CLEARY GOTTLIEB

Alert Memo

BRUSSELS AND LONDON, OCTOBER 19, 2009

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Commission Adopts Proposals for New EU Financial Regulatory System

The European Commission adopted a package of draft legislative proposals intended to strengthen financial supervision in Europe (the "Draft Legislation") on September 23, in advance of the Pittsburgh G20 meeting.[1] The proposals will be discussed at the European Council meeting on October 29-30. The Draft Legislation provides for an enhanced European financial supervisory framework, which will be composed of two new pillars: the European Systemic Risk Board (the "ESRB") and the European System of Financial Supervisors (the "ESFS"). It is expected that the new framework will be operational in 2010.

The new proposed framework has been the subject of extensive consultation since 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] The current proposals, first set out in the Commission communication entitled *"European Financial Regulation"* (the "Communication"), were endorsed by the European Council on June 19, 2009.[3]

The Draft Legislation will 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. With regard to the ESRB, the Commission noted in announcing the Draft Legislation that the existence of the EU internal market and the increasing political and financial integration of the EU require an EU-level institution to supervise and monitor risks to the financial systems. With regard to the ESFS, the Commission noted that the new authorities will play an important role in working towards a common 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. These standards will only become binding law after formal endorsement by the Commission. The Commission will also

1 Commission Press Release IP/09/1347, September 23, 2009.

2 COM(2009) 114. These developments are discussed in the CGS&H Alert Memoranda, "Expanding EU role in European Financial Regulation", March 27, 2009; and "Proposed new EU Financial Regulatory System", June 19, 2009.

3 COM(2009) 252.

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have the power to declare an emergency situation in which the new authorities will be able to adopt decisions requiring national supervisors to take action.

I. THE ESRB

The ESRB 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 ESRB's function will be:

1. To collect and analyze 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 Financial Stability Board and other non-EU counterparts.

The ESRB will have no independent regulatory authority; its role will be advisory. It will provide an early warning of systemic risks that may be building up and, where necessary, issue recommendations for action to deal with these risks. The warnings could be general and addressed to the Council, but they could also be directed at specific EU Member States or groups of States.

Whilst the ESRB will possess no legally binding powers, compliance with the ESRB'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 ESRB proposals. When a national supervisory authority intends to deviate from an ESRB recommendation, it must first discuss and justify it with the competent European authority and will have to take into account that authority's view before answering the ESRB. If the ESRB feels that the explanations are not convincing, it shall inform the Council. The ESRB will have the discretion to publish its recommendations, but is not obliged to do so, and when considering whether to do so will take into careful consideration the implications on the wider markets of making any recommendation public.

The General Board of the ESRB will be composed of the heads of the European Central Bank (the "ECB") and the Governors of the 27 national Member State banks, a member of the European Commission, as well as the chairpersons of three European Supervisory Authorities. A representative of each national supervisory authority will also attend as an observer. The members of the General Council of the ECB will elect the chair of the ESRB for a term of five years, which will be renewable. The ESRB 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 ESRB chairperson and vice-chairperson, five additional central bank members of the ESRB, the chairpersons of the European Supervisory Authorities and the Commission member. The ESRB will also be assisted by an advisory technical committee, which will be tasked with providing detailed technical analysis of financial stability issues.

The ESRB will be created by means of a regulation on Community macro-prudential oversight of the financial system and establishing a European Systemic Risk Board and by a decision entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board.

The Commission believes that the creation of the ESRB 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 ESFS

The ESFS 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 and Markets Authority (together, the "European Supervisory Authorities"), which will be established by three regulations. 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 responsible for overseeing 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, the European Supervisory Authorities will have the power to issue binding formal decisions, although as a last resort. The European Supervisory Authorities will also be responsible for investigating manifest breaches of Community law, either on their own 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. Where the Commission determines that there is an "emergency situation", the European Supervisory Authorities will be empowered to adopt decisions, which will require supervisors in Member States to take specific action. The Commission envisages that such a power might have been used to require European regulators to adopt co-ordinated short selling bans early in the financial crisis.

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

8. Undertaking an international role by dealing on behalf of the Community with third countries; and

9. In exceptional cases, the European Supervisory Authorities will have limited powers to take decisions directly applicable to financial

> institutions. Those powers will be exercised as a matter of last resort, where other processes for ensuring the consistent application of Community law have been exhausted, and on the basis of EU legislation which is itself directly applicable.

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.

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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

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