

ILA - INTERNATIONAL SECURITIES REGULATION COMMITTEE MEETING

A meeting of the ILA - International Securities Regulation Committee was held on November 16, 2009 at the offices of Linklaters in London.

The Committee covered recent securities regulatory developments, and started its planning for the ILA 2010 Conference in The Hague.

The substantive portion of the meeting consisted of three panel discussions:

- BRIC/Asia (Chaired by Professor Lichtenstein)
- EU Panel (Chaired by Ms. Levine)
- US Panel (Chaired by Mr. Fleischman/Ms. Green)

The meeting included participation by 12 present/prospective committee members present in person, and another 5 by conference telephone.

An outline of the presentations and discussions below was prepared by the Rapporteur of the Committee, Dr Emilius Avgouleas, with the help of Mr Kabir Ahmed.

A. BRIC/Asia Panel

BRAZIL - (Mr Gustavo Grebler)

Securities regulation in Brazil has developed significantly, with numerous major regulatory reform initiatives in order to bring the Brazilian market up-to-date. Main institutional changes have focused on enhancement of disclosure and corporate governance rules, protection of minority interests, strengthening of fiduciary duties, regulation of organized markets, and enforcement of property rights. Major regulatory changes have included the following:

- (a) Rule 358 (enacted in 2003) – Comprehensive mandatory disclosure of material facts, and prohibition on insider trading.
- (b) New Corporate Governance Standards for companies listed in the Brazilian Stock Exchange (BMF&BOVESPA).
- (c) Rule 400 (enacted 2003) – Regulation of public distributions. Emphasis on the obligation for dissemination of adequate and sufficient information prior to an investment decision.

- (d) Rule 461 (enacted in 2007) - Modernization of self-regulatory attributions by Securities Exchanges, permission for exchanges to operate as for profit PLCs and electronic trading systems.
- (e) Release 36 in 2007 codifying directors' fiduciary duties in connection with business reorganization involving related party transactions. Convergence with the International Framework.
- (f) Draft rule for the regulation of securities analysts in 2008, providing for certification and obligations destined to enhancement of securities analysts' role as gatekeepers.
- (g) Draft rule for broker-dealer regulating conflicts of interest, commissions, soft dollars, inducements etc in 2009
- (h) Regulation of Tender Offers (enacted 2003) – Obligation to launch tender offer in transactions involving sale of control in concentrated form. A new rule (by Stock Exchange) is under consideration, regulating sale of controlling interests held in dispersed ownership;
- (i) Rule 480 (enacted 2009) – New registration and reporting requirements, new requisites for foreign status by issuer. Subdivision of issuers in classes, in accordance of exposure and reporting history. Detailed information on executive compensation and related parties transactions.
- (j) Enforcement – Brazilian CVM has played an increasing role in enforcing cases involving claims for breach of directors and officers' fiduciary duties, and reducing agency costs.

Summary: The market has increased from \$200 billion to 1.3 trillion, due to improvement in institutional framework. We will see further gradual improvements. A copy of Mr. Grebler's presentation is available on request.

People's Republic of China - (Mr Jian Fang)

- (a) China followed the Glass-Steagall Act model and imposed very restrictive requirements on the operation of commercial banking, investment banking and insurance businesses.
- (b) Recently traditional rules are changing rapidly. Legislative activism is on the rise. There have been deviations as banks were given exemptions to invest in insurance companies as well as operate in the commercial banking sector.
- (c) The objective of securities regulation is to protect consumers and investors. However, most financial intermediaries are state-owned, and there is

always some tension between the protection of investor interests and state interests.

- (d) There is recently a shift in favour of consumer interests.
- (e) Liberalization continues to dominate the policy-making agenda. China has kept the pace of liberalization of domestic markets opening them up to foreign entrants and providing level playing field.
- (f) Foreign banks are able set up joint ventures in China.
- (g) China has revamped the bond market. Corporate issuers are allowed to issue short term and long term bonds. Traditionally they relied on banking finance. This has posed new risks which the Government is addressing.
- (h) Deregulation in the market for corporate bonds is a shift away from traditional bank lending.
- (i) Government has introduced new products in the market which has increased the liquidity of the market.
- (j) Government is simplifying the market.
- (k) The market has increased in sophistication: increased use of derivatives. In relation to disclosure or transparency of these products, more rules are to come.
- (l) The securities regime is less than 20 years old and the regime is not yet strictly enforced. Enforcement has become a major issue in the past 2 years. Government has become very proactive and there have been a few prosecutions (including 11 for insider dealing and market manipulation).

Summary: The underlying theme is to open up the market to foreign players pursuant to a recently announced initiative to promote Shanghai as a major international financial centre.

Hong Kong (and certain other jurisdictions in Asia) - (Mr Alan Ewins)

- (a) In general Asia provides a spectacular example of fragmentation and opportunity for regulatory arbitrage.
- (b) Regulators of Hong Kong and Singapore are grappling with investor protection, suitability etc issues with respect to the Lehman 'minibonds' scandal.
- (c) Settlements have been imposed on brokers who distributed the minibonds.

- (d) While in Singapore the Monetary Authority investigated rapidly the distributors and their systems and controls. Furthermore it imposed bans of various lengths, up to a minimum of 2 years, on all of the distributors.
- (e) There is an ongoing Judicial Review in the Hong Kong Courts of the Securities and Futures Commission's decision to pursue a settlement.
- (f) There is currently a review of legislation and of regulatory requirements for the sale of structured products to retail investors in Hong Kong.
- (g) For investor protection, there is an intention to set up an Investor Education Council and an Ombudsman Service.
- (h) SFC has taken increasingly aggressive enforcement action in the last 18 months – in relation to mis-selling, insider dealing and other market misconduct.
- (i) The Hong Kong Monetary Authority is consulting with reference to bankers' bonuses with a view to establishing deferrals and claw backs in line with the G20/Financial Stability Board resolution.
- (j) Elsewhere: There has been litigation in Taiwan with regard to structured products; Korea has had a financial services "Big Bang" in early 2009, but its development has been hampered by the market turmoil and various high-profile derivatives disputes; Indonesia has exhibited protectionist tendencies with moves towards usage of local language for documentation, Thailand is considering its own "Big Bang" and has relaxed certain derivatives trading restrictions, Japan continues to be a challenge for financial institutions operating there.

B. EU Panel

The EU Panel covered recent developments at EU level and in member states, UK, Italy, Germany, and Austria.

EU Reform of Financial Supervision - (Mr Bart De Meester)

- (a) On basis of the de Larosière Report of 25 February 2009, the EU Commission proposed reform of financial supervision in Europe.
- (b) On 27 May 2009, the Commission issued a Communication announcing the reform of financial supervision as suggested in the de Larosière Report. On 2 December 2009, the ECOFIN Council modified the proposal in some respects.

- (c) Two new supervisory bodies will soon be established, following the adoption of the recommendations of the de Larosière report: a European Systemic Risk Board (ESRB) and a European System of Financial Supervisors (ESFS).
- (d) The European Systemic Risk Board (composed of national central bank governors and under chairmanship of ECB President) will be responsible for macro-prudential supervision in the EU. ESRB will be able to issue risk warnings and recommendations. However, the ESRB will have no binding powers (Member States have to 'act or explain'). Recommendations will not be made public, unless a 2/3 majority of the ESRB-members agree to make them public.
- (e) European System of Financial Supervisors may lead to some (limited) centralization of supervision in EU. However, the day-to-day supervision of financial markets and financial institutions remains at the national level.
- (f) ESFS will be a network of financial supervisors, consisting of the European Banking Authority, European Securities and Markets Authority and European Insurance and Occupational Pensions Authority (*i.e.* the successors of former Lamfalussy 'level 3' Committees).
- (g) The three 'Authorities' will have the old competences of the level 3 Committees and a number of new competences, including the power to:
 - i. Develop technical standards (addressing differences in national transposition of Community law in order to ensure a 'single EU rule book');
 - ii. Focus on the consistent application of harmonised rules (In addition to the existing system whereby the Commission can start infringement procedures before the ECJ against Member States, a faster procedure via the 'Authorities' will be introduced to tackle inconsistent application of harmonised rules by Member States);
 - iii. Take supervisory measures and register certain institutions that have EU-wide actions, especially credit rating agencies.
 - iv. Settle disagreements between national supervisory authorities (especially in colleges of supervisors) (Authority may assist in reaching a settlement, take a decision to settle the matter and can take measures addressed at the financial institution in case of non-compliance.);
 - v. Coordinate actions of national authorities when a crisis threatens (In case of 'cross-border emergency situation')

(declared by ECOFIN Council), the Authority will have power to require national authorities to take joint specific action.).

Powers (iv) and (v) lead to clear centralisation of supervisory competences in the EU. However, in both cases, Member States may invoke a 'safeguard clause' and refuse to comply with decision of Authority for budgetary reasons. However, Member States must explain this clearly. The Authority has then one month to inform the Member State of whether to maintain the decision or to withdraw it. If the measure is maintained, the issue must be referred to the Council, which has two months to decide whether to maintain or revoke the decision. (The decision will be maintained if upheld by majority of votes cast for (iv) and by majority of members of the Council for (v). In case of (v), the Member State that still does not want to comply with the decision can refer the matter to the European Council. This provides in fact a veto-power for the Member State, since voting in the European Council is by consensus.)

- (h) The relevant Regulation and Directives shall be implemented in 2010 and the above bodies are expected to be full operational by the end of the year.

Alternative Investment Fund Managers Directive - (Ms Ida Levine)

- (a) Scope - it covers everything that is not a UCITS. So, first observation is that the scope is very broad
- (b) It takes a different approach than UCITS Directives, as it regulates the managers and not the funds themselves.
- (c) Authorisation requirements, inc. minimum capital
- (d) Limited ability to delegate.
- (e) Appointment of independent valuers, and controversial new provisions on depositaries -- the duty of care initially seemed to be strict liability instead of negligence (although the Commission appears to have clarified this).
- (f) Limitations in the amount of leverage in funds managed by an AIFM.
- (g) Is the passport going to be extended to offshore managers? The third country passport is not in favour with all member states. The Commission draft requires a MOU and tax treaty with third country.
- (h) Abolition of member states private placement regimes in favour of the passport provided by the Directive (but it may be preserved as this part of the Directive is still being decided)

UK Developments - (Professor Iain MacNeil)

Market Issues

- (a) Market discipline runs ahead of legal and regulatory changes.
- (b) Market system is showing potential to resolve the issues.
- (c) The return of the market to some form of 'normality' because of the fiscal and monetary stimulus has meant that regulatory reform has lost impetus.
- (d) The current regulatory structure is in place, which means that it is easy to have fundamental change without new legislation.
- (e) Government has taken large stakes in different banks. The government has moved from being a regulator to being an investor in the markets, thus, it has acquired the capacity to engineer change wearing the investor's hat instead of the regulator's hat.
- (f) The above has also had competition implications.
- (g) The 'too big to fail' issue has not been tackled which is also closely linked to the 'narrow' and 'universal' banking
- (h) The Banking Act 2009 does not deal with capital adequacy and bank supervision for the future; it essentially deals with bank insolvency.

The Turner Review:

- (i) The style of regulation – principle based is not going to entirely change.
- (j) Higher capital and liquidity requirement regulations. Adoption of new code on remuneration packages.
- (k) The FSA distances itself from 'light touch' regulation though this doesn't really mean abandoning 'principles based regulation'.
- (l) The scope of regulation will be expanded to bring off balance sheet activities on balance sheet.
- (m) We have not seen much of litigation against directors, no class actions in the UK. Breach of duty, nowhere close to the extent of litigation witnessed in the US.
- (n) Walker guidelines for Bank corporate governance processes.
- (o) Structure of regulation remains an open question.

Dr Emilius Avgouleas has added at this point that there is a possibility that the structure of regulation in the UK may change with the change of Government. FSA may become part of Bank of England.

- (p) Bringing OTC business on exchange.
- (q) Not much FSA enforcement action specifically linked to the crisis.
- (r) FSA published an Internal Audit report after Northern Rock. The only regulators to do so. FSA may need to change its style and adopt more intrusive supervisory style. No appetite for adopting more rules.
- (s) On the other hand, market discipline was swifter, managers and directors responsible are gone.

Regulatory Issues (Ms Christina Sinclair):

- (t) The FSA role has been very transparent about its failures.
- (u) It has publicly responded by changing its style of supervision, and will become a much more intrusive regulator with more macroeconomic savvy.
- (v) It would not replace its principles based approach.
- (w) The FSA will in future look much more closely at a bank's business model and assess what are the risks arising from there.

Italy - (Dr Anna Gardella)

Misapplication of the Prospectus Directive in bond exchange offers.

- (a) Incorrect implementation of the Prospectus Directive in Italy.
- (b) Cross-border bond exchange offers complicated in Italy – foreign offerors needed CONSOB approval.
- (c) Foreign offerors could not address the Italian market unless an Italian prospectus was issued.
- (d) A new regulation allows now cross-border bond exchange offers to take place pursuant to the 'passport regime', provided a prospectus has been published and approved abroad.
- (e) There is still no mutual recognition of foreign exempted bonds. So Italy and Italian bond holders are excluded. For these cases the new

centralisation of EU supervision could be beneficial and lead to more consistent implementation of harmonization legislation.

Germany - (Dr Hagedorn):

- (a) Regulatory reform discussions in Germany have focused on the new EU architecture and Basle reform.
- (b) Another development has been the establishment of a Fund to facilitate government aid to the banks.
- (c) The Fund allocates financial aid through three different ways:
 - i. Guarantees
 - ii. Equity participation
 - iii. Toxic assets fund (bad bank)
- (d) But most banks have decided to keep the toxic assets and profit from an eventual market price appreciation, so the bad bank facility has not been successful.
- (e) The German government opposes further centralization of supervision because it is the national taxpayer who finally bears the costs of bank rescues.
- (f) The crisis has mostly hurt the Landesbanken and some Hypobanken.
- (g) The Landesbanken have received serious amounts of regional government aid.
- (h) For Landesbanken and some Hypobanken the problems arose from the non-core business.
- (i) Banks have received aid subject to a commitment to downsize their business.

Austria - (Dr Schwank):

- (a) In Austria, the right laws and supervisory competences have always been in place, but historically, there has been an issue of lack of compliance and enforcement.
- (b) There has been strict interpretation of rules quite recently.

- (c) After the 4th largest Austrian bank collapsed, there has been a debate about reform of banking supervision. Supervision should move from the Central Bank.
- (d) Interested parties can take civil proceedings against the regulator if they consider that the regulator has not discharged its supervisory duties properly.
- (e) Implementation of the EU regulation on public limited companies.
- (f) The Transparency directive is not properly implemented, as there is no competent authority for financial reporting.
- (g) There has been several criminal investigations for insider dealing cases. Securities Authorities arrested a British national in relation to insider trading.
- (h) Essentially, bank secrecy laws have been abolished.

C. US PANEL

US Developments (Ms Barbara Green):

- (a) White Paper on financial regulatory reform outlining the Obama Administration plan to reform the US financial services regulatory system..
 - (i)- SEC Registration of asset managers and private pools of capital including hedge funds, private equity funds and venture capital funds and require regular reporting.
 - (ii)- Require Asset Backed Securities (ABS) sponsors to retain 5% credit risk. Increase transparency of standardisation of ABS markets and require more robust reporting.
 - (iii)- Urges SEC to adopt additional regulations applicable to Credit Rating Agencies.
 - (iv)- Provide far more comprehensive regulations of OTC derivatives including CDS.
 - (v)- Create a Consumer Financial Protection Agency to cover consumer financial products and services.
- (b) Authorised SEC to strengthen the investor protection framework under existing legislation and more legislation to be brought in.
- (c) Establishing a fiduciary duty for broker- dealers and harmonise broker dealer and investment adviser regulations.
- (d) Suggestions for the establishment of a Financial Services Oversight Council.

- (e) Provides for increased supervision and regulation of large financial firms (principally via the Federal Reserve)
- (f) Proposed legislation to address risk and other reform.

Reform has lost impetus in the US too and lots of lobbying going on

D. COMMITTEE SESSION

Planning for the Hague Report

The Report will broadly discuss:

- (a) Developments in the US, EU, Emerging Markets, Japan and Australia in the fields of:
 - (i) systemic risk supervision,
 - (ii) OTC markets regulation,
 - (iii) regulation of investment funds and short sales, and
 - (iv) litigation relating to the financial crisis.
- (b) Global developments (G20 & Regulatory cooperation),
- (c) Corporate governance in the banking sector, and
- (d) Islamic Finance.