same company?

Would a wider investor base, including individuals, reduce the cost of capital to the EU's industrial base, thereby increasing the output and profitability of the wealth generators, creating more jobs and solving many economic problems at the same time?

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And what about small and medium-sized enterprises, who suffered most from the recent funding squeeze? Perhaps if they were able to issue bonds to those retail investors who know them best, they would blossom into tomorrow's industry champions even quicker than at present.

I suspect that answers to all of the above questions (and others) may point to the conclusion that it would be a good thing to develop a more active EU retail bond market. But the point is that *how* one develops a market will necessarily be informed by a clear understanding of *why* one is doing it. The intended result will dictate much of the detailed regulatory regime. Questions such as those raised above therefore need answers.

Having determined the "why" part of the equation, one can turn to the "how". This part of the equation requires answers to further questions. For example, why has an international retail market not developed in Europe? Is it to do with the savings culture (or relative lack of it)? Is it because funding needs have been adequately supplied by institutional investors? Is it because savers have put their money into things like UCITS or, attracted by the prospect of capital growth, shares or real estate? Is it because the consumer protection laws in Europe are too difficult or too expensive to comply with, so that issuers and intermediaries avoid retail investors?

Finally, having identified the need to develop the market and the roadblocks that have prevented its creation, we come to the final set of questions. These involve policy. For example, how do we balance consumer protection against making the markets attractive to issuers – (there is not much point in a market whose rules are so off-putting that it has no sellers)? Or, again, which regulatory tools are we going to employ to create the market? Will we limit everyone to "safe" investments (such as UCITS investing in a limited range of products)? Or will we permit wealthier investors to buy direct? Should issuer disclosure be written for the retail investor; or should retail investment involve financial intermediaries, who will read and understand issuer disclosure and recommend investments to individuals based on that knowledge and their understanding of the investor's circumstances? It is only by having a clear understanding of policy decisions such as these that the detailed regulation can be written. Without that understanding, there is a risk that individual measures will conflict with other measures, and hamper the development of the market.

Enough questions. Time for some answers. Anyone?

Lachlan Burn[1]

1 Lachlan Burn is a Partner of Linklaters LLP, and a member of ICMA's Legal & Documentation Committee

Message from ICMA's Chief Executive

Martin Scheck

Your Association's work has continued unabated over the summer, and in this short message I want to highlight a few of the most important aspects of our current activities at ICMA.

In the last Newsletter we discussed the dysfunctional sovereign bond markets and mentioned that we were setting up a Sovereign Bond Working Group to analyse the situation and suggest measures to improve it.

The first meeting of the group indicated that we needed to focus our attention initially on transparency issues, since it became apparent that many investors were not fully aware of the level of investors protection contained in the bonds they had bought – specifically what covenants were contained in the terms and conditions – and in some cases were unclear as to what governing law their bonds had been issued under. In addition it was not always obvious how investors could find the relevant information.

We have been looking at ways to improve this, and are working on putting together some concrete suggestions for discussion.

Another recent development has been the ICMA Issuer Forum. This is a new grouping of senior treasury staff from some of the major financial issuers of Eurobonds, and it provides an opportunity for them to discuss areas of mutual interest. So far we have had two meetings and a dynamic group is beginning to emerge, with worthwhile topics on the agenda. We expect to expand this Forum over time.

The MIFID review is also gathering pace. Many of our member firms took the time to fill in our comprehensive questionnaire on transparency and liquidity earlier in the summer. The results have been widely reported and we used these in our submission to CESR, who have subsequently made their own recommendations to the European Commission. We will continue to be heavily engaged in the MIFID review. It is a heavy commitment, where much of the detail remains undefined, but it is important given it affects almost every aspect of the securities markets. We have arranged a series of half day seminars for our members throughout Europe to raise awareness of what is at stake, and provoke discussion on some of the critical issues. The first two of these, in Zurich and Luxembourg, took place two weeks ago. The feedback has been so favourable that we will be extending the seminars to many other European cities.

These are just three of the main initiatives – there are many others described in the following pages.

Aside from this our membership keeps growing quarter by quarter; registrations for ICMA Executive Education courses in 2010 already exceed full year 2009; and overall the level of engagement of our members on our committees and councils is at a very high level.

As a final point, we always strive to ensure that standards of best practice are as high as possible, and in this context we sent out recently a questionnaire to all our members asking for your input on the usage of the ICMA Secondary Market Rules and Recommendations. Please do take the time to fill this in – it is a critical step in ensuring that we keep the rules and recommendations up to date and relevant.

Martin Scheck, Chief Executive, ICMA
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Note for ICMA members

A conference call to discuss with ICMA members the issues raised in this Newsletter and to answer members' questions is due to take place at 12.00 London time on 19 October. For further information, please contact Allan Malvar at: allan.malvar@icmagroup.org

Characteristics of a well-functioning capital market

What are the characteristics of an orderly, efficient and well-functioning capital market for securities?[2] The answer to this question is important in two ways:

- First of all, the international capital market is still recovering from the recent international financial crisis, during which trust between market participants broke down and parts of the market froze, leaving the authorities no option but to intervene on an unprecedented scale. As a result of the crisis, the market needs to be repaired and an orderly market needs to be restored.
- Second, the characteristics of a well-functioning and mature capital market represent a benchmark against which the development of emerging capital markets around the world can be measured.

This assessment sets out an inventory of the characteristics of a well-functioning capital market. It is divided into a number of sections: general characteristics; preconditions; the primary market and the secondary market; prudential regulation and conduct of business regulation; market structure and market infrastructure; and the role of good market practice. The assessement also outlines the changes in international regulation that will affect capital markets in response to the international financial crisis.

General characteristics

A capital market works best when there is:

- free and open *competition* among market participants on a level playing field, with no cross-border barriers to participation;
- sufficient *transparency* to enable buyers to assess the financial instruments offered by sellers, so that the rewards match the risks;
- a resilient post-trade *infrastructure* for clearing and settling the financial transactions that result; within
- a mutually accepted and robust *legal framework*.

In addition:

- *financial reporting and corporate governance* should conform to internationally agreed standards;
- *regulation* should be proportionate to the risks involved, so that the market is open to innovation and integration, and so that competitiveness is not undermined; and
- *taxation* should be predictable, fair and consistent with international practice.

Preconditions

A capital market cannot function well without:

- an efficient means of bringing buyers and sellers together, either directly or via dealer intermediation;
- a liquid and effective interbank money market with a reliable reference rate which can be used in derivatives transactions;
- a liquid and effective derivatives market which allows hedging, arbitrage and speculative positions;
- a liquid and effective repo and reverse repo market which allows funding of inventory and dealer short positions;
- a benchmark reference yield curve; and
- a single or integrated securities depository and clearing and settlement system.

Primary market

A well-functioning capital market should enable capital to be allocated efficiently so that productive users of capital obtain funds through the primary market at the lowest rate and investors supplying capital earn the highest return.

In a well-functioning capital market, there should be:

- a wide range of tradable securities in issue by public, corporate and financial issuers, in the form of money market instruments (including repos and commercial paper), bonds (of different maturities), equities and related derivatives;
- market-determined interest rates; a developed government bond yield curve, both for pricing and for hedging; and a developed interest rate swap market to meet the needs of issuers and investors; and
- a diversified investor base, including long-term institutional investors.

2 I am grateful to René Karsenti, Timothy Baker, Richard Britton, David Clark and Chris O'Malley for their input.

Secondary market

The secondary market should provide liquidity (ie an exit), for which investors are prepared to pay by accepting lower rates of return in the primary market. And the secondary market should also provide a vital signalling function for primary market pricing by bringing together buyers and sellers of equivalent securities at an agreed price.

There are different methods of price formation in a well-functioning capital market: eg on-exchange or over-the-counter (OTC). In some markets, notably those for the equity of large companies, the orders of buyers and sellers can be matched. As a result, investors provide each other with liquidity. In others (eg the fixed income OTC markets), market makers use their own capital to provide liquidity to sellers when there are no immediate buyers. All these methods of price formation are designed to bring together providers and users, buyers and sellers, at an agreed price.

In addition, in a well-functioning capital market:

- new information should be broadcast to the market in a timely and accurate way; and
- credit ratings should be provided by reputable, independent and appropriately regulated agencies.

Prudential regulation

In a well-functioning capital market, banks should be subject to appropriate prudential supervision (eg of their risk management and controls); and they should be subject to prudential regulation of their capital and liquidity, which should conform to internationally agreed definitions and minimum levels. In response to the international financial crisis, the definitions of capital and liquidity will become tighter, and the minimum levels higher, after a transitional period, than before. The proposed regulatory framework is intended to be countercyclical so as to reduce, rather than increase, the incidence of economic shocks, and a special capital charge may be imposed on systemically important financial institutions.

In a well-functioning capital market, the authorities should be responsible for monitoring systemic risk: ie any risk arising from the international capital market for the financial system as a whole. They should also implement any internationally agreed standards for the resolution of market participants. These should be designed to ensure that a market participant's failure is managed in an orderly way and does not destabilise the financial system as a whole.

Conduct of business regulation

In a well-functioning capital market, appropriate arrangements need to be in force for the authorisation of market participants, and the regulation of their conduct of business, relating in particular to: the best execution of client orders; and the suitability and appropriateness of financial instruments, products and services, for clients. Special attention needs to be given to the regulation of complex financial instruments for retail – as distinct from professional – clients. The risks associated with complex financial instruments, such as collateralised debt obligations and collateralised loan obligations, need to be properly disclosed.

There should also be provisions: to ensure accurate and timely transaction reporting; to prevent market abuse and insider trading; to safeguard client assets; and to manage conflicts of interest.

Market structure

In response to the international financial crisis, the structure of capital markets is coming under greater scrutiny from international regulators in a number of ways:

- First, regulators are giving a much higher priority than before to market transparency. This needs to be achieved without damaging the level of liquidity in the market.
- Second, regulators are encouraging greater use of exchanges. A level playing field between exchange and OTC trading is the best way of promoting competition.
- Third, OTC markets are to be regulated – as regards central clearing, regulatory reporting and transparency – more heavily than before. Initially, the focus is on OTC derivatives, but eventually it may be extended to the OTC cash markets as well.
- Fourth, the perimeter of financial regulation is being broadened to include institutions (such as hedge funds) previously outside the perimeter.
- Fifth, regulators are giving more attention to the suitability of financial products: not just to protect retail investors in particular; but also to promote the integrity of markets.
- Finally, regulators are considering whether some types of transactions in financial instruments (eg naked short selling via credit default swaps) should be made more transparent, or whether these transactions should be restricted or banned. When they consider restrictions, these should be based on evidence and not on anecdote. Regulators also need to consider the risk of unintended consequences elsewhere, given the degree of capital market integration.

Market infrastructure

A separate priority for the authorities in response to the international financial crisis is to make the market infrastructure more resilient: for example, by encouraging liquid derivatives contracts to be cleared through central counterparties (CCPs), which net exposures and increase transparency. Several issues need to be addressed:

- Use of CCPs eliminates the risk between counterparties, but has the effect of concentrating risk in a few systemically important institutions. Not all transactions can be cleared through CCPs but, in the case of those that can (eg liquid derivatives contracts), decisions need to be taken about whether use of CCPs should be voluntary or mandatory and, if mandatory, whether CCPs will be able to cope; whether CCPs should compete or become monopolies; whether, and if so how, "lender of last resort" facilities can be made available; and whether it matters where they should be located.
- If market participants are required to record transactions not cleared by a CCP in a trade repository, the confidentiality of market-sensitive data should be safeguarded.

Role of good market practice

Finally, market participants themselves can help the capital market to work well by using their practical experience to set standards of good market practice and to develop standard market documentation. In the case of ICMA's standards of good market practice in the international capital market, self-regulation of this kind is voluntary. But if markets meet standards of good market practice voluntarily, there is less need for the authorities to impose new legislation in the form of mandatory regulations.

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Recent practical initiatives by ICMA

Response to the crisis

With guidance from the ICMA Chairman and our new Sovereign Bond Working Group, chaired by Robert Gray of HSBC, and with technical assistance *pro bono* from Linklaters and Clifford Chance, we are preparing a Sovereign Bond Consultation Paper.

Short-term markets

With the help of Richard Comotto, the ICMA European Repo Council has published a *White Paper on the Operation of the European Repo Market, the Role of Short-Selling, the Problem of Settlement Failures and the Need for Reform of the Market Infrastructure*. The White Paper has provoked a considerable degree of interest in the market and with the authorities. An updated version is in progress for publication later this year.

Primary markets

We have held a second Allocation Roundtable to bring together representatives of ICMA's sell-side and buy-side members to discuss bookbuilding and allocation policy.

With Martin Scheck as Chair, we have launched the ICMA Issuer Forum, representing bank issuers.

We have held two separate meetings involving experts from our member firms with the European Commission on underwriting.

Under ICMA's Euro Debt Market (AMTE) Council, chaired by René Karsenti, we are finalising guidance on the transparency of buyback policies by government, government agency and supranational issuers.

We are consulting our primary market constituency (through the ICMA Primary Market Practices Committee, Legal & Documentation Committee and ECP Committee) on the usage of, and on the need for any improvements in, the ICMA Primary Market Handbook.

Secondary markets

We have held a meeting involving experts from our member firms with the European Commission on post-trade transparency in the corporate bond market.

We have held two seminars on the MiFID review with our members, at SIX in Zurich and at the EIB in Luxembourg, and a roundtable in London on the implications of MiFID for fixed income markets.

We have sent an electronic questionnaire to all ICMA members on the usage of, and on the need for any improvements in, the ICMA Secondary Market Rules and Recommendations.

Asset management

ICMA's Asset Management and Investors Council (AMIC), chaired by Robert Parker of Credit Suisse, has set up a Working Group on the Valuation of Financial Assets. Technical advice is being provided *pro bono* by KPMG.

The AMIC has responded to the European Commission's Consultation Paper on Corporate Governance, focusing on shareholder engagement and remuneration policy in the asset management industry.

ICMA's Private Banking Working Group has continued to work on a draft Private Banking Charter of Quality, reporting to the AMIC.

Market infrastructure

Under ICMA's AMTE Council, we have finalised a change to ICMA's Secondary Market Rules and Recommendations to cover electronic trade confirmations in the OTC securities market.

G20 financial regulatory reforms

In the Third Quarter Newsletter we reported on both the work leading up to and the conclusions from the 26-27 June Toronto G20 Summit. The G20 will meet next in Seoul, Korea, on 11-12 November 2010. It will then convene in November 2011 under the Chairmanship of France and in 2012 under the Chairmanship of Mexico.

In preparation for the November meeting, a G20 Sherpa meeting and a G20 High-Level Development Working Group meeting were held from 19-22 July; and a G20 Finance and Central Bank Deputies meeting was held on 4-5 September. A 20 July G20 progress report, prepared by Korea, has been made available. G20 Finance Ministers and Central Bank Governors meetings will take place in October.

The G20 Seoul Summit will focus first on following up on previous G20 commitments within the established timeframe. Those commitments include:

- safeguarding the ongoing recovery and restoring fiscal sustainability;
- ensuring strong, sustainable and balanced global growth;
- building a stronger international financial regulatory system; and
- modernising international financial institutions.

However, Korea will also bring new perspectives and new issues to the G20, with a view to addressing the needs of the emerging and developing world as part of the effort to support sustainable growth globally. Toward that end, Korea will introduce plans for a global financial safety net system and development issues as additional agenda items. In a similar vein, on 2-3 September Korea's G20 Committee and the Financial Stability Board (FSB) co-hosted a conference. This was intended to facilitate engagement of emerging market economies in the on-going discussions led by the G20 on regulatory reform and help bring to the G20 table specific issues with particular relevance to emerging economies – such as foreign exchange market stability, international cooperation and capacity building.

On 27 September, the FSB met in Paris. It reviewed risks and vulnerabilities affecting the global financial system and progress on the regulatory reform agenda under coordination by the FSB. Also, in a 27 September press release, the IMF has announced that it is expanding its surveillance to require mandatory financial stability assessments of countries with systemically important financial sectors. In this context a total of 25 jurisdictions were identified as having systemically important financial sectors, based on a methodology that combines the size and interconnectedness of each country's financial sector. This group of countries covers almost 90% of the global financial system and 80% of global economic activity; and it includes 15 of the G20 member countries.

Significant developments relating to several specific elements of the G20 financial regulatory reform agenda are covered elsewhere in this Newsletter.

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European reform of financial supervision

As most recently described in the Third Quarter Newsletter, work is progressing on an important package of draft legislation to create a new European Systemic Risk Board (ESRB) and also to set up a European System of Financial Supervisors (ESFS). The package comprises proposals:

- for the establishment of the ESRB and regarding the powers of the ESRB;
- for the establishment of a European Banking Authority (EBA); of a European Insurance and Occupational Pensions Authority (EIOPA); and of a European Securities and Markets Authority (ESMA) – collectively the European Supervisory Authorities (ESAs); and
- amending existing directives regarding the ESAs' powers (the "Omnibus" Directive).

Dated 26 August, the Financial Markets Law Committee published its analysis of certain core areas of the European Commission's proposals for European financial supervision which are capable of giving rise to significant legal uncertainty.

On 2 September, the European Parliament (EP) issued an ECON press release, *EP adds bite to EU financial watchdog rules*. This, together with a related article, *MEPs secure overhaul of EU financial regulation*, reports on MEPs having successfully concluded negotiations with the European Commission and EU Governments on the future shape of financial supervision in Europe. Commissioner Barnier welcomed the outcome of the trialogue, commenting: "we have reached a crucial milestone – we have reached a political consensus on the creation of European financial supervisory framework." The 2 September agreement was approved by the ECOFIN on 7 September and then, by a huge majority, in 22 September EP Plenary votes. Following these approvals work has begun in earnest on completing the various practical steps necessary to establish the new system by January 2011.

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OTC (derivatives) regulatory developments

The European Parliament's work on future policy actions for derivatives markets was covered in the Third Quarter Newsletter, together with some background on the European Commission's related work. The Commission's draft *Regulation on OTC Derivatives, Central Counterparties and Trade Repositories* has now been released and is further discussed in the Market Infrastructure Section of this Newsletter. Illustrative of the efforts being made to coordinate this legislation with that being developed in the US, there is a 28 September joint statement, by CFTC Chairman Gary Gensler and European Commissioner Michel Barnier, on the financial reform agenda.

On 12 May, the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) published their joint consultation papers on policy guidance for central counterparties and trade repositories in the OTC derivatives market. Responses to these two papers, which were required by 25 June, have subsequently been released.

On 19 July, the Committee of European Securities Regulators (CESR) launched its consultations on *Standardisation and Exchange Trading of OTC Derivatives* and on *Transaction Reporting on OTC Derivatives* and extension of the scope of transaction reporting obligations. In respect of the former, CESR conducted an open hearing on 11 August. Written responses, which were requested by 16 August, have been made available both for the standardisation and trading and for the transaction reporting obligations papers.

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Capital requirements

Following on from its 17 December 2009 consultation on strengthening the resilience of the banking sector, the Basel Committee on Banking Supervision (BCBS) issued a 16 July press release. This reported on its 14-15 July meeting where the design and overall calibration of the capital and liquidity frameworks were reviewed. Nout Wellink, Chairman of the Basel Committee and President of the Netherlands Bank, noted that "the Committee made significant progress at its meeting and remains fully on track to deliver a complete package of capital and liquidity reforms, including design and calibration, in time for the November 2010 G20 Leaders Summit in Seoul." The Committee also issued for consultation a fully fleshed out countercyclical capital buffer proposal.

Dated 26 July, there is a press release from the Bank for International Settlements (BIS) in which the Group of Governors and Heads of Supervision (the Governors) announced that they have now reached broad agreement on the BCBS capital and liquidity reform package. In doing so they have considered the comments received during the public consultation, the results of the Quantitative Impact Study, the assessments of the economic impact over the transition and the long run economic benefits and costs. The Governors are deeply committed to increase the quality, quantity, and international consistency of capital, to strengthen liquidity standards, to discourage excessive leverage and risk taking, and reduce procyclicality. The key broad agreements of the Governors are summarised in an Annex.

On 18 August, the Financial Stability Board (FSB) and the BCBS announced the publication of reports prepared as inputs to the calibration of the new bank capital and liquidity standards; and to inform the transition arrangements for implementation of the new standards. The two reports are: *An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements*, prepared by the BCBS; and *Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements*, the interim report of the joint FSB-BCBS Macroeconomic Assessment Group (MAG). The BCBS's assessment of the long-term economic impact finds that there are clear net long term economic benefits from increasing the minimum capital and liquidity requirements from their current levels in order to raise the safety and soundness of the global banking system; and the FSB-BCBS MAG assessment of the macroeconomic transition costs, prepared in close collaboration with the IMF, concludes that the transition to stronger capital and liquidity standards is likely to have a modest impact on aggregate output. The MAG's final report will reflect the fully calibrated global capital and liquidity standards, which are to be delivered in advance of the Seoul G20 Leaders Summit.

Intended to help address concerns about the quality of capital, on 19 August the BCBS issued for consultation a proposal based on a requirement that the contractual terms of capital instruments will allow them at the option of the regulatory authority to be written off or converted to common shares in the event that a bank is unable to support itself in the private market in the absence of such conversions.

The BCBS met on 7 September to finalise the calibration and phase-in arrangements for their capital and liquidity reform package. The Governors then met on 12 September, following which they announced a substantial strengthening of existing capital requirements and fully endorsed the agreements reached on 26 July. In brief, the Basel Committee's package:

- increases the minimum common equity requirement from 2% to 4.5%;
- requires banks to hold a capital conservation buffer of 2.5% to withstand future periods of stress, bringing total common equity requirements to 7%;
- adopts a countercyclical buffer, within a range of 0% - 2.5%, of common equity or other fully loss absorbing capital to be implemented according to national circumstances;
- supplements these capital requirements by a non risk-based leverage ratio, which serves as a backstop to these risk-based measures (in July, the Governors agreed to test a minimum Tier 1 leverage ratio of 3% during a parallel run period);
- calls for systemically important banks to have loss absorbing capacity beyond the standards announced above – work continues on this issue in the FSB and relevant BCBS work streams. The Basel Committee and the FSB are developing a well integrated approach to systemically important financial institutions which could include combinations of capital surcharges, contingent capital and bail-in debt. In addition, work is continuing to strengthen resolution regimes.

The Governors also agreed on transitional arrangements for implementing the new standards, to help ensure that the banking sector can meet them through reasonable earnings retention and capital raising while still supporting lending to the economy.

Broadly in parallel with all of this, the European Commission is continuing its work on further possible changes to the Capital Requirements Directive (CRD) and has a legislative proposal scheduled for the first quarter of 2011. In relation to the specific open question of the possible role of "bail-in" debt (mentioned in the last bullet point above), the European Commission held a 10 September roundtable on *Debt Write Down as a Resolution Tool*.

Dated 21 September, there was the latest version of an associated draft ECON report from its rapporteur, Othmar Karas. The main reason for his draft report is a call of the European Parliament (EP) on the Basel Committee to be included in an appropriate way in the ongoing negotiations; and a call to make necessary adjustments to the framework so that the European industry and economy are not disadvantaged. ECON continues its work on this report, which was the subject of a final vote in the 7 October EP plenary session.

Separately, on 7 July the EP adopted in plenary the CRD 3 legislative report covering remuneration, higher capital charges for the trading book and re-securitisations. The finalised rules are expected to take effect in January 2011 for the bonus provisions and January 2012 for the capital requirements provisions. An applicable set of frequently asked questions was made available.

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Credit rating agencies

As the EU's Credit Rating Agencies (CRA) Regulation entered into force on 7 December 2009, the use of credit ratings by EU authorised financial institutions will be constrained in accordance with Article 4(1) as from 7 December 2010.

Article 21 calls upon CESR to issue guidance on various items. Following from consultation in May, CESR has on 30 August now published two further sets:

- *Guidance on Common Standards for Assessment of Compliance of Credit Rating Methodologies with the Requirements set out in Article 8(3)* (with a feedback statement).
- *Guidance on the Enforcement Practices and Activities to be Conducted under Article 21.3(a) of the Regulation* (also with a related feedback statement).

The CRA Regulation requires CRAs to provide information on their historical performance data and CESR to make this information accessible to the public by establishing a central repository (named CEREP). In order to help CRAs to comply with Article 11 of the Regulation on reporting requirements, CESR conducted a meeting on 8 July setting out the timeline for the implementation of the CEREP and the details of the connectivity tests between CRAs and CESR (which took place in July and August). Also to support CRAs' understanding of how technically to comply with the CEREP reporting requirements, CRAs were invited to a one day CESR seminar on 9 September.

As discussed in the Third Quarter Newsletter, on 2 June the Commission proposed improved EU supervision of CRAs. This proposal is being scrutinised by the European Parliament's ECON, whose rapporteur, Jean-Paul Gauzès, has produced a draft report dated 23 September. *Inter alia*, this notes that the Commission will propose various supplementary measures concerning ratings in 2011 and that Parliament will meanwhile adopt an own-initiative report with proposals on this issue.

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Crisis management-related measures

On 1 June, the European Commission organised a public hearing in Brussels on improving the enforcement of judgments and facilitating cross-border debt recovery. 84 participants representing ministries of justice, judicial authorities, law firms, bailiffs, academics, banks, businesses and citizens' groups were registered for this event. Speakers were all eminent experts in their field. As a result the hearing provided stakeholders with an opportunity to express their opinion on existing problems in these areas and the possible solutions. The hearing was part of an on-going consultation process. It followed the publication of two Commission Green Papers on the attachment of bank accounts and on the transparency of assets, issued in 2006 and 2008. It broadly showed that more data was needed to substantiate the definition of the problem of unpaid debt in the EU. The debate on the policy options had indicated a consensus in favour of a free-standing European bank attachment order, although many details were still to be decided as to the conditions for and the effects of such order. Furthermore, some consistency of the European procedure with existing national enforcement schemes is to be sought. Dated 2 July, the agenda and other papers are available.

On 1 July, the Executive Board of the International Monetary Fund (IMF) discussed a proposed framework for enhanced coordination of cross-border bank resolution. The framework was outlined in a staff paper prepared in response to calls from G20 leaders, who have placed the complex issue of the resolution of international financial groups high on their agenda. Building on existing work in this area by other international bodies, the paper proposes a pragmatic approach to cross-border resolution focused on enhanced coordination among national authorities (this is also the topic of a 9 July speech by John Lipsky).

They generally agreed that the following elements would be important features of a policy framework:

- First, countries would amend their national laws so as to remove legal or practical barriers to cross-border cooperation. This would be a significant first step towards coordinated cross-border resolution.

- Second, countries would ensure that their national resolution regimes met core coordination standards. These would include the harmonization of resolution regimes in key areas on such issues as the non-discrimination against foreign creditors, and would ensure that countries adhere to robust standards of supervision, and have the institutional capacity to implement an international solution.
- Third, it could be useful to establish criteria for *ex ante* burden-sharing agreements, although some directors recognized the potential obstacles to reaching consensus in this regard. A primary objective of any resolution regime (national or international) should be to minimize the need for public funding.
- Fourth, countries would agree to procedural mechanisms for the coordination of cross-border resolution actions. This would entail not only procedures for information sharing but also rules to determine which jurisdiction's competent authorities would assume a lead role in resolving a particular international firm.

Directors agreed that countries sharing specific cross-border banks should enhance cooperation and work to meet these criteria. Such enhanced cooperation would represent a step forward, in particular if it involves the principal financial centres.

On 30 August, the IMF announced that it has expanded and enhanced its lending tools to help contain the occurrence of financial crises. As part of the efforts to enhance the institution's crisis-prevention toolkit, the Fund's Executive Board decided to increase the duration and credit available under the existing Flexible Credit Line (FCL) and to establish a new Precautionary Credit Line (PCL) for members with sound policies who nevertheless may not meet the FCL's high qualification requirements.

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ICMA's Sovereign Bond Working Group

The Third Quarter Newsletter mentioned that ICMA has set up a new Sovereign Bond Working Group under the Chairmanship of Robert Gray, ICMA's Vice-Chairman. This Working Group's focus will be on establishing good market practice in the area of sovereign bonds. The Working Group held its inaugural meeting on 14 July.

Both in the course of the discussion at the first meeting and during subsequent work, particular attention has been given to concerns regarding the different position of investors when sovereign bonds are issued under domestic law as opposed to another internationally accepted law; and problems arising from a lack of transparency of the terms of issuance. With much welcomed assistance from the Working Group, including external legal counsel, a Sovereign Bond Consultation Paper is being developed.

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Euro Commercial Paper market

Liquidity regulation continues to be the subject of further new official pronouncements.

As reported in the Third Quarter Newsletter, in April submissions were made on behalf of the ICMA Euro Commercial Paper (ECP) Committee to the Basel Committee and the European Commission, promoting ECP as a liquid asset – in context of the debate about the broader definition of liquid assets for the proposed new liquidity regime. Dated 26 July, there is a press release from the BIS in which the Group of Governors and Heads of Supervision announced that they have now reached broad agreement on the Basel Committee capital and liquidity reform package. The key broad agreements of the Governors and Heads of Supervision are summarised in the Annex linked to the press release.

With respect to the liquidity coverage ratio (LCR), the Governors and Heads of Supervision agreed on the Basel Committee's concrete proposals to recalibrate the stress scenarios to achieve a conservative bank level and plausibly severe system-wide shock. The Committee also made revisions to the definition of qualifying liquid assets subject to the overall requirement that such assets remain prudently liquid in periods of stress.

"Definition of liquid assets:

- …As part of the narrow definition of liquid assets, allow the inclusion of domestic sovereign debt for non-0% risk weighted sovereigns, issued in foreign currency, to the extent that this currency matches the currency needs of the bank's operations in that jurisdiction;
- Introduce a "Level 2" of liquid assets with a cap that allows up to 40% of the stock to be made up of these assets.
    - o Include (with a 15% haircut) government and PSE assets qualifying for the 20% risk weighting under Basel II's standardised approach for credit risk, as well as high quality non-financial corporate and covered bonds not issued by the bank itself (eg rated AA- and above), also with a 15% haircut;
    - o Utilise both ratings and additional criteria as outlined in the December proposal (bid-ask spreads, price volatility, etc) to determine eligibility."

Dated 12 September, there is a further press release from the BIS. Related to liquidity this says: "After an observation period beginning in 2011, the liquidity coverage ratio (LCR) will be introduced on 1 January 2015. The revised net stable funding ratio (NSFR) will move to a minimum standard by 1 January 2018. The Committee will put in place rigorous reporting processes to monitor the ratios during the transition period and will continue to review the implications of these standards for financial markets, credit extension and economic growth, addressing unintended consequences as necessary."

Central banks' financing requirements also continue to evolve. On 17 March, the Bank of England published a Consultative Paper entitled *Extending Eligible Collateral in the Discount Window Facility and Information Transparency for Asset-Backed Securitisations*. The first part of this sought market participants' views on further widening the range of collateral in the Discount Window Facility (DWF): specifically, a proposal to accept as eligible collateral portfolios of loans. The second part of it sought views on the Bank's initiative to require greater transparency in relation to structured products (ABSs and covered bonds) as part of the eligibility criteria for instruments accepted in all of its operations, including the extended-collateral long-term repo operations, the Special Liquidity Scheme while it is outstanding, and the DWF. In a Market Notice dated 19 July, the Bank confirmed that it intends to implement both of these initiatives, with further detail on the criteria and timescales to be announced later in the year.

The European Central Bank's 6 August note of other decisions taken by the Governing Council of the ECB includes the following items:

- "Review of the Eurosystem risk control measures: On 28 July 2010 the ECB announced amendments, as adopted by the Governing Council, to the risk control measures for assets eligible for use as collateral in Eurosystem credit operations. These amendments stem from the biennial review of the Eurosystem risk control measures. The press release also details the new haircut schedule, which will enter into force on 1 January 2011, in line with the Governing Council's decision of 8 April 2010 to introduce graduated valuation haircuts for lower-rated assets."
- "New Short-Term European Paper (STEP) market convention: On 5 August 2010 the Governing Council, having taken note of the new STEP market convention and the assumption of sole responsibility for the STEP labelling process by the STEP Market Secretariat, approved the discontinuation of the Eurosystem's involvement in this activity with immediate effect. More information on the STEP market is available on the ECB's website."

Money market funds are key investors for ECP, so the ECP Committee continues to review various official changes directly impacting such funds.

Newly proposed Moody's ratings methodology changes present fresh concerns for money market funds (MMFs). The proposal suggests that, instead of using AAA ratings for MMFs, there should be a scale of MF1+ to MF4. The aim is to better differentiate between funds. In response, there is concern that the new criteria may prove highly subjective and open to interpretation by Moody's. Also, as well as it being potentially confusing to have a new scale, many investment guidelines explicitly require AAA ratings – so unless they are adjusted many investors will have to move out of Moody's rated funds (at the very least this factor seems to dictate that any such change has an extended phase-in period). The new top rating envisages very strict criteria which, assuming that funds seek to achieve this rating, will drive MMFs to become even more liquid and short term. Moody's consultation runs to 5 November.

Proposed accounting changes also pose a threat to the popularity of MMFs. On 1 July, the IASB and the US FASB posted to their websites a staff draft of a proposed standard that reflects tentative decisions made to date on a joint project on financial statement presentation. These proposals include eliminating the cash equivalents category, meaning that all MMF holdings would be considered as investments and not cash equivalents. This could have serious repercussions on corporate treasurer investment in MMFs, making the placing of paper increasingly difficult for ECP.

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Repo market

European Repo Council (ERC) White Paper: As reported in the Third Quarter Newsletter, an ERC White Paper on the working of the repo market was published on 13 July. This ERC White Paper has been widely distributed and also formed part of the ERC's responses to the European Commission's recent consultations on derivatives and market infrastructures, and on short selling. By way of follow-up it is anticipated that Richard Comotto will draft an Annex to the White Paper to clarify certain points and/or add new elements, responsive to comments received and subsequent developments.

Strengthening Repo Clearing and Settlement Arrangements: At the 18 March ERC AGM in Brussels there was a progress report from Andy Sturm (Chairman of the CPSS Working Group on Repo Infrastructure), which can be found at pages 31-40 of the meeting's cumulative presentation.

Dated 15 September, the CPSS has published the anticipated report, *Strengthening Repo Clearing and Settlement Arrangements*. This report first presents a comprehensive survey of the clearing and settlement arrangements for repos in selected CPSS member countries. In particular, it sheds light on the experience with these arrangements during the financial crisis. Second, the report identifies several issues related to clearing and settlement arrangements for repos that have the potential to affect the resilience of repo markets (eg the risks related to the extension of significant amounts of intraday credits within some repo settlement arrangements; the lack of transparency of some repo infrastructure roles, responsibilities, practices and procedures; concerns regarding the protection against counterparty credit risk in repo transactions; and inadequate capabilities for liquidating repo collateral in the event of a cash borrower's default). Finally, the report outlines options and measures through which these issues can be addressed.

The report concludes that it is worthwhile for the stakeholders in each market to review how the clearing and settlement arrangements for repos could be further strengthened. As a first step, the report suggests that the providers of such arrangements in each country should, jointly with market participants, regulators and the central bank, attempt to develop a common view on the relevance of the identified issues for their market. As a second step, each provider could then evaluate which measure or combination of measures would be best suited to address the relevant issues in its specific circumstances.

Liquidity and capital: As discussed in the Third Quarter Newsletter, submissions were made in April by the ICMA ERC to the Basel Committee and the European Commission, raising points about counterparty credit risk, leverage and liquidity ratios. Dated 26 July, there is a press release from the BIS in which the Group of Governors and Heads of Supervision announced that they have now reached broad agreement on the Basel Committee capital and liquidity reform package. The key broad agreements of the Governors and Heads of Supervision are summarised in an Annex to the press release.

As far as counterparty credit risk is concerned, the key point of note from the Annex is:

- "Banks' mark-to-market and collateral exposures to a central counterparty (CCP) should be subject to a modest risk weight, for example in the 1-3% range, so that banks remain cognisant that CCP exposures are not risk free."

For the leverage ratio, points of particular note are:

- "For all derivatives (including credit derivatives), apply Basel II netting…"; and
- "The leverage ratio will be calculated as an average over the quarter."

For the leverage ratio, a supervisory monitoring period will commence on 1 January 2011; a parallel run period will commence on 1 January 2013 and run until 1 January 2017; and disclosure of the leverage ratio and its components will start on 1 January 2015. Based on the results of the parallel run period, any final adjustments will be carried out in the first half of 2017 with a view to migrating to a Pillar 1 treatment on 1 January 2018.

With respect to the liquidity coverage ratio (LCR) the most pertinent points are:

- "For secured funding backed by assets that would not be included in the stock of liquid assets, assume a 25% roll-off of funding.";
- "Secured funding: Only recognise roll-over of transactions backed by liquidity buffer eligible assets." and
- Definition of liquid assets:

  o "As part of the narrow definition of liquid assets, allow the inclusion of domestic sovereign debt for non-0% risk weighted sovereigns, issued in foreign currency, to the extent that this currency matches the currency needs of the bank's operations in that jurisdiction.

  o Introduce a "Level 2" of liquid assets with a cap that allows up to 40% of the stock to be made up of these assets.
- Include (with a 15% haircut) government and PSE assets qualifying for the 20% risk weighting under Basel II's standardised approach for credit risk, as well as high quality non-financial corporate and covered bonds not issued by the bank itself (eg rated AA- and above), also with a 15% haircut."

The Basel Committee also remains committed to the introduction of the net stable funding ratio (NSFR) as a longer term structural complement to the LCR. Nevertheless, the initial NSFR calibration as set out in the December 2009 proposal needs to be modified – the Committee will issue a new set of proposals by the end of this year.

Though still short on details, this update seems broadly encouraging in offering beneficial treatment for CCP exposures and regulatory netting for leverage; whilst it is not surprising that the decisions regarding the definition of liquid assets only involve a rather limited extension of which assets will qualify for recognition. Dated 12 September, there is a further press release from the BIS. Related to liquidity this says: "After an observation period beginning in 2011, the liquidity coverage ratio (LCR) will be introduced on 1 January 2015. The revised net stable funding ratio (NSFR) will move to a minimum standard by 1 January 2018. The Committee will put in place rigorous reporting processes to monitor the ratios during the transition period and will continue to review the implications of these standards for financial markets, credit extension and economic growth, addressing unintended consequences as necessary."

Central counterparty (CCP) large exposures: The ERC's March response in context of the UK FSA's CP09/29 sought clarification regarding the treatment of "large exposures" to CCPs. Dated 23 July, the UK FSA has now issued its CP10/17, *Strengthening Capital Standards 3*, which includes its feedback statement in respect of CP09/29. At paragraph 5.20 this notes:

- "A few respondents asked for clarity on the position for exposures to central counterparties, in particular how BIPRU 10 interacts with the provisions for calculating exposure values in relation to central counterparties in BIPRU 13.3." (ie the point that the ERC's submission raised).The FSA's related response text includes the following statement:
- "We can clarify that exposures to central counterparties which firms are able to attribute a zero exposure value under BIPRU 13.3.12R and BIPRU 13.3.13R do not contribute as exposures for the purpose the large exposures limit. Guidance has been added to the BIPRU 10 Handbook text to make this clearer."

Appendix 2 provides the near final text of the related proposed guidance to be added to the BIPRU 10 Handbook. Appendix 5 anticipates Handbook text concerning CEBS guidance re large exposures, which (in 10.2.2A) refers to CEBS guidelines applicable to the clearing related exemptions. In relation to this, dated 28 July, CEBS has published its implementation guidelines on large exposures exemptions for money transmission, correspondent banking, clearing and settlement and custody services – as announced (with the relevant linked document). These guidelines have to be transposed into Member States' national law by 31 October and to be applied from 31 December.

CCP standards: In the Third Quarter Newsletter it was reported that on 12 May the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) published their joint consultation paper – *Guidance on the Application of 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives CCPs;* and the ERC responded concerning repo-oriented aspects. This response has been published by the CPSS, together with other submissions received. The CPSS and the Technical Committee of IOSCO do not plan to issue finalised reports after the consultation period. Instead, the guidance presented in the reports, as well as the feedback received in the consultation process, will be incorporated in the general review of the international standards for financial market infrastructures that was launched by the CPSS and the Technical Committee of IOSCO in February this year.

Derivatives and market infrastructures: On 14 June, the European Commission published its Consultation Paper, *Derivatives and Market Infrastructures.* The consultation document outlines the Internal Market DG's current thinking on how to implement four of the policy actions that were announced in October 2009, notably:

- mandatory clearing of all "standardised" OTC derivatives;
- mandatory reporting of all OTC derivatives to trade repositories;
- common rules for CCPs and for trade repositories; and
- more transparency through reporting to trade repositories.

The ERC submitted a response concerning the repo-oriented aspects of this consultation. Particular points made related to CCPs and interoperability; and a copy of the 13 July ERC White Paper was appended for consideration.

This exercise was part of the preparatory work on the basis of which on 15 September the Commission adopted a Regulation on *OTC Derivatives, Central Counterparties and Trade Repositories* (which is also reported on elsewhere in this Newsletter). Broadly speaking the Commission's new legislative proposal seems accommodative of the points made by the ERC in its consultation response. The ERC is now considering if there are nevertheless concerns in the Commission's legislative proposal which they wish to highlight during the coming negotiation of this legislative proposal amongst Council and the European Parliament.

Resolution arrangements for investment banks: In March, the ERC submitted comments to HM Treasury in respect of its Consultation Paper, *Establishing Resolution Arrangements for Investment Banks*. Dated 29 July, the UK Government published a summary of consultation responses.

Dated 16 September, HM Treasury has now launched a further consultation on *Special Administration Regime for Investment Firms*. The proposed new special administration regime will provide administrators with clarity and direction to manage a firm's winding up in a way that is both less expensive and less disruptive. The new regime will include new special administration objectives that will ensure that administrators focus on:

- the return of client assets;
- engagement with market infrastructure bodies and the authorities; and
- maximising returns to creditors.

This will be carefully considered, in particular from a legal perspective, to see if its proposals in any way contradict the rights which repo creditors would expect to enjoy.

US tri-party: As mentioned in the Third Quarter Newsletter, on 17 May the Federal Reserve Bank of New York announced the publication of a White Paper on the work of the Tri-Party Repurchase Agreement (Repo) Infrastructure Reform Task Force. This White Paper highlights policy concerns over weaknesses in the infrastructure of the tri-party repo market. Dated 16 August, the NY Fed has issued a press release regarding the consequent, supportive responses – the comments focus on the following key themes:

- support for the Task Force's recommendations to improve operational effectiveness and significantly reduce the level of intraday credit provided by the clearing banks by introducing three-way, real-time trade confirmation; shifting settlement times; automating collateral substitution; and eliminating the clearing banks' daily unwind;
- support for the Task Force's recommendations to improve margining practices and increase transparency, although some comments cautioned that the recommendations could result in risk management behavior that might not be consistent with a counterparty's creditworthiness; and
- recognition that, despite these infrastructure improvements, the potential for a disorderly liquidation might still exist.

Trading review: Dated 25 August, the UK FSA released DP10/4: *The Prudential Regime for Trading Activities - a Fundamental Review*.

This DP sets out a number of recommendations which are grouped into three key areas:

- *Valuation:* The FSA recommends an increased regulatory focus on the valuation of traded positions and thinks there is a need for a specific assessment of valuation uncertainty.

- *Coverage, coherence and the capital framework:* The FSA recommends changing the structure of the capital framework to bring greater coherence and reduce the opportunities for structural arbitrage within the banking sector and the wider financial system.
- *Risk management and modelling:* The FSA recommends specific measures aimed at improving firms' risk management and modelling standards, and ensuring that these are aligned with regulatory objectives.

The ways in which this may impact on the repo market are being reviewed and considered.

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Review of the GMRA 2000

As reported some time ago, ICMA is currently coordinating a review of the Global Master Repurchase Agreement (GMRA), 2000 version. Whilst the GMRA responded well to the challenges of the financial crisis, in order to ensure that the agreement remains the leading market standard for documenting cross border repo transactions, ICMA's European Repo Committee put together a working group to consider whether any amendments are necessary.

In regular meetings over the last 12 months, the GMRA Review Working Group, which is made up of both market participants and legal practitioners, has discussed a variety of topics and shared a number of drafting ideas. The Group has considered lessons learned from the financial crisis, amendments made to other master agreements (eg the GMSLA), the feedback of GMRA users and the recommendations recently published by the European Financial Markets Lawyers Group (EFMLG). A lot of time has been invested in discussing issues at a conceptual and commercial level before moving onto drafting.

The aim is to publish the revised standard in time to incorporate it into the coverage of the 2011 ICMA GMRA legal opinions which will be made available to ICMA members in spring 2011.

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19th semi-annual survey of the European repo market

The latest ICMA-ERC repo survey, published in September, sets the baseline figure for market size at €6,979 billion. This represents an increase of 25% on the figure of €5,582 billion for the previous survey in December 2009. The size of the market is now larger than the previous highest figure of €6,775 billion recorded in June 2007 before the international financial crisis.

The results of the survey confirm the continuing recovery of the European repo market and the underlying trading activity that it supports. The survey is based on returns received from 57 offices of 52 financial groups, mostly banks, including most of the largest European repo market participants. The survey also confirms the broader underlying shift towards greater use of CCPs for repo business. Until recently, access to CCPs was largely restricted to repo business transacted on electronic trading systems. Over the past two years, however, the post-trade registration of transactions negotiated, not electronically, but directly with other parties or through voice-brokers, has become significant. In the latest survey, post-trade registration of direct or voice-brokered repos through CCPs reached 8.7%, which means that the total share of surveyed repo business (electronic and non-electronic) that was cleared across CCPs was 22.4%.

The next survey will take place in December. For more information, or to participate, contact: reposurvey@icmagroup.org

Securities lending guide for pension fund trustees

A group of the UK's leading financial trade associations, including ICMA, has recently published a range of educational materials, designed to enhance pension fund trustees' understanding of the securities lending market.

The documents include an introductory guide and checklist for investors contemplating starting securities lending programmes, as well as a disclosure code of guidance for securities lending agents.

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Review of the Prospectus Directive

The proposed amendments to the Prospectus Directive (Directive 2003/71/EC) voted by the European Parliament in June (and notified to the European Council) were described in the Third Quarter Newsletter (at page 19). The Parliament and Council published a revised version of the proposed amendments on 29 September, consisting mainly of minor changes.

The amendments are expected to be reviewed by the Council's Committee of Permanent Representatives before being submitted, as a formality, for final approval to one of the configurations of the full Council. Publication in the *Official Journal* is currently anticipated for the end of November or the start of December, with the amendment Directive coming into force 20 days later – the deadline for grandfathering of new issues in respect of the increase of the Transparency Directive's €50,000 thresholds to €100,000. Member States will then have up to 18 months to transpose the amendments into their national law, by which time it is anticipated that amendments to the PD Regulation (Regulation 2003/71/EC) will have been proposed by the Commission and adopted. ICMA submitted its views to the Commission in this respect in section 4 of its response to the Commission's consultation on the review of the Prospectus Directive in the first quarter of 2009.

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Bookbuilding and allocations

Following discussions with investors reported in the Third Quarter Newsletter (at pages 19 and 20), ICMA is elaborating an explanatory note for inclusion in the ICMA Primary Market Handbook that will seek to provide some practical information on pre-sounding, bookbuilding and allocation processes, as often used in the prevalent "pot" context of the European cross-border syndicated institutional primary debt markets.

As market practices are continually evolving and individual transactions are structured according to their specific circumstances, the note will not be intended to prescribe or endorse particular structures or practices. Rather, it will be a document designed both to enhance transparency for, and to serve as a helpful point of reference to bookrunners when explaining their working practices to, colleagues, issuers and investors. It will set out common practices relating to pre-sounding, bookbuilding and allocation – noting that some issuers, intermediaries and investors may find useful in the context of their participation in individual bond issuance transactions.

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UK Listing Authority

HM Treasury published in July a consultation on reforming the structure of financial regulation in the UK, notably proposing a reattribution of the various regulatory responsibilities currently held by the Financial Services Authority. ICMA has concerns regarding the proposal that the UK Listing Authority (UKLA) should be merged with the Financial Reporting Council as a first step towards creating a companies regulator under the Department of Business, Innovation and Skills, rather than remain within the Markets Division of the Consumer Protection and Markets Authority (CPMA). First, only 6% of securities admitted to listing by the UKLA are shares of UK companies, with the other 94% consisting largely of bonds issued by non-UK entities (including many which are not companies, but sovereigns, supra-nationals and agencies). Second, the UKLA's detailed, working level, knowledge of forthcoming new issuance is particularly relevant to other supervision functions (such as the monitoring of insider trading in existing related securities), which will be the responsibility of the CPMA. On the same basis, there is a strong risk that firms will face duplicate action by each of the two agencies. Finally, most of the material legislation used in daily practice by the UKLA is based on EU directives and regulations that are elaborated in conjunction with ESMA, on which UK representation will be the responsibility of the CPMA. ICMA is intending to submit a response to HM Treasury in this respect by the 18 October deadline. Individual firms submitting additional direct responses (particularly if citing material illustrating specific instances of how problems would arise) would help give HM Treasury a clearer view of the potential impact of the different possible approaches.

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Issuer Forum

The ICMA Issuer Forum met for the second time in September. One of the issues on the agenda concerned "bail-ins", involving possible haircuts being applied to senior debt. While many considerations need to be taken into account in this debate, it will be important also to keep in mind the marketability of senior bonds that would be subject to such a haircut, and the potential impact on credit ratings and on an investor base in bonds that is distinct from equity investors.

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MiFID review: implications for fixed income markets

The Third Quarter Newsletter commented on CESR's consultation on non-equities transparency – part of CESR's wider consultation on the imminent review of MIFID – and on the ICMA corporate bonds survey, on the basis of which ICMA responded to CESR.

Further consultations: On 29 July, CESR recommended amendments to MiFID to the European Commission. Drawing on this advice, and a draft report of the European Parliament, DG Markt is due to launch its own consultation. ICMA is planning to respond, in coordination with other associations.

Legislation: The Commission is expected to make a legislative proposal for amendments to MiFID in early 2011. Amendments to the Level 2 legislation, which includes much of the detail, will follow. It is not clear when new requirements will come into force.

The following issues in the discussion so far seem relevant to fixed income markets. ICMA's work is likely to focus around them.

Post-trade reporting: CESR proposes post-trade transparency requirements for a broad range of fixed income instruments – including corporate and public bonds, covered bonds, convertible and exchangeable bonds – which are the subject of a prospectus, including all those admitted to trading on Regulated Markets or MTFs. CESR foresees "significant change for the markets in question"; with the Commission's emphasis on market transparency, this may signal a change from EU authorities' previous policy not to use regulation to drive market change. It will be important to be alert to unintended consequences.

CESR acknowledges the need to protect liquidity provision, but rejects a limitation of scope of trade reporting based on illiquidity, arguing that an objective measure of liquidity is not available. Instead CESR proposes to calibrate reporting delays to protect liquidity. For trades above €5 million, only price, not value, would be reported at end of day. For smaller trades, price and value would be reported, in real time (up to 15 minutes' delay) for small trades, at end of day for large trades. The cut-off between small and large is proposed at €1 million for "public bonds", with the possibility of a smaller figure for corporates.

ICMA will need to gauge how the market might react to broad-scope post-trade transparency, and what measures may be needed to maintain liquidity and service provision. Is there a need to press for a limitation of scope to the most liquid bonds? How far can the publication delays and exemptions that CESR proposes obviate liquidity concerns? How far might CESR's proposed very short publication delays need to be extended? How should CESR's promised review of the regime after a year's operation be approached?

CESR proposes trade reporting requirements also for ABSs and CDOs subject to a prospectus or admitted to trading on Regulated Markets or MTFs. Unlike bonds, CESR recommends only end-of-day reporting, with no real-time reporting obligation. For clearing-eligible CDSs, requirements would vary for single name, index, and sovereign CDS trades. We aim to clarify that ABCP is not within the scope of post-trade reporting.

Pre-trade transparency: At this stage, CESR recommends no pre-trade transparency requirements for OTC fixed income markets, leaving these to the market. CESR does however suggest the possibility of national powers to introduce such requirements for particular markets. CESR proposes harmonised requirements on advertising trading interest in fixed income instruments on Regulated Markets and MTFs, taking account of differences between markets, and with waivers where appropriate: it will be important to ensure that harmonisation, and any national powers, do not cut across pre-trade arrangements currently tailored to users' needs.

Changes to equity trading transparency: Though the proposed non-equity regime is differentiated in many respects, CESR models aspects of it on the MIFID equity regime, some other elements of which may bear on future development of the fixed income regime. For equities, CESR proposes a tighter, more rule-based pre-trade transparency regime, controls (particularly on market share) over automated broker crossing systems, greater standardisation of trade reporting content, and the development of a European consolidated tape. It will be important to consider, in the light of the trend towards greater use of automated technology to trade bonds, especially government bonds, and the regulatory push towards tightening of regulation of automated trading mechanisms, and towards on-exchange trading of CDS, how increasing regulation may affect automated trading.

Transaction reporting to regulators: CESR proposes separate reporting of client facilitation transactions. It also proposes mandatory reporting of client/counterparty identifiers.

Underwriting and placing. CESR suggests MIFID rules on conflicts of interest where a firm acts on behalf of both issuer and investor. ICMA is seeking to influence and guide CESR's and the Commission's thinking in this area.

Client classification: CESR will advise the Commission on client categorisation, following its consultation. It will be important to ensure that any changes to the regulation of dealings in complex instruments between eligible counterparties maintain the efficiency of dealer markets, also taking account of any new restrictions on non-advised "execution only" trades in complex instruments.

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ICMA Secondary Market Rules and Recommendations: Usage Review

ICMA has sent an electronic survey to members asking about the extent to which ICMA's Secondary Market Rules and Recommendations are used in the market. The survey also asks for views on secondary bond market trading volumes.

The results of this survey will help us in two ways. First, feedback will allow ICMA to confirm the extent to which our Rules and Recommendations are used and govern market practice. Second, feedback may help to highlight those areas of the Rules and Recommendations that are in need of updating to ensure that they continue to be in accord with market practice. In the light of the feedback we receive, ICMA will consider whether the usage review should be conducted annually.

ICMA is conducting this survey as part of a review of the usage of both ICMA's Primary Market Handbook and Secondary Market Rules and Recommendations.

The deadline for completing the survey is 22 October.

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FAQ about ICMA's Secondary Market Rules and Recommendations

ICMA has recently included a list of 38 questions and their answers about its Secondary Market Rules and Recommendations (FAQ) on its website. The FAQ reflects the questions that ICMA members have most frequently raised with the Legal Helpdesk over past years. It is intended to serve ICMA's members as an initial, easily navigable and comprehensive reference guide in the context of their daily activities. The Legal Helpdesk welcomes suggestions on how the FAQ could be expanded further.

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Short selling

On 15 September, the European Commission published its much awaited proposed Regulation on Short Selling, accompanied by an in-depth (116 page) Impact Assessment, Summary Impact Assessment and FAQs. The Commission proposal sets out the following:

Transparency requirements for short positions in certain instruments: This broadly follows proposals set out in the Commission's June consultation (based on CESR's March Report) for a two-tier transparency model. Accordingly, a notification of a significant net short position is required to be made privately to the competent authority if a lower threshold is met, and if a higher threshold is met a public disclosure is required to be made to the market. The transparency regime requires notification and/or disclosure where a change in a net short position results in an increase or decrease above or below the thresholds.

The transparency requirements will apply to significant positions relating to EU shares and EU sovereign debt and significant credit default swap positions relating to EU sovereign debt issuers. Also covered are short positions created by trading of shares or sovereign debt on both trading venues (defined as a Regulated Market or MTF in the EU) and OTC as well as economic net short positions created by the use of derivatives such as options, futures, contracts for differences and spread bets relating to shares or sovereign debt.

Shares: The threshold for a private notification to the competent authority in respect of net short positions in shares is 0.2% of the value of the issued share capital of the company and each 0.1% above that. The threshold for disclosure to the market in respect of net short positions is 0.5% of the value of the issued share capital and each 0.1% above that.

EU sovereign debt: The proposed Regulation applies to EU sovereign debt, which includes debt issued by the EU and Member States, including any ministry, department, central bank, agency or instrumentality that issues debt on behalf of a Member State. It does not include regional bodies or quasi public bodies that issue debt. Only a private notification to regulators is required in respect of significant net short positions relating to EU sovereign debt. Thresholds have not been specified in the proposed Regulation, though the Commission will, by means of delegated acts, specify the thresholds. In doing so, the Commission will take into account the total value of outstanding issued sovereign debt for each Member State and the EU and the average size of positions held by market participants.

Credit default swaps (CDS): The proposed Regulation applies to uncovered positions in CDS relating to an obligation of a Member State or the EU. As with EU sovereign debt, thresholds for private notification to the competent authority have not been specified and the Commission will, by means of delegated acts, specify thresholds.

Timing: Net short positions will have to be calculated at 12:00 pm on the trading day on which the person has the position. The notification or disclosure is to be made no later than 3:30 pm on the next trading day.

Marking of short orders: Trading venues will have to establish a mechanism for the marking of short orders for shares. Accordingly, a trading venue is required to mark or flag sell orders executed on that trading venue as a "short order" where the seller is entering into a short sale of shares. Such a requirement would provide additional information about volumes of short sales executed on the trading venue. Trading venues are also required to publish daily information about volumes of short sales executed on the venue.

Uncovered short sales: Persons entering into a short sale of shares or sovereign debt must, at the time of the sale, have: (1) borrowed the instrument; (2) entered into an agreement to borrow the instrument; or (3) made other arrangements which ensure that the security can be borrowed so that settlement can be effected when it is due. The Commission is given the power to adopt further standards about the agreements to borrow and other arrangements that will be acceptable under this requirement. In this regard, ESMA is required to submit draft implementing technical standards by 1 January 2012 at the latest. Notably, Article 12(2) of the proposed Regulation provides: "The Commission shall in particular take into account the need to preserve liquidity of markets especially sovereign bond market and sovereign bond repurchase markets (repo markets)."

Additionally, trading venues must ensure that there are adequate arrangements in place for the buy-in of shares or sovereign debt where there is a failure to settle. Moreover, in the case of non-settlement, daily penalties must be imposed. The quantum of the daily penalties is not set out, though the proposed Regulation sets out that they should be sufficiently high not to allow the seller to make a profit from the settlement failure yet act as a deterrent to persons failing to settle. Trading venues must also have rules to prohibit persons from entering into further short sales of shares or sovereign debt while that person has an outstanding fail resulting from a short sale.

The Commission will also look at the issue of harmonisation of settlement periods in the EU in the context of other initiatives such as the forthcoming Directive on legal certainty of securities holding and transactions.

Exemptions: Three exemptions are included in the proposal. First, an exemption is provided for shares of a company where the principal market for the shares is outside the EU.

A second exemption will apply to market making activities, though proprietary trading will not be included within this exemption. The exemption will apply to an investment firm (or third country equivalent) when it deals as principal in a financial instrument, whether traded on or outside a trading venue, in either or both the following capacities:

- by posting firm, simultaneous two-way quotes of comparable size and at competitive prices, with the result of providing liquidity on a regular and ongoing basis to the market;
- as part of its usual business, by fulfilling orders initiated by clients or in response to clients' requests to trade, and by hedging positions arising out of those dealings.

Finally, an exemption is provided for primary market operations performed by dealers to assist sovereign debt issuers for the purposes of stabilisation schemes under the Market Abuse Directive.

Emergency measures: Competent authorities have been given temporary, emergency, powers to require further transparency or impose restrictions on short selling and CDS transactions or limit persons from entering into derivative transactions. These powers extend to a wide range of instruments. However, these powers will be temporary (usually for up to a three month period) to the extent necessary to deal with the exceptional situation though such measures could be extended for further periods if the conditions for use are complied with. ESMA has been given a key co-ordination role in situations where an emergency extends beyond one Member State or has other cross border implications. ESMA has also been tasked with ensuring that emergency action is only taken where it is necessary and proportionate to do so.

Powers and sanctions: Competent authorities have been given powers to access documents, obtain information and take enforcement action.

The draft Regulation now passes to the European Parliament and the Council for adoption. Once adopted, the Regulation would apply from 1 July 2012.

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European EDGAR

In July, CESR published a Consultation Paper on *Development of Pan-European Access to Financial Information Disclosed by Listed Companies*. The paper notes that three years after the implementation of the Transparency Directive (TD) all Member States have set up an Officially Appointed Mechanism for the central storage of regulated information (OAM). However, the way that national OAMs operate (ie type of operator, business model, etc) varies significantly across Member States. CESR has also set up an initial network of OAMs based on CESR's MiFID database of shares admitted to trading on EU Regulated Markets.

Neither the Commission nor CESR feel that CESR's network of OAMs is satisfactory or adequate and development of a pan-European OAM network has been slow. Moreover, the national OAMs lack visibility – they are not well known and are seldom used as a primary source of information for company information. It is difficult for investors to carry out cross-border searches of OAMs. Language is also problematic, though CESR feels that the current TD language regime should be maintained – EU issuers should not be required to disclose regulated information in English. However, CESR hopes that as the pan-European OAM network gains greater visibility, issuers may be incentivised to disclose information in more than one language.

CESR sees benefits to establishing an integrated pan-European OAM network and is considering two options:

Option one would build on the current system – issuers would continue to file regulated information with their national OAMs while investors would access regulated information from a pan-European Central Access Point (CAP). Development of the network would be carried out in three steps. Step one would expand CESR's MiFID database of share issuers to include issuers of all securities and their respective OAMs. Step two would enhance the search facilities at the CAP level by storing more metadata on issuers. Step three would allow investors to view information from multiple jurisdictions in a single search. This would require the development of common technical standards by CESR members and OAMs. It is envisaged that this approach would be implemented through a minimum harmonisation approach to allow national OAMs to provide additional services if so desired.

Option two would establish a new single pan-European OAM. Issuers of all securities admitted to trading on an EU regulated market would have to file regulated information with the European OAM (operated by ESMA or another entity). A single European OAM would allow more flexible development of the OAM network, as coordination amongst the Member States would not be required. However, investments that have already been made to establish existing OAMs would partially be wasted though national OAMs could still provide additional services to investors based on data feeds from the single European OAM.

CESR's preference is option one as national OAMs would support the supervision of regulated information in the home Member State. CESR members have also expressed a preference for a CAP to be operated by CESR, which would mean that the implementation of step three would probably require external funding by the EU. Such a network would complement the existing sources of regulated information and would not compete with national OAMs (for example by selling newsfeeds).

The deadline for responses was 24 September. ICMA's response to this consultation can be found here.

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Alternative Investment Fund Managers Directive

Alternative Investment Management Association

Andrew Baker

The process by which European Union lawmakers will pass the draft Alternative Investment Fund Managers Directive (AIFMD), a major piece of legislation affecting hedge fund managers and other sectors of the alternative investment fund industry, has entered a critical phase. Negotiating teams which have worked in parallel on the draft legislation – the European Parliament and the Council of the European Union – have been meeting regularly in Brussels to agree on a final text on which to vote. Although the process has been the subject of many delays, postponements and false dawns, it remains the case that agreement could come very soon.

These "trialogue" discussions between the Parliament and Council are being overseen by the European Commission, which originally proposed the legislation in April 2009.

Although the draft Directive has subsequently gone through a number of iterations, essentially the main concerns of the industry relate to the following:

- *Proportionate regulation:* The purpose of the Directive is to address "systemic risk" yet all significant analysis, including the de Larosière Report to the Commission, has found that the hedge fund industry neither caused the financial crisis nor played a significant role in it; good regulation needs to be introduced proportionately, supported by evidence of market failure, rather than on the basis of myths and misconceptions.
- *Conflict with existing EU financial services legislation:* Hedge fund managers are already subject to regulation under a number of existing EU financial services legislative measures, including MiFID, the Capital Requirements Directive, the Market Abuse Directive, and the Transparency and Prospectus Directives. The current text of the AIFM Directive overlaps with, or conflicts with, much of this, requiring the deletion and revision of large parts of the present text and/or revision of the above Directives.
- *Policy coordination:* There should be more coordination with the G20 Global Plan for Recovery and Reform, as an EU-only solution risks being detrimental to investors and managers in the EU.
- *Disclosure of systemically relevant information:* There is a real risk that regulators could be overwhelmed by a mass of data of little or no relevance for the purposes of maintaining the build-up of systemic risks. Whilst we would support regulation of all AIFMs (with no set thresholds), requiring comprehensive data only from AIFMs managing in excess of €1 billion would be a more proportionate and effective means of meeting the Commission's stated purpose.
- *Third country marketing provisions are protectionist and unworkable:* There is a danger that non-EU funds could be prevented from being marketed to EU professional investors by non-EU managers by the imposition of conditions which non-EU managers would find difficult or prohibitive to comply with (and so making it impossible to obtain authorisation); such a protectionist measure would run obvious risks of retaliatory measures being taken against EU managers wishing to market outside the EU.
- *Reduction of choice and diminishing returns for EU investors:* There is a possibility that EU based investors – including institutional investors, pension funds, endowments and insurance companies who invest on behalf of millions of EU savers – would not be able to access funds domiciled in, or managed from, outside the EU. This would deny EU investors access to up to 90% to 95% of the eligible universe of funds in which they currently invest. This reduction of investor

Alternative Investment Fund Managers Directive – continued

choice would have a detrimental effect on consumers as it would seriously impact portfolio diversification and hence, potentially, the returns on pensions, savings and other financial products. AIMA estimates that the denial of access to non-UCITS funds as part of a European pension portfolio and the implicit cost related to the draft Directive could cost the industry up to €25 billion per annum in lost investment performance.

Directive revisions: Notwithstanding the above issues, many of the goals of the AIFMD are laudable. It is desirable, for example, to create appropriate European structures for the registration and authorisation of hedge fund managers. Moreover, the reporting by those managers of systemically-relevant information will enable supervisors and macro-prudential authorities to better tackle systemic risk. And establishing a "passport" for managers to market funds to specified investors within the EU could in theory be a welcome and positive step, creating what would be a European single market for alternative funds.

However, when the first draft of the AIFMD was published, it quickly became clear that it contained some important flaws. We were far from being alone in thinking along such lines. Those quoted expressing concern or reported as doing so included pension funds and pension fund industry groups, other European institutional investors, global custodial banks, prime brokers, administrators, international law firms, commercial real estate groups, private equity, government ministers, the chair of the European Parliament's ECON committee Sharon Bowles, the US Treasury, the UK Conservative party, the Mayor of London Boris Johnson, the German Funds association, *The Financial Times* and *The Economist*, and heavyweight European figures like Jacques de Larosière and Charles McCreevy. It amounted to an impressive coalition against the early drafts of the AIFMD.

It is vital that the parties in the trialogues are able to agree on a proportionate, sensible and workable final outcome. While those meetings continue, we continue to devote all of our efforts to support the work of the participants in the discussions. We have been undertaking this through our contacts with the Council Presidency, Commission, Parliament and our regular visits to Brussels, as well as meetings with senior representatives of EU member states. The Belgian Presidency of the Council is backed by a capable team and is doing a good job of reconciling the competing interests.

In summing up, let us be clear that we are not supporters of the pre-crisis *status quo*. We share the concern of international policymakers that insufficient information existed about the build-up of systemic risks in financial markets. Our response, on behalf of the industry, was to offer our full co-operation in contributing to structures that would supply them with the timely, relevant information which they need to assess financial stability issues. We have been working with national and supranational authorities to develop a supervisory framework, and all the effort will have been worthwhile if it creates a structure that enables the authorities to better manage systemic risk and to avoid market disruption.

The stakes, after all, are high. The European hedge fund industry has more than €250 billion of assets under management within the EU, employs about 50,000 people directly and indirectly, and generates tax revenues of an estimated €4 billion a year. The great majority of the money invested with hedge funds comes not from wealthy individuals these days but from institutional investors, including pension and insurance funds investing on behalf of EU citizens.

We have always said that we would welcome a Directive which would see appropriate and proportionate regulation of alternative investment fund managers and which would provide national regulators with the information they need to monitor financial stability effectively within their markets, while allowing Europe to maintain its position as an attractive place in which to do business and increasing investor protection. Those have been our aspirations since day one of this process, and even while the text of the draft Directive may have changed, they remain our firm position.

Andrew Baker, Chief Executive Officer,
Alternative Investment Management Association

Covered bonds

Following publication by the Bank of England in late July of a Market Notice (see the ECP Market Section above), Covered Bond Investor Council (CBIC) members had a meeting with the Bank of England to explain that covered bonds were a quality instrument, and to express concern that asking to expand requirements for both covered bonds and ABS would have an adverse impact on the reputation for high quality that the covered bond product currently has in the market.

In the same vein, HM Treasury and the Department of Business, Innovation and Skills published a Green Paper entitled Financing a Private Sector Recovery in which the definition of covered bonds and the quality of the cover pool may be diluted. The CBIC promotes the view that covered bond pools should be "clean" and should consist only of specific types of loan. The CBIC believes that SME loans do not belong in the covered bond cover pools. High quality cover pools of covered bonds should only include tangible assets with a long historical track record and/or public loans. This is considered one of the essential cornerstones of the future of a sound European covered bond market. Covered bond pools should primarily be composed of strong prime mortgages and some public loans. Likewise it is important for the CBIC that covered bonds are not confused with ABS. The two asset classes attract different types of investors and, by lowering the quality of the cover pool and therefore blurring the distinction between the two asset classes, there is a risk that UK banks' accessibility to term funding may be weakened.

All the events and latest news from the CBIC are available on its dedicated webpage.

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Corporate governance

The ICMA Asset Management and Investors Council (AMIC) responded to the European Commission Green Paper on *Corporate Governance in Financial Institutions and Remuneration Policies*. The AMIC explained that the Green Paper's broad approach of considering the financial services industry as a whole was not appropriate. Instead, the asset management industry should be differentiated from the banking industry as asset managers are responsible for their clients' assets and have a fiduciary duty as agents. Institutional investors have been criticised for not exercising their responsibilities as shareholders and failing to hold boards to account for their activities. Regulators are calling upon institutional investors to be more proactive in participating in the management of companies.

The AMIC focused on two main aspects of the consultation, namely shareholder engagement and remuneration policy.

The AMIC believes that good corporate governance does not necessarily imply activism, and no proposal should encourage the buy side to be activist. The AMIC welcomes efforts that have been made to improve corporate governance standards through market-led initiatives such as the UK FRC Stewardship Code. Legislative proposals would in effect turn the shareholders' right to direct their company's management into an obligation to do so, for the common good. Asset managers have clients worldwide, all subject to different sets of rules. The AMIC believes that it is good practice to be transparent (and publish voting records, for instance) and to ensure that clients are made aware of certain issues to be voted on. Moreover, no asset manager has the resources to vote on all issues of every company its clients hold a stake in. Therefore it is important to emphasise the costs that active engagement entails – costs that would inevitably be passed onto the ultimate asset owners in the form of higher fees, raising again the question of whether some principals would accept the extra charges, especially if they did not intend to exercise their rights to vote.

In the context of remuneration policies, taking a broad approach to financial services can also prove problematic. The industry represented by the AMIC has, as mentioned previously, a fiduciary duty towards its clients. The way asset managers are compensated therefore is aligned with clients' interests and their longer-term time-horizons: asset management is a multi-year business rather than a transactional business and remuneration arrangements already reflect this, with variable pay being based on a multi-year performance rather than a one-year record of transaction-driven profits. As a result, the time period on which an asset manager's performance is based is more likely to be of 2-3 years. In the UK, the FSA has published a consultation on revising the Remuneration Code (FSA CP 10/19). The AMIC has responded to this consultation as well.

The results of the public consultation should be made available in the autumn this year. The Commission will decide in the first quarter of 2011 on the need for any non-legislative and legislative proposals regarding corporate governance in financial institutions. Moreover, the Commission considers that issues relating to corporate governance of listed companies more generally also deserve to be addressed and has started work to this end. A further Green Paper is expected in the autumn.

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Valuation of assets

The AMIC effectively created a Valuation of Assets Working Group at its June meeting. The issue of valuation has been discussed for a year and a half within the Council. It was decided that a set of principles focusing on governance arrangements surrounding valuation models will be drafted by the Working Group. KPMG is supporting the work of the Working Group. In the first instance, the Working Group will be responding to the IOSCO Technical Committee's Standing Committee on the regulation of market intermediaries, which has published a consultation report on *Intermediary Internal Controls Associated with Price Verification of Structured Finance Products and Regulatory Approaches to Liquidity Risk Management.*

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AMIC: recent and forthcoming events

6 July 2010: CBIC meeting at the ECB

The ECB organised a meeting with covered bond market participants in the ECB's offices. Participants discussed the main challenges and the current market initiatives in the covered bond market.

12 July: EC 2nd meeting on shareholder engagement

This meeting was a follow-up to the informal meeting on shareholder engagement which was organised on 2 February 2010, and discussed the questions raised in the Green Paper on corporate governance with regard to shareholders. The meeting also considered reflections on corporate governance in listed companies (paper expected early 2011).

14 July: AMIC meeting with Peter Montagnon (Financial Reporting Council)

The meeting considered the FRC Stewardship Code and its implementation.

3 August: CBIC meeting with Bank of England

The Bank of England released a statement about expanding eligible collateral in the discount window facility and information transparency for ABS. CBIC members discussed the implications of the market notice on the UK covered bond market.

18 August: Valuation of Assets Working Group meeting with KPMG

26 August: Buy-side associations meeting

Representatives of buy-side associations met in London discussed their current priorities (MiFID, corporate governance, AIFM Directive, money market funds, pensions).

27 September: AMIC meeting in Luxembourg

27 September: AMIC dinner hosted by the EIB

30 September: Meeting with Dan Waters and Tony Hanlon of the FSA

October: Private Banking Working Group (Liechtenstein)

October: ECBC technical issues group meeting

CBIC members are invited to participate in the meeting and discuss disclosure requirements with covered bonds issuers.

October: AMIC meeting with the Financial Reporting Council

December: AMIC meeting to be held at ICMA's offices in London

Representatives of HM Treasury will be joining the meeting.

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Personal view: Market trading infrastructure and regulation: the interface *by Richard Britton*

In 2000 ICMA built and launched an exchange for Eurobonds called Coredeal. At that time there was great enthusiasm for the concept of multilateral trading platforms in which dealers would quote bids and offers in a wide range of bonds and, depending on the business model, other dealers (as in the case of Coredeal) or institutional investors would lift or hit the quotes. It had worked in the trading of domestic sovereign debt on one dominant platform; although as rapidly became apparent, the collective power of a number of euro zone sovereign debt managers to compel their primary dealers to trade electronically, and on one particular platform, played a significant part in its success. Elsewhere the enthusiasm was short lived. Several systems closed or scaled back their aspirations and became niche players. ICMA sold Coredeal in 2002. The moment for multilateral platforms had passed. ICMA made a little money out of Coredeal; most other platform builders and operators lost significant sums. Since then successful platforms have been bilateral dealer client systems and request for quote systems. But success is a relative term; volume as a percentage of the total corporate market turnover remains small.

Why the failure? In my view it has its roots in the basic illiquidity of the corporate bond market and the "buy and hold" approach of most investors, institutional as well as retail. This puts a premium on the knowledge of the lead manager as to who owns what, and whether they are potential buyers or sellers. Exploiting that knowledge to assist clients to execute orders in the secondary market can be very profitable. But it requires one to one interaction. Multilateral platforms have been unable to replicate this. Furthermore, whether a system posts firm dealer quotes or institutional limit orders, the poster is exposed to the risk of being hit by more knowledgeable counterparties (the "free option" problem).

A decade later will it be different?

As for the market, despite record volumes in the primary market, dealers' commitment to making firm prices in the secondary market remains patchy. This is despite the fact that the market infrastructure is essentially unchanged from 2006/07. There is no real-time trade feed. This contrasts with the US where the TRACE-provided trade transparency is said to be responsible for an increase in "worked" orders and a decline in capital commitment and immediate execution by dealers. Quotes, especially in size, are only firm when requested by a client. This is perhaps why the specialised brokerage model is beginning to gain traction in the European bond market – and not just for searching out and placing obscure issues. In this environment could a simple Limit Order Book (which in an illiquid market seems likely to be little more than a "bulletin board") generate significant activity, particularly if the order book was provided almost entirely by investors with little or no dealer participation?

As for regulation, as late as 2007 when MiFID was introduced, legislators and regulators were prepared to accept the analysis of ICMA that bond markets are different from equity markets and that the practical needs of European corporate issuers and investors as expressed in their own decisions should take precedence over essentially intellectual and philosophical concepts such as the benefits of centralised order flow and the need to secure "equality" of access to information for all market participants by mandating "full" transparency. MiFID as it currently stands embodies that understanding.

The results of the MIFID review may be very different. In 2010 European regulators are showing little hesitation in using regulation to change market structures and commercial incentives. Just as was the case of the US SEC in 1998, when it instructed the industry to develop TRACE, they now have a strong view of the benefits of direct regulatory intervention and seem prepared to live with any unintended consequences. And a TRACE-like system is where Europe appears to be headed if CESR has its way.

A straw in the wind is that more European exchanges are offering electronic bond trading. The London Stock Exchange (LSE) launched a retail platform for sterling bonds in February of this year; NYSE Euronext recently announced what it describes as "the first pan-European multilateral trading facility for corporate bonds". It will apparently be a traditional Limit Order Book on the equity market model. The exchanges' European trade association, FESE, is arguing strongly for mandatory pre- and post-trade transparency regimes to be applied to all bond types, not only corporate bonds. Its argument is that improved transparency will lead to lower bid/offer spreads and professional and retail investors will benefit from better prices and better execution.

You, the reader, will have your views. In my view a last trade tape will probably not further damage the secondary market as it is today, although it will not encourage the reintroduction of dealer capital. The US corporate bond market did not grind to a halt when TRACE arrived, although fund managers reportedly found it took much longer to get large orders filled. More disturbing is the current regulatory pressure to bring

Personal view: Market trading infrastructure and regulation: the interface by Richard Britton – continued

more equity dealers into the net of compulsory market making or "systematic internalisation" and to mandate minimum trade sizes and possibly spreads. The current position was a vigorously negotiated compromise between the dealing community and the legislators. Only 10 equity dealers in all of Europe have elected to be systematic internalisers; and according to CESR some of those obey the letter but not the spirit of the law by quoting a one sided price in one share! This practice is, frankly, provocative. Even in the old days in the US, when NASDAQ was a simple OTC market, dealers posted two way prices in at least 100 shares.

But the example of the UK equity market post Big Bang (1986) is cautionary. On its SEAQ system the LSE mandated firm quotes in large size by competing identified dealers. The major houses all participated – with varying degrees of success. But in less than a decade it had largely been replaced by a limit order book. It was not adopted elsewhere. Indeed, as one commentator at the time observed, "SEAQ was so successful that no other exchange adopted it". Mandatory market making, if the obligations are to meaningful, does not work.

Furthermore, joining the LSE as a dealer was a voluntary act. In my view it would be quite wrong for the EU to direct a private sector firm to use its shareholders capital in a particular way, such as by requiring a dealer to buy securities from or sell securities to a client or an anonymous counterparty. And it would be particularly offensive if the regulator was to seek to determine the price and size of such transactions (eg by delineating the maximum size of spread and the minimum amount to be traded at the price). That would be a very different economy from the one we have at present. On the other hand, a government can legitimately provide incentives to get firms to act in ways it deems bring social benefits – such as via the tax system. It can even use markets to do this. Emissions trading, (cap and trade), is a good example.

Whichever tactics are employed by Europe's legislators, if the argument that "bond markets are different" is no longer persuasive, do not be surprised if trading bonds will look very different in a few years time.

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Regulation of the market infrastructure

Expert Group on Market Infrastructures

In the Third Quarter Newsletter we reported on the European Commission services' intention to set up an Expert Group on Market Infrastructures (EGMI) – to contribute to the development of an efficient, safe and sound European post-trade market. Following from its call for expressions of interest, the Commission has published a list of the selected members – this Group brings together high-level experts in post-trade issues with proven and recent experience.

The EGMI's inaugural meeting, the agenda for which centred around discussion of the Group's role and future work, was held on 16 September. Members agreed to give further input on the following subjects for discussion within the group: CCP; collateral; insolvency; competition; transparency; business risk; fragmentation/regulatory arbitrage/internalisation; cost/inefficiencies; choice of infrastructures; and CSDs. The next meeting is on 25 November.

European Market Infrastructure Regulation

In the Third Quarter Newsletter we highlighted the main issues included in the Commission's *Public Consultation on Derivatives and Market Infrastructures*. On 5 July, ICMA participated in a closed roundtable meeting with the Commission, organized on behalf of the European Financial Markets Federation (EFMF) under the auspices of CEPS. In addition to the invitation made to EFMF members, invitations were extended to a small number of market infrastructure experts from firms and to European Capital Markets Institute (ECMI) members. The Commission was represented by Patrick Pearson (Head of Unit - Market Infrastructure) and Fabrizio Planta (who works with him). This meeting was arranged to provide the opportunity of direct, frank discussion of the above consultation with the Commission, in a neutral and independent venue. The discussion ranged across many aspects of the proposal and was found beneficial by those involved.

Thereafter, ICMA's European Repo Council (ERC) submitted a written response concerning the repo-oriented aspects of this consultation. Particular points made related to CCPs and interoperability; and a copy of the 13 July ERC White Paper was appended for consideration.

Subsequently published on 15 September, the Commission's European Market Infrastructure Regulation (EMIR) proposal is a Regulation (ie directly applicable across the EU without the need for transposition by Member States) on *OTC Derivatives, Central Counterparties and Trade Repositories*. The proposed scope of the Regulation is wide and lays down uniform requirements covering financial counterparties, non-financial counterparties (where exceeding certain thresholds) and all categories of OTC derivatives contracts. Its prudential parts apply to central counterparties as a result of the clearing obligation and, for the reporting requirement, to trade repositories. It is important to note, however, that the authorisation and supervision requirements for CCPs apply irrespective of the financial instrument the CCPs clear: OTC or other. Exemptions are explicitly foreseen for the members of the ESCB; public bodies charged with or intervening in the management of the public debt; and multilateral development banks.

The proposal now passes to the Council and the European Parliament, to follow the standard co-decision procedure. The aim is that, in line with G20 commitments, the new rules should be fully in place and operational by the end of 2012.

Proposal for a Securities Law Directive

As previously reported in the Third Quarter Newsletter, the Commission is preparing a proposal for a Securities Law Directive (SLD). The timetable for this work has moved back a little, with the Commission now anticipating issuance of its proposals later this year. The SLD will deal with legal certainty of securities holding and disposition, building on the conclusion of the Geneva Securities Convention last year. A second public consultation is planned, to request stakeholders' views on a set of detailed legal rules, whereas the 2009 consultation was held on the basis of principles.

Settlement legislation

It is also anticipated that the Commission will separately propose provisions for a more formal legal framework for the carrying on of settlement activities in the EU (as this is not encompassed by the EMIR proposal). This is expected to consist of requirements for the authorisation and conduct of settlement activities, akin to those for clearing activities that are envisioned in EMIR but tailored to accommodate the specificities of (I)CSD business.

TARGET2-Securities (T2S)

In late July a new issue of *T2S OnLine* was published by the ECB. In brief, this provides the following project status update:

- *Framework Agreement (FA):* After intensive negotiation with the CSDs, the T2S Programme Board has prepared a first draft of the FA, the contract regulating the relationship between the Eurosystem and the CSDs. The Eurosystem intends to finalise the FA by early next year and to sign it with participating CSDs in the second quarter of 2011.
- *Currency Participation Agreement (CPA):* The CPA will govern the relationship between the Eurosystem and the non-euro area central banks that will allow settlement of securities transactions in their currencies in T2S. An ad hoc task force has recently been set up to negotiate the text of the CPA, which is expected to be finalised by early 2011.
- *Future governance:* The T2S Programme Board has continued its extensive debate with the market about the future T2S governance arrangements, which will enter into force after the signature of the FA and the CPA; and will be valid for both the remainder of the development phase and the operational phase. In short, it is anticipated that the Advisory Group will continue to exist as a forum involving all stakeholders, and that CSDs and non-euro area central banks will be represented by a CSD Steering Group and a Foreign Currency Steering Group respectively, through which they will be able to have an appropriate level of influence on the T2S programme. The management of the project will rest with the T2S Board, the successor of the T2S Programme Board.
- *Financial dossier:* Following the June meeting of the Advisory Group, the T2S Programme Board adapted its proposal for the pricing structure, based on the amount of IT processing capacity required by each service, in response to the market's request for a simpler tariff structure. As a result, instead of being priced separately, several items will be included in the general settlement fee charged for each transaction. A complete financial dossier should be ready in the autumn for market review (see also T2S pricing taking shape).
- *Technical documentation:* Work on the T2S technical documentation by the 4CB and ECB teams has progressed substantially over the last few months. In its May meeting, the T2S Programme Board approved

version 4.0 of the *T2S General Functional Specifications* (GFS). The document is based on version 5.0 of the *T2S User Requirements Document* (URD). The GFS provide a comprehensive description of the functional design of the T2S platform and will also form the basis for the development of further technical documentation, such as the User Detailed Functional Specifications (UDFS), which will be published in the first half of 2011.

- *Network issues:* Significant progress has been made in this field since April, when the Governing Council decided that connectivity to T2S shall be provided by up to three competing network providers. The selection criteria are currently being defined in consultation with the market. The Eurosystem will then launch a formal tender in the autumn, aiming to select the T2S network providers in the last quarter of 2011.

Besides an editorial – *T2S Governance: Finding the Right Path* – and the above T2S Project Update, the other items in this quarterly issue of T2S OnLine are:

- an article by Mehdi Manaa (in charge of T2S product management), on the GFS, the latest version of which was approved ahead of schedule by the T2S Programme Board in May;
- a double interview with Göran Fors and Henry Raschen (Chairs of the National User Groups in Sweden and the UK respectively), with a focus on issues relating to participation of non-euro area markets in T2S;
- a forward-looking view from Marc Bayle (T2S Programme Manager), on the future selection of T2S network providers; and
- a presentation of the CSD Contact Group.

The Advisory Group (AG), which is an advisory body that reports directly to the ECB's decision-making bodies on the T2S project, met on 7-8 September for its latest progress review (and next meets on 6-7 December). The most recent T2S info session was in Dublin on 8 October.

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Towards a more resilient and safer securitisation market[3]

A well functioning and properly supervised securitised market is essential to efficient and resilient financial markets. Risks inherent in the securitisation market leading up to the severe failures we experienced some 3 years ago are being addressed by regulators in consultation with the industry. It will take time and money to implement regulatory changes and transitional arrangements are important in this respect.

Indeed the critical issue for a revival of the securitisation market is to deal with investors' perceptions and confidence in the market. Signals by regulators that structured products have sound structures when headline risks are properly managed are most important.

An overall coordination through a dialogue between regulatory authorities both at the European level and at a global level is decisive given the global nature of the securitisation market. There needs to be coordination between securities regulators, prudential supervisors and accounting standard setters so that a change in one area does not have an unintended consequence in another. It is important that regulatory convergence on issues like retention of economic interest and standardisation of disclosure is put in place. Implementation may be tailored to the peculiarities of the local market, but mutual recognition or equivalence between jurisdictions needs to be considered. Indeed, without convergence of regulation, cross-border capital flows may be constrained and opportunities for regulatory arbitrage may emerge.

In conclusion, new regulatory initiatives which are underway are necessary to restore investor trust and confidence in the securitisation market. It is also one important element of the reform agenda leading to the reduction of systemic risk. At the same time an extensive dialogue between the industry and regulators is also central to avoid any unintended consequences which could repress the securitisation market recovery. If designed properly, all market participants and the whole economy will benefit from the enhanced regulatory framework. This is an important objective we all share.

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3. Contribution to Eurofi Newsletter

Electronic trade confirmations

A letter has been sent to the Autorité des Marchés Financiers by René Karsenti, President of ICMA and Chairman of the AMTE Council, and Patrice Brault, Chairman of the AMTE Electronic Trade Confirmation Working Group. The Working Group is seeking to put in place industry best practice for OTC securities trade confirmations. The Working Group strongly believes that the use of electronic and standardised messaging should be extended to all OTC securities transactions, except when the administrative burden imposed by such a system is unacceptable (eg for some low volume users).

An addition relating to electronic trade confirmations has been made to ICMA's Secondary Market Rules and Recommendations.

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ICMA events

ICMA Networking Reception, Paris, 20 October

ICMA and the Chairman and Committee of its French Region are holding an evening reception for financial market participants at Cercle National des Armées on Wednesday 20 October.

The occasion will provide an opportunity to meet ICMA's newly constituted committee for the Paris and Monaco Region and to introduce the work of ICMA at a point in time when new regulation is shaping the financial markets of the future and when France is playing an increasingly important role in this process.

European Repo Council Meeting, Amsterdam, 27 October

The next meeting of the ICMA European Repo Council will be held on Wednesday 27 October in the margins of the SIBOS conference in Amsterdam. The meeting agenda includes a keynote speech on regulatory and market infrastructure developments from Patrick Pearson, Head of Financial Markets Infrastructure Unit (Unit G2) of the European Commission's Internal Market Directorate. There will also be updates on the legal framework and other regulatory issues affecting the repo market. The event is open to the wider repo community outside the membership of the ERC but pre-registration is essential.

ICMA MiFID Conference, Milan, 4 November

In association with Banca IMI and ASSIOM FOREX

ICMA is presenting a half day conference on the MIFD review in Milan on 4 November to update its members, and other interested parties, on progress with the review and its impact on the business of capital market participants in Europe. The conference features presentations from policy experts, market participants and regulators and from ICMA and the International Swaps and Derivatives Association (ISDA) on the implications of the review for fixed income and derivatives markets.

An expert panel will consider changes to the balance of liquidity and transparency in light of changes to the transparency regime for both equity and non-equity instruments under MiFID. Changes to secondary market infrastructure driven by impending regulatory change will feature in a second expert panel.

Training seminar on Commodities – trading and investment strategies, Istanbul, 9 November

In association with TSPAKB - Association of Capital Market Intermediary Institutions of Turkey

In partnership with TSPAKB ICMA is delivering a series of workshops designed to foster exchange of information between the Turkish market and the international market. This follows an earlier workshop on the corporate bond market.

Understanding the Primary Market Handbook, London, 25 November

ICMA's Primary Market Handbook (IPMA Handbook) contains recommendations on best practice for the issuance of international debt and debt-related instruments. This half day session will give an overview of the scope and application of the recommendations, including which securities and transactions are covered by them, and will also review recent developments and changes.

4th ICMA Primary Market Forum, London, 30 November

ICMA's 2010 Primary Market Forum will be held on the afternoon of 30 November in London's Canary Wharf, with panels covering bail-ins, recent regulatory developments (notably the forthcoming amendments to the Prospectus Directive) and the general market outlook into 2011.

GMRA/GMSLA Workshop, London, 1-3 December

In response to demand following the September workshop, ICMA and the International Securities Lending Association (ISLA) are holding a further joint workshop on the Global Master Repurchase Agreement (GMRA) and the Global Master Securities Lending Agreement (GMSLA) on 1-3 December. The two separate Master Agreements are the essential legal underpinnings for repo and securities lending markets respectively. The Workshop includes a detailed review of both legal agreements and their application, together with case studies, the operational and basic legal characteristics of the repo and securities lending markets will also be covered.

This 3-day Workshop will be delivered by Richard Comotto, the author of ICMA's Repo Survey, with legal and documentation professionals and representatives from ICMA and ISLA.

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ICMA Executive Education

New diplomas

ICMA Executive Education has announced that two new diplomas are to be issued by the ICMA Centre, Henley Business School, University of Reading in partnership with ICMA. The two diplomas focus on either securities and derivatives or financial market operations. Either diploma can be achieved by candidates successfully completing a number of current ICMA EE courses on offer. Foundation, intermediate and specialist courses are put together to successfully complete the recognised diplomas. Note that for candidates that have already completed some or all of these courses these will qualify even though taken before the announcement of the two diplomas.

ICMA Executive Education Diploma in Securities and Derivatives requirements:

- successfully complete Financial Markets Foundation Course (FMFC)
- successfully complete either International Fixed Income and Derivatives (IFID) Certificate or Primary Market Certificate (PMC)
- attend in full any two level 3 courses in securities and derivatives

ICMA Executive Education Diploma in Financial Market Operations requirements

- successfully complete Securities Operations Foundation Course (SOFC)
- successfully complete Operations Certificate Programme (OCP)
- attend in full any two level 3 courses in financial market operations

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ICMA AGM and Conference, Paris, 25 to 27 May 2011

The venue for the 2011 Paris meeting will be the Marriott Rive Gauche Hotel. There are a number of sponsorship and exhibition opportunities available at varying levels.

Please contact the events team, events@icmagroup.org for further details.

The 2011 programme is in development: ICMA members are invited to become involved by suggesting themes and speakers.

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Summary of forthcoming ICMA Executive Education courses

Intermediate programmes

International Fixed Income and Derivatives (IFID) Certificate Programme
Next residential course
24-30 October, Sitges, Barcelona

Primary Market Certificate (PMC)
15-19 November, London

Specialist programmes

Securitisation - Understanding the Mechanics
22-23 November, Brussels

Corporate Actions - An Introduction
25-26 November, London

Credit Default Swaps (CDS) - An Introduction
29 November, London

Credit Default Swaps (CDS) - Operations
30 November, London

ICMA welcomes feedback and comments on the issues raised in the Regulatory Policy Newsletter.

Please e-mail:
regulatorypolicynews@icmagroup.org
or alternatively the ICMA contact whose e-mail address is given at the end of the relevant article.

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