CLEARY GOTTLIEB Alert Memo

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Proposed New EU Financial Regulatory System

On June 19, 2009, the European Council supported, with certain modifications, the Commission communication entitled *"European Financial Regulation"* (the "Communication").[1]. The Communication proposes an enhanced European financial supervisory framework, which will be composed of two new pillars: the European Systemic Risk Council (the "ESRC") (referred to in the European Council's conclusions as the European Systemic Risk Board) and the European System of Financial Supervisors (the "ESFS"). The proposal is largely based upon the recommendations of the February 25, 2009 report by the High Level Group on Financial Supervision, chaired by Jacques de Larosière (the "de Larosière Report"), which received the Commission's support in its Communication entitled *"Driving European Recovery"* of March 4, 2009.[2]

Much of the Commission's work since the financial crisis began has been directed at reform of the regulation of specific participants in the European financial sector, such as the reform of the regulation of credit rating agencies[3] and the proposal for a Directive on Alternative Investment Fund Managers.[4] The Communication, by contrast, seeks to establish a new set of European institutions to better address systemic regulatory risks. Together, these proposals represent a major shift towards centralized authority in the European financial regulatory system

The proposals set out in the Communication are designed to create a framework within which risk in the financial system will be subject to supervision at the EU level, and through which the actions of national supervisors will be coordinated. The new institutions will develop, in effect, a "single European rulebook" that will harmonize the differences in the national approaches to the transposition of existing and future Community law, creating a core set of standards common to all Member States. The mechanisms will not impact upon resolution authority, capital adequacy or mutual recognition.

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[1] COM(2009) 252.

[2] COM(2009) 114.

[3] Regulation of the European Parliament and of the Council on Credit Rating Agencies (2008/0217 (COD)).

[4] COM(2009) 207 final.

I. THE ESRC

The Commission proposes that the ESRC will be responsible for macro-prudential oversight; specifically, monitoring and assessing potential threats to financial stability that arise from macro-economic developments and from developments within the financial system as a whole. The ESRC's function will be:

1. To collect and analyze all information relevant for monitoring and assessing potential threats to financial stability that arise from macro-economic developments as well as developments within the financial system as a whole;

2. To identify and prioritize such risks;

3. To issue warnings where risks appear to be significant;

4. To make recommendations on the measures to be taken in reaction to the risks identified;

5. To monitor the required follow-up to warnings and recommendations; and

6. To liaise with the International Monetary Fund, the newly created Financial Stability Board and other non-EU counterparts.

The ESRC will have no independent regulatory authority. Its role is advisory. It will provide an early warning of system-wide risks that may be building up and, where necessary, issue recommendations for action to deal with these risks. The warnings could be general, but they could also be directed at specific EU Member States. The warnings and recommendations will be made, not directly to the institutions concerned, but indirectly via the European and Financial Affairs Council ("ECOFIN") and the three new European Supervisory Authorities (see below).

Whilst the ESRC will possess no legally binding powers, compliance with the ESRC's recommendations will be encouraged by means of an "act or explain" mechanism: a requirement that the addressees explain and justify their reasons for not acting upon ESRC proposals. The ESRC will have the discretion to publish its recommendations, but is not obliged to do so.

The ESRC will be composed of the heads of the European Central Bank (the "ECB") and the 27 national Member State banks, as well as the chairpersons of three European Supervisory Authorities. A representative of each national supervisory authority will also attend as an observer. It will report bi-annually to both the European Council and the European Parliament. Direction will be provided by a small steering committee composed of the ESRC chairperson and vice-chairperson, five additional central bank members of the ESRC, the chairpersons of the European Supervisory

Authorities and the Commission member. The ESRC will also be assisted by an advisory technical committee, which will be tasked with providing detailed technical analysis of financial stability issues.

The Commission believes that the creation of the ESRC will address one of the fundamental weaknesses highlighted by the financial crisis, which is the vulnerability of the financial system to interconnected, complex, sectoral and cross-sectoral systemic risks.

II. THE ESFC

The ESFC will consist of a network of national financial supervisors working in tandem with three new European supervisory authorities: the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities Authority (together, the "European Supervisory Authorities"). The Commission has deliberately chosen a model of regulation that preserves the separate supervision of the banking, insurance and securities markets. However, the structure would also encourage cross-sectoral co-operation and allow for convergence and the identification of common regulatory principles. These three new bodies will replace the existing Committees of Supervisors, known as Level 3 committees, that advise the Commission within the Lamfalussy process.

The European Supervisory Authorities will be charged with the oversight of micro-prudential regulation: safeguarding financial soundness at the level of individual financial firms and protecting consumers of financial services. The new European network will be built on shared and mutually reinforcing responsibilities, combining nationally based supervision of firms with centralization of specific tasks at the European level to foster harmonized rules and coherent supervisory practice and enforcement. Their competencies will include:

1. Ensuring a set of harmonized rules by developing binding technical standards in specific areas and drawing up interpretative guidelines for the competent national authorities to apply in taking individual decisions (especially regarding the licensing and supervision of financial institutions);

2. Encouraging consistent application of EU rules by facilitating dialogue between competent national authorities that disagree on the application of Community legislation. As a "last resort", the European Supervisory Authorities will have the power to issue a binding formal decision. The European Supervisory Authorities will also be responsible for investigating manifest breaches of Community law, either on their own

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initiative or at the request of national supervisors, and may address recommendations for action to national supervisors;

3. Ensuring a common supervisory culture through various measures such as common training programs;

4. Assuming full supervisory powers for specific entities with pan-European reach (*e.g.*, credit rating agencies and EU central counterparty clearing houses);

5. Ensuring a coordinated response in crisis situations by facilitating exchange of information between competent national authorities and mediation between those authorities where required;

6. Collecting all relevant micro-prudential information emanating from national supervisors into one depository; and

7. Undertaking an international role by dealing on behalf of the Community with third countries.

Each of the three authorities will have its own board of supervisors comprised of the highest-level representatives from the national supervisory authorities and chaired by the chairperson of the respective European Supervisory Authority. That chairperson will be nominated after an open competition and then confirmed by the European Parliament with a five-year term of office.

III. CONCLUSION

The Commission's proposed reforms have been backed at both the meeting of Member State finance ministers on June 9 and at the European Council meeting on June 19. However, certain aspects of the Communication proved controversial. The ministers rejected the Commission's proposal that the ECB chair the ESRC and instead agreed that the members of the General Council of the ECB will elect the chair of the ESRC. A number of Member States, including the United Kingdom, are concerned that the reforms would empower EU institutions to require Member States to rescue failing banks, which could in turn affect Member State taxpayers. Accordingly, a guarantee has been secured that the proposed reforms will not affect the fiscal responsibilities of Member States.

In the fourth quarter of 2009, the Commission will publish a further set of proposals that will establish legislative changes required to implement the proposed supervisory framework. It is intended that the framework will be operational during the course of 2010.

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For additional information, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under antitrust, banking and finance or private equity in the "Practices" section of our website (www.clearygottlieb.com) if you have any questions.

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

CLEARY GOTTLIEB STEEN & HAMILTON LLP

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Office Locations

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

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

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

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

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

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

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

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

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

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

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

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