Issue 25
Second Quarter 2012
Editor: Paul Richards

ICMA quarterly report

Assessment of Market Practice and Regulatory Policy

2 FOREWORD

2 An adrenalin shot for the European capital market
3 Message from ICMA's Chief Executive

4 QUARTERLY ASSESSMENT

4 Restoring confidence in the European capital market
10 Recent practical initiatives by ICMA

11 REGULATORY RESPONSE TO THE CRISIS

11 G20 financial regulatory reforms
12 European financial regulatory reforms
14 Macro-prudential regulation
15 OTC (derivatives) regulatory developments
16 Credit rating agencies
17 Financial Transactions Tax
18 Collective action clauses

19 SHORT-TERM MARKETS

19 European repo market
19 2012 ICMA GMRA legal opinions update
20 ECP market
21 Shadow banking and repo
23 Treatment of securities in the Basel III LCR

24 PRIMARY MARKETS

24 Public Sector Issuer Forum
25 Prospectus Directive regime
26 FATCA
27 ICMA CoCo survey
28 Other primary market developments
29 Asset encumbrance

30 SECONDARY MARKETS

30 MiFID II and MiFIR
31 CSD Regulation and settlement fails
32 ICMA ERC's approach to the CSD Regulation
33 Short Selling Regulation

35 ASSET MANAGEMENT

35 Corporate governance
36 Covered bond transparency
36 CRA3: an investor perspective
37 ETFs: future regulatory framework and other UCITS issues
38 Shadow banking: an investor perspective
38 Solvency II: reporting requirements

40 MARKET INFRASTRUCTURE

40 European Market Infrastructure Regulation
40 Other market infrastructure developments

42 ICMA EVENTS AND COURSES

45 GLOSSARY

ICMA
International Capital Market Association

4 April 2012

Issue 25 | Second Quarter 2012
www.icmagroup.org

An adrenalin shot for the European capital market

Foreword by Allegra Berman

With the first quarter now behind us, many of us feel able to breathe a small sigh of relief. Financial markets have had a much smoother start to 2012 than most market participants could have possibly envisaged. The wall of new issuance supply across the key sectors (sovereigns, financials and corporates) has been easily executed and rapidly digested and the market tone has been significantly more constructive.

The majority of market participants and by extension ICMA's members look at Greece as an extreme case. Post the completion of the PSI and a CDS trigger event being declared and successfully auctioned, the peripheral sovereign markets appear somewhat more stable. This stability, however, is likely to be short-lived. The focus has once again returned to Portugal and Spain with Ireland and Italy not far behind, although seemingly out of the eye of the storm for now.

In these peripheral sovereign markets, nearly all the recent economic data continue to point to either anaemic growth or recession. The argument for austerity is obvious given the very substantial debt levels in these countries, but without the real economy on a firmer footing, it is far from clear how these countries are to recover and work down their debts – be they public or private – via organic growth. The euro-area sovereign crisis will play on for some time and the market volatility we have suffered has become the new normal.

Aside from Greece, the other key event in the first quarter was clearly the second LTRO auction. This was very well received and gave the market the adrenalin shot it very much needed in terms of reducing the imminent funding pressure for many financial institutions across Europe. Regardless of the discussions around the actual long-term merits of these auctions, the short-term benefits for the market as a whole cannot be denied. A marked increase in confidence led to a dramatic increase in the appetite we subsequently witnessed for both senior unsecured and covered bond bank paper. Many financial institutions still do not have direct market access and we all hope that this second auction has helped buy them some time to de-lever and restructure further without huge funding pressures compounding the challenges they already face. The equity capital markets, however, have not yet sufficiently re-opened to allow financials to raise meaningful volumes of fresh capital. This will be the main additional challenge, as the scramble for capital increases amid ongoing regulatory pressures.

In the sovereign, supranational and agency (SSA) world, the capital markets have proven to be surprisingly robust. This issuer base, which relies so heavily on the debt capital markets for its funding, has been very responsive to the crisis by demonstrating, where possible, its flexibility in terms of tenor, currency, size and price for its new issues. Many of these issuers have had to become more reliant on their home market for their large benchmark funding (mostly in euro and US dollars), as their domestic investor base is more

Aside from Greece, the other key event in the first quarter was clearly the second LTRO auction.

familiar and therefore comfortable to invest. This home bias is natural in times of crisis and has served these issuers well, particularly given the difficulties many of them face due to the lack of competitive cross-currency swaps available (most notably at the longer end of the curve). Notwithstanding the volatile market backdrop, large volumes across a number of markets have been absorbed quickly by investors globally. The SSA issuers usually front-load their borrowing programmes and 2012 has been no exception. The fear of a market shut-down on the back of any number of possible events (sovereign default, political upheaval or military unrest) has exacerbated this trend with some SSA issuers already over 60% funded for the year.

ICMA has recently established a Public Sector Issuer Forum (PSIF) comprising a number of senior and highly experienced officials from government debt management offices, government agencies and supranationals. This is a welcome initiative and one which I hope will give issuers, investors and underwriters alike greater confidence and clarity in the framework for primary debt issuance and debt management. This is particularly valuable given the fragile and volatile state of the markets.

Allegra Berman
Vice Chairman of Global Capital Markets, Global Head of Sovereign, Supranational & Agency Fixed Income and Co-Head of European Debt Capital Markets, UBS

Message from the Chief Executive

What a difference a quarter makes. As I sat down in mid-December last year to write the Foreword for January's Quarterly Report, we were just coming to the end of a particularly bleak year in the capital markets, characterised by a shortage of liquidity in both the short and long-term markets, dislocation in almost all sectors – notably the unprecedented closure for many months of the new issue market for bank senior unsecured debt – the prospect of disorderly sovereign default and ongoing regulatory uncertainty.

The period since then has been momentous for our members in – at least – two respects: namely, the intense focus on the sovereign debt crisis, in particular the recently completed Greek PSI, as well as the ECB's offers of unlimited liquidity, provided through the two LTROs, which were extensively taken up by banks throughout Europe. The immediate market impact of this liquidity provision has been profound, sparking a deluge of new issues, reopening the market for senior unsecured financing, and leading to significant spread tightening in much of the financial institution and sovereign markets.

However, uncertainty remains high. Market practices continue to be stressed, business models are changing, and despite some progress the sovereign crisis is ongoing.

The regulatory agenda is ever more packed, with many of the changes proposed being fundamental to the way the markets work. One important role of ICMA is to facilitate the dialogue between our members in the financial industry and regulators, particularly in the context of proposed regulation. We have registered our concerns that the time frame for consultations has in many cases become so short that it makes it unrealistic to provide the industry input that is vital in the formulation of practical and effective regulation.

ICMA's staff is working intensively on all fronts – whether to update our rule books and standard documentation, or to assess the impact of new regulation in the primary, secondary or short-term securities markets and to represent the views of our buy and sell side members accordingly. We continue to expand our reach and the range of our services for the investor and issuer communities (we comment on the new Public Sector Issuer Forum in this Quarterly Report), to respond to the geographical concerns of various groups of members through our regional committees, to develop further our educational offerings and to hold a broader range of conferences, round tables and events for our members – further details of these initiatives are included in this publication and also on our website www.icmagroup.org.

All of these place substantial requirements on our resources. In order to be effective we prioritise at every stage, and we are committed to cooperating wherever possible with other associations. Our goal remains to serve our members, and we welcome all input which will allow us to do this better.

Contact: Martin Scheck
martin.scheck@icmagroup.org

Quarterly Assessment
by Paul Richards

Restoring confidence in the European capital market

Although the ECB does not act as lender of last resort to governments in the euro area, the ECB *is* willing to provide unlimited liquidity to the euro-area banking system against eligible collateral. The ECB's two 3-year Longer-Term Refinancing Operations (LTROs) – providing €489 billion gross (and €210 billion net) to around 500 banks on 21 December and €530 billion gross (and €310 billion net) to around 800 banks on 29 February – have helped to restore confidence in the European capital market by reducing the liquidity problem in the euro area. This Quarterly Assessment considers the position at the end of the first quarter.

Resolving the liquidity problem

Following the announcement on 8 December of the two LTROs:

- euro-area sovereign bond yields have fallen significantly during the first quarter (with 10 year Italian yields falling from around 7% to around 5%), though most still contain a substantial risk premium over bunds (with 10 year yields of 2%) as a result of the market's view that many sovereigns are no longer risk-free; market volatility, which affects liquidity, has also been reduced;
- euro-area sovereigns have made considerable progress in funding their budget deficits and maturing debt this year (with gross funding estimated at over €700 billion in total), to which banks have contributed by using some of the proceeds of the LTROs to purchase new issues of sovereign bonds; and

- banks have also made progress in repaying maturing medium-term debt (of around €700 billion this year) or refinancing it – eg through senior unsecured and covered bond issues – and in meeting the EBA's 9% core Tier 1 capital requirement by the end of June. Some banks, which did not previously have access, have now been able to return to the capital market.

In addition to the provision by the ECB of liquidity to the banks:

- the LTROs have been provided by the ECB at an interest rate of 1% rather than at a penal rate;
- the ECB has eased the terms on which it accepts collateral against the loans it provides, though there is a continuing debate about how far the ECB should go, and there is still a shortage of collateral, given the extensive use by the market of covered – as opposed to unsecured – transactions, including bank borrowing from the ECB against eligible collateral;
- the ECB appears to have wound down – at least for the time being – its purchases of government debt in the secondary market under the Securities Market Programme;
- the ECB has continued to keep short-term interest rates low (at 1%), and has the opportunity to reduce them further, should this be necessary; and
- the euro exchange rate has remained relatively stable in the first quarter.

Immediately after the LTROs, many banks initially increased their deposits with the ECB (to over €800 billion in total), though they may subsequently use these deposits to buy sovereign bonds, repay maturing debt or lend to the private sector. While it is too early to judge to what extent the proceeds of the LTROs will ultimately be used to finance the recovery of the real economy in the euro area, the market's assessment of global economic prospects (in particular in the US) has improved.

Resolving other problems in the short term

Greece: The most immediate remaining problem in the euro area relates to Greece and the risk of contagion elsewhere:

- The second bail-out of Greece by the euro-area authorities and the IMF, which amounts to around €130 billion in new financing, in addition to €34 billion remaining under the first bail-out, is conditional on substantial policy reforms by the Greek authorities. It is not clear what will happen if Greece is not willing or able to keep to the terms of the second bail-out: whether there would be a third Greek bail-out, a Greek default or Greek exit from the euro area. Even if the second bail-out works, Greek Government debt is still projected to be around 120% of GDP in 2020.
- One of the conditions for the second Greek bail-out is that €206 billion in Greek sovereign bonds held by bondholders covered by negotiations on "private sector involvement" (PSI) has been exchanged for new bonds at a discount of 53.5%. Of the 46.5% in new bonds, 15% take the form of short-term (one to two year) bonds issued by the European Financial Stability Facility (EFSF), while the remaining 31.5% take the form of 20 new bonds issued by the Greek Government under English law in a range of maturities from 11 to 30 years with low (albeit rising) coupons and a weighted average interest rate of 3.65% over the 30 years.
- A large proportion of the bonds exchanged (€177 billion or 86% of the total) were originally issued by the Greek Government under Greek law. Voluntary take-up of the exchange offer has been sufficiently high to enable the Greek authorities to compel the remainder to accept the exchange offer as well, using a retroactive collective action clause (CAC). Of the €29 billion bonds issued by the Greek Government under foreign law and bonds issued with Government guarantees, which are also included in the bond exchange, take-up has not been as high.

> **THE ECB's LTROs have helped to restore confidence in the European capital market by reducing the liquidity problem in the euro area.**

“

The most immediate remaining problem in the euro area relates to Greece and the risk of contagion elsewhere.

- Even so, the effect of the bond exchange has been to restructure at least 95.7% of Greek Government and Government-guaranteed debt to private sector bondholders, and reduce the amount of Greek sovereign debt outstanding to private sector bondholders by over €100 billion (out of around €350 billion in total). As a result of successive rounds of PSI negotiations, the "haircut" accepted by private sector bondholders has increased from 20% in July 2011 to 50% in October to 75% of net present value in March this year after taking account not only of the discount on new bonds to existing bonds, but also of the low coupon and extended maturity on the new bonds. These new bonds themselves now trade at a discount, with high yields, in the secondary market.
- Following the declaration in the case of Greece of a "credit event" by ISDA on 9 March, an auction has been held. The auction set a net payout of $2.9 billion on 98% of all credit default swaps (CDS) outstanding. Market participants who bought protection against a Greek default received the face value of their bonds in exchange for a payment of 21.5% of face value to protection sellers.
- To allow continued access to the liquidity required by Greek banks from the Eurosystem and provide credit enhancement following Greece's credit rating of "selective default", Greece has provided the Eurosystem with one year EFSF bonds to back Greek sovereign bonds provided to the Eurosystem as collateral. The EFSF bonds are due to be returned following the "selective default" period. In addition, Greek banks are being recapitalised with funds from the EFSF.
- The ECB has exchanged its own holdings of Greek Government bonds (acquired for around €40 billion in the secondary market under its Securities Market Programme) for new Greek bonds to avoid having to participate in the PSI and to avoid being caught by the retroactive CAC. It is understood that future profits from holding these bonds will be returned to euro-area governments and recycled to provide financial support for Greece. But the preferential treatment of the ECB over private sector bondholders in the Greek case has raised fears among private sector bondholders that the ECB will continue to receive preferential treatment in any future bail-out.

Portugal and Ireland: Greece is officially being treated by the euro-area authorities as an exceptional case. Despite this, the market considers that there is still a risk of contagion, at least to Portugal, which has also received a bail-out. While 10 year Italian Government bond yields have fallen significantly from around 7% to 5% during the first quarter, and 10 year Spanish Government yields have remained around 5½%, Portuguese Government yields have remained at unsustainably high levels (of around 12% on 10 year bonds at the end of the first quarter). Besides Greece and Portugal, the third euro-area Member State in receipt of a bail-out is Ireland. By contrast with Greek and Portuguese bond yields, Irish Government bond yields have fallen significantly since the Irish bail-out (to around 7% on 10 year bonds at the end of the first quarter).

A *"firewall"*: While the provision of liquidity to the banks by the ECB appears to have reduced the immediate danger, it has generally been recognised for some time that a "firewall" around Greece is needed to prevent euro-area contagion; and that, to be credible in the market, the firewall needs to be sufficiently large that it is unlikely ever to be used up. However, the ECB's Securities Market Programme is limited in size and may be run down, while the size of the EFSF is also limited (with around €200 billion out of €440 billion already committed); and the interest rates at which the EFSF has been able to raise funds in the market have been affected by the fall in the number of triple A sovereigns providing several (but not joint) guarantees to four (as a result of the downgrading of France and Austria). The agreed way of increasing the size of the firewall is to introduce the European Stability

Mechanism (ESM) – with resources of €500 billion in addition to the €200 billion already committed by the EFSF – in July 2012 (ie a year earlier than originally planned). The EFSF will remain active for a transitional period while the ESM is being set up. It seems clear that the euro area will have to take steps to increase the size of its contribution significantly first, before third countries are willing to make contributions of their own through the IMF.

Resolving longer-term problems

Sovereigns: The liquidity measures taken by the ECB have helped to resolve the euro crisis in the short term. But there is still a longer-term problem in the euro area as a result of the lack of competitiveness of the countries on the periphery in comparison with Germany, as evidenced by imbalances on the current account of their balance of payments. It is also important to note that the Bundesbank has accumulated claims of around €500 billion on the Eurosystem through TARGET2 (from a zero balance in 2007). The problems arising from a lack of competitiveness of this kind are not easy to address in a single currency area (ie where there is no exchange rate to offer flexibility, and where it is difficult to reduce costs such as wages and pensions). Structural reforms take time to work. Progress has been made in Italy and Spain. But among the bail-out countries, although some progress has been made in Ireland, less progress has been made on structural reforms so far in Greece or Portugal. There may also be political constraints on what can be done in practice.

Banks: While the ECB's LTROs, by addressing the liquidity problem, reduce the immediate risk of a bank run, the main problem for the longer term is that a large number of banks in the euro area have now become dependent on ECB financing. The ECB's measures help provide liquidity in the short term, and may help banks rebuild their capital base by improving their profitability, but they do not guarantee these banks' continued solvency in the longer term, and may simply enable those most in need of adjustment to delay this. It also seems likely that the liquidity provided by the LTROs will need to be withdrawn in due course to prevent a recurrence of inflation. In addition, the banks will need to meet the EBA's requirement for a minimum core Tier 1 capital ratio of 9% by the end of June 2012. Banks that need extra capital, and cannot obtain it from the market at all (or only at a very high cost), are engaged in deleveraging by force of circumstance, while others are deleveraging by choice.

The crisis has also provoked from the banks a response which takes the form of "Balkanisation", under which they have reduced their cross-border lending and have increasingly matched their assets and liabilities within national boundaries (ie "home bias"). More use appears to have been made by banks of separate national subsidiaries, even though the EU Single Market makes provision for branches. As a result, cross-border lending has increasingly been conducted through the intermediation of the ECB's balance sheet. This is a direct result of lack of market confidence and concern about the possible break-up of the euro area; and is only likely to be reversed if and when confidence is more fully restored. Euro-area governments could in theory encourage the restoration of bank lending across borders by providing cross-border guarantees. But in practice the provision of sovereign guarantees across borders would raise many of the same problems that have so far prevented the provision of joint and several guarantees for the issue by euro-area governments of Stability Bonds.

"There is still a longer-term problem in the euro area as a result of the lack of competitiveness of the countries on the periphery in comparison with Germany.

"There will be little scope under the Fiscal Compact for fiscal transfers from the core of the euro area to countries on the periphery to help offset their lack of competitiveness.

It is possible that bank deleveraging, coupled with the onset of Balkanisation, will lead over time to a greater use of the international capital markets in place of bank lending to finance the economic recovery, and will provide a greater role for asset managers.

Preventing the next crisis

Sovereigns: The main official measure designed to prevent another crisis in future is the Fiscal Compact, which was signed by 25 EU Member States in March (though it only applies to Member States within the euro area), and is due to come into effect when 12 out of 17 euro-area Member States have ratified it. Ratification is likely to take time, and parliamentary approval in some Member States may not be straightforward. Ireland is proposing to hold a referendum. If a Member State failed to ratify the Fiscal Compact, this would not stop it coming into effect, but could affect market sentiment. And should the Irish vote be negative, Ireland would not qualify for future bail-out funds from the ESM.

Under the Fiscal Compact, euro-area governments each undertake to introduce national constitutional limits on their structural deficits, which should not exceed 0.5% of GDP, and are subject to automatic sanctions if government deficits exceed 3% of GDP, unless a qualified majority of euro-area Member States oppose this. As a result, there will be little scope under the Fiscal Compact for fiscal transfers from the core of the euro area to countries on the periphery to help offset their lack of competitiveness. There are also doubts about whether the Fiscal Compact will in practice be enforced this time, just as the Stability and Growth Pact was not enforced in practice last time. For example, the new Spanish Government recently set a budgetary target for 2012 (of 5.8% of GDP) above the level previously agreed with the European Commission (4.4%), and a compromise of 5.3% has subsequently been agreed, with the objective of returning to 3% in 2013. Many other Member States also have a long way to go to achieve budgetary balance.

Finally, it is not yet clear whether agreement on the Fiscal Compact will make it easier for agreement to be reached as well on the issue of joint and several euro-area Stability Bonds. That might also require a further EU Treaty change.

Banks: The authorities' focus here is on tighter regulation of the financial services industry as a whole, encompassing not just financial institutions, but also market trading, clearing and settlement. By increasing the resilience of the financial system, the regulations being introduced are intended to prevent a repetition of the crisis, but may have the unintended consequence of making it more difficult for the banks to finance the economic recovery:

- Bank capital and liquidity requirements will increase. While there is a significant period of time for banks to adjust to the new requirements under Basel III and (in the EU) CRD IV, the EBA's requirement – that banks in the EU meet core Tier 1 ratios of at least 9% by the end of June this year – represents a much tighter deadline. There is a separate issue to be resolved about whether EU requirements should be harmonised, or whether national regulators should have discretion to raise requirements above the minimum if they consider that financial stability is at risk.
- The review of the regulatory and accounting treatment of sovereign risk (eg whether it should be zero-weighted for capital purposes) raises questions about whether and to what extent sovereign credit should any longer be treated in the market as risk-free.
- The shortage of collateral – as a result of increased dependence on ECB financing against eligible collateral and increased use of secured financing to the private sector – restricts the extent to which banks can lend if they are not able to raise finance on an unsecured basis. Encumbering their balance sheets in this way also has the effect of subordinating any unsecured creditors.
- The restrictions on the ability of banks to make markets (eg as a result of the extraterritorial effects

of the Volcker Rule in the US and the proposed new EU requirements in MiFID II/MiFIR) are likely to reduce market liquidity and could raise the cost of financing.

- Some of the measures to increase the resilience of the financial system – eg clearing OTC derivatives through CCPs – may, by concentrating risk in CCPs, create new institutions which are "too big to fail".
- If a Financial Transactions Tax (FTT) were to be introduced on the banks in the EU to help repay taxpayers for their support during the crisis, as proposed by the European Commission, this would have the effect of reducing financial activity – particularly at the short end of the market – and creating more unemployment, particularly if banks moved some of their financial activities elsewhere. Possible variants – such as restricting the FTT to banks in the euro area or limiting the scope of the tax to equity transactions – might reduce its adverse impact, but could still put the EU at a competitive disadvantage.

Heavier regulation of the banking industry has also increased the regulatory focus on "shadow banking" so as to prevent financial activity from avoiding regulation. But if "shadow banking" is defined or regulated in an inappropriate way, this risks harming essential market financing (eg through the repo market).

"

The regulations being introduced are intended to prevent a repetition of the crisis, but may have the unintended consequence of making it more difficult for the banks to finance the economic recovery.

Finally, new regulations need to be handled consistently, not just nationally or at European level, but globally. Otherwise there is a risk of regulatory arbitrage. But the measures that are being introduced in the EU are not all the same as those in the US. And the authorities in the West attach a higher priority to introducing new regulatory measures than the authorities in the East, which has largely avoided the crisis, though may be affected by the knock-on effects of weaker Western growth.

Contact: Paul Richards
paul.richards@icmagroup.org

In brief

- The ECB's two 3-year LTROs have helped to restore confidence in the European capital market by reducing the liquidity problem in the euro area.
- The most immediate remaining problem in the euro area relates to Greece and the risk of contagion elsewhere.
- There is also still a longer-term problem in the euro area as a result of the lack of competitiveness of the countries on the periphery in comparison with Germany.
- The Fiscal Compact provides little scope for fiscal transfers from the core of the euro area to the periphery.
- While the ECB's LTROs help provide liquidity to the banks in the short term, they do not guarantee these banks' continued solvency in the longer term, when the liquidity subsequently needs to be withdrawn.
- Meanwhile, the regulatory measures bring introduced to prevent a repetition of the crisis may have the unintended consequence of making it more difficult for the banks to finance the economic recovery.

Recent practical initiatives by ICMA

General

1. Together with six other trade associations, ICMA wrote to Commissioner Barnier, Minister Corydon, and Chairman Bowles, in the context of their leading roles in the adoption of financial services legislation in each of the three main EU institutions, in order to address concerns over the cumulative workload confronting the European Supervisory Authorities and the short timetable for market consultation.

Short-term markets

2. ICMA arranged and hosted the first meeting of the Collateral Initiatives Coordination Forum (CICF). CICF has been conceived as a joint trade associations' body, in order to facilitate appropriate coordination across the private sector of all collateral-related initiatives.
3. ICMA hosted a workshop regarding the use of credit claims as repo collateral, bringing together interested parties from loan and financing businesses to review progress and discuss steps to take forward this ongoing project.
4. ICMA hosted meetings to bring together representatives of the ICMA European Repo Council (ERC), European fixed income CCPs and the ICSDs, to facilitate discussions regarding the best way in which to realise the ongoing project to establish triparty settlement interoperability.
5. The ICMA ERC submitted comments to ESMA in respect of its discussion papers on draft technical standards for EMIR.
6. Together with AFME, ISLA and ISDA, ICMA submitted joint input to ESMA regarding its consultation papers on possible delegated acts concerning the Regulation on Short Selling and certain aspects of credit default swaps.
7. As a contribution to official discussions on shadow banking, the ICMA ERC published two papers written by ICMA Centre's Richard Comotto: *Haircuts and Initial Margins in the Repo Market;* and *Shadow Banking and Repo.* An ICMA members' roundtable was subsequently held, chaired by Godfried De Vidts, Chairman of the ERC.
8. The ICMA ERC released the results of its 22nd semi-annual survey of the European repo market, which measured the amount of repo business outstanding on 7 December 2011, setting the baseline figure for market size at €6.2 trillion.
9. The 2012 ICMA GMRA legal opinions update will shortly conclude with updates of the 2011 legal opinions being obtained in over 60 jurisdictions.

Primary markets

10. Following publication of an explanatory note on *New Issue Processes,* ICMA is considering further guidance or recommendations, taking into account the legal constraints imposed by the Market Abuse Directive and MiFID.
11. ICMA is continuing its work to update the Primary Market Handbook, overseen by a Working Group of the ICMA Legal & Documentation Committee.
12. ICMA responded to a consultation by the FSA and HM Treasury on the UK's transposition of the EU's 2010 amendments to the Prospectus Directive.
13. ICMA participated in joint association comments on aspects of the Volcker Rule that impact securitisations and on proposed Rule 127B under the US Securities Act of 1933.
14. ICMA participated in the Joint Associations Committee response to the FSA consultation on retail product development and governance.
15. ICMA conducted a survey on the marketability of the contingent convertible instruments proposed by the European Banking Authority for bank recapitalisation purposes.

Secondary markets

16. ICMA established a Rules Review Group to examine ways of reducing the rates of late and failed settlement in the market. The Group will also be looking at the broader question of whether ICMA's Secondary Market Rules and Recommendations require development or adjustment in the light of the various regulatory initiatives in train.
17. ICMA held a members' roundtable on *Self-regulation – a renaissance?* The discussion was led by Richard Britton, Senior Adviser to ICMA.

Asset management

18. The ICMA Covered Bond Investor Council discussed the feedback received on its consultation paper on *European Transparency Standards* and published detailed responses on its webpages.
19. The AMIC ETF Working Group prepared the AMIC response to the ESMA consultation paper on ETFs and other UCITS issues.
20. ICMA arranged a meeting in Paris with the Autorité de Contrôle Prudentiel in order to give members of the AMIC Solvency II Working Group an opportunity to explain their concerns about data reporting on assets.

Meetings with regulators

21. ICMA led delegations of members on both the sell side and the buy side for separate meetings with the ECB, ESMA, DGMARKT and national regulators, to discuss market practice and regulatory issues.

Relevant information

22. ICMA created a new documentation website page, including a comprehensive compendium of ICMA's rules, recommendations, standard documentation and guidance covering the primary, secondary and repo markets in particular.
23. ICMA updated its sovereign debt information website page, including a number of updates to its Q&A relating to the Greek sovereign debt restructuring.

Regulatory Response to the Crisis

by David Hiscock

G20 financial regulatory reforms

The Group of Governors and Heads of Supervision (GHOS), the oversight body of the Basel Committee on Banking Supervision (BCBS), met on 8 January. The GHOS endorsed the BCBS's comprehensive approach to monitoring and reviewing implementation of the Basel regulatory framework. The BCBS will monitor, on an ongoing basis, the status of members' adoption of the globally-agreed Basel rules, with each BCBS member country having committed to undergo a detailed peer review, the results of which will be made public, of its implementation of all components of the Basel regulatory framework.

With respect to the Liquidity Coverage Ratio (LCR), GHOS members reiterated the central principle that a bank is expected to have a stable funding structure and a stock of high-quality liquid assets that should be available to meet its liquidity needs in times of stress. Once the LCR has been implemented, its 100% threshold will be a minimum requirement in normal times. But during a period of stress, banks would be expected to use their pool of liquid assets, thereby temporarily falling below the minimum requirement. The BCBS has been asked to provide further elaboration on this principle, including through additional guidance on the circumstances that would justify the use of the pool. The GHOS also reaffirmed its commitment to introduce the LCR as a minimum standard in 2015.

At its 10 January meeting, the FSB discussed vulnerabilities currently affecting the global financial system; and its work plan for 2012 to strengthen global financial regulation. On regulatory reform, the FSB:

- discussed the work ahead to further develop and implement the SIFI framework, including extending it to domestic systemically important banks, and global systemically important insurance companies and other types of financial institution. The FSB also approved workplans to implement the Key Attributes of Effective Resolution Regimes for each global SIFI by end-2012;
- reviewed the status of workstreams to strengthen the regulation and oversight of shadow banking; and in March will revisit in more detail the progress made;

> a reaffirmed commitment to common global standards by pursuing the financial regulatory reform agenda according to the agreed timetable

- has set up an OTC Derivatives Coordination Group, comprising the chairs of relevant standard-setting bodies, to ensure close coordination of the different international workstreams. An initial focus of the group will be on establishing adequate safeguards for a global framework for CCPs, in support of meeting the commitment on OTC derivatives central clearing by end-2012; and
- Is supporting the development of an LEI by coordinating work among the global regulatory community to prepare recommendations for the appropriate governance framework, as requested at the G20 Cannes Summit. The FSB has set up a group to deliver concrete implementation proposals by April, for review by the FSB and delivery to the G20 at the June 2012 Summit.

In January, Mexico's Presidency of the G20 issued a discussion paper presenting its strategic vision of the G20 agenda for 2012 and outlining the priorities of Mexico's Presidency. The paper's purpose is to serve as a guide for the preparation of seminars, events and documents throughout the year, and provide orientation as to the proposed objectives for the 18-19 June G20 Leaders' Summit in Los Cabos.

Mexico has established five priorities, including: strengthening the financial system and fostering financial inclusion to promote economic growth; and improving the international financial architecture in an interconnected world. These priorities reflect both the continuation of work streams of previous presidencies of the G20 and the challenges for policy coordination derived from the economic outlook for 2012.

A communiqué was issued following from the G20 meeting of Finance Ministers and Central Bank Governors held in Mexico City on 25-26 February. With respect to ongoing financial regulatory reform, paragraph #7 is particularly pertinent. This states a reaffirmed commitment to common global standards by pursuing the financial regulatory reform agenda according to the agreed timetable in an internationally consistent and non-discriminatory manner. This agenda includes Basel II, II.5 and III, the reforms to OTC derivatives markets, and the policy measures to address SIFIs. Also encouraged is work underway on systemic financial market infrastructures, on strengthening the oversight and regulation of shadow banking activities and on the global governance framework for the legal entity identifier.

Contact: David Hiscock
david.hiscock@icmagroup.org

European financial regulatory reforms

As announced by Commissioner Michel Barnier at the European Parliament in November last year, the European Commission has set up a High-Level Expert Group to examine structural aspects of the EU's banking sector.

The Group's mandate is to determine whether, in addition to ongoing regulatory reforms, structural reforms of EU banks would strengthen financial stability and improve efficiency and consumer protection, and if that is the case to make proposals as appropriate. Structural reforms go beyond regulating and supervising banks' behaviour and instead directly affect the structure of individual banks and the market as a whole. Such reforms could for example include prohibiting banks from carrying out some activities or requiring banks to put certain activities (eg taking deposits from retail customers) into separate legal entities.

In agreement with President Barroso, Commissioner Barnier in January appointed Erkki Liikanen (currently Governor of the Bank of Finland and a former member of the European Commission) as the Chairman. On 22 February, Commissioner Barnier announced the appointment of the Group's members, chosen on the basis of their technical expertise and professional background; and appointed in a personal capacity. The Group has now started its work and will present its final report to the Commission by the end of this summer.

On 6 January, the Danish Government presented the programme of the Danish EU Presidency for the next six months. In the programme the four priorities (a responsible, dynamic, green and safe Europe) and the most important issues of the Presidency are presented. With specific reference to "Strengthened financial regulation and supervision" the programme says:

"The financial crisis has emphasised the need for stronger regulation and supervision of the financial sector, and the Danish Presidency will therefore place strong focus on this work. The Danish Presidency will work for consensus in the Council on the Commission's proposed revision of capital and liquidity requirements for credit institutions (CRD IV), which translates the Basel III standards into EU legislation. The Presidency will also work for a common European framework for crisis management in the financial sector, such as early intervention and prevention in relation to ailing banks as well as consensus in the Council regarding a revised regulation on credit rating agencies. The Presidency will also prioritise the negotiations with the European Parliament on regulation of derivatives trading. Similarly, work will be carried forward on the rules regarding markets in financial investments, etc. (MiFID) and on the rules governing market abuse (MAR). In addition, the Presidency will in general assign particular priority to improving the protection of European consumers in relation to the financial sector."

Accordingly in the ECOFIN Council, the Presidency will *(inter alia)* prioritise "swift and effective implementation of the financial regulation reforms".

Alongside the European Commission's 2012 Work Programme released in November 2011, DGMARKT in January made available its Management Plan 2012 (dated 20 December 2011). Boosting new sources of economic growth, restoring consumer confidence in financial services and continuing the work on creating a supervisory and regulatory framework in the financial sector will be the priorities for 2012. Pages 22-23 of the plan cover "Financial Services Policy and Financial Markets", whilst pages 24-26 go on to cover "Financial Institutions". Within the first of these sections it is interesting to note the "Key activities" reported under "Objective 19: Promote stability and integrity in financial markets through adequate supervision, robust market infrastructures and a high level of transparency".

ESMA made available its 2012 Work Programme, highlighting key priorities and explaining how they will be delivered. This document has been approved by ESMA's Management Board and Board of Supervisors. Annex 3 presents a more detailed view on the key work streams ESMA will run in 2012. While 2011 was the year of establishment for ESMA, 2012 will be the first full year of delivery against its objectives. In order to enable ESMA to deliver on its demanding 2012 work programme, ESMA will need to substantially increase its staffing and budget. Compared to 2011, in 2012 staff numbers will grow from 75 to 101, and the budget from €16.9 to €20.2 million.

ESMA decided to structure the different work streams it will undertake according to its key responsibilities and objectives. This document therefore presents the planned activities for 2012 under the headings of: Single Rulebook; Contribution to Financial Stability; Financial Consumer Protection; Supervision; Convergence; and Operational Set-up. Considering the key work streams, at this point in time, ESMA views the following areas as the key priorities for 2012: (1) EMIR; (2) Financial Consumer Protection; (3) Harmonisation of Supervisory Practices; (4) CRA Regulation and Supervision; (5) MiFID and Market Abuse Directive Review; (6) Alternative Investment Funds Management Directive; and (7) Short Selling Regulation.

The ESMA Securities and Markets Stakeholder Group (SMSG) also set its work programme for 2012, which is largely based on ESMA's own work programme for 2012. Given the demanding nature of ESMA's work programme the SMSG has had to prioritise its work. The SMSG considers that it cannot respond to all

"To deliver on its demanding 2012 work programme, ESMA will need to substantially increase its staffing and budget.

> Member States should designate an authority in national legislation to conduct macro-prudential policy with the ultimate objective of safeguarding the stability of the financial system.

the formal requests for advice that ESMA is required to make to it and so has chosen to focus its work based on what it considers to be the most important issues and those on which it can add the most value given the range of input ESMA can expect to receive from stakeholders generally. In particular, the SMSG aims to focus on influencing ESMA's strategy as early as possible when proposals are being developed, and to provide input at a strategic rather than at a technical level.

Conclusions from the 1-2 March European Council meeting have been published. Particularly noteworthy in respect of financial regulatory measures are:

- Point 21, which covers taxation matters, including on the common consolidated corporate tax base, on the Financial Transactions Tax and on the revision of the Savings Tax Directive;
- Point 22, which covers the importance of rapidly completing the regulatory reform of the financial sector. EMIR should now be adopted as rapidly as possible, whilst the proposals relating to bank capital requirements and to markets in financial instruments should be agreed, respectively by June and December 2012, bearing in mind the objective of having a Single Rulebook, and ensuring timely and consistent implementation of Basel III. The amendments to the Regulation on Credit Rating Agencies should be adopted as soon as possible;
- Point 23, which stresses the importance of restoring investor confidence in the EU banking sector and ensuring the flow of credit to the real economy, in particular through the strengthening of banks' capital positions without excessive deleveraging and, where required, measures to support bank access to funding; and
- Point 25, where it is reported that the agreed priorities for the G20 Summit include implementing the G20 commitments on financial market reform, including strict monitoring, to ensure a global level playing field.

On 19 March, the European Commission published its Green Paper on *Shadow Banking*. This sets out how existing and proposed EU measures already address shadow banking activities – eg off-balance sheet vehicles, such as SPVs, are regulated indirectly through banking regulation; hedge fund managers are regulated directly through the AIFMD, which addresses a number of shadow banking issues; and some Member States also have additional national rules for the oversight of financial entities and activities that are not regulated at EU level.

Although these measures go some way towards addressing shadow banking entities and activities, the Commission considers there is still further progress to be made given the continually evolving nature of shadow banking and the understanding of it. In coordination with the FSB, the standard-setting bodies and the relevant EU supervisory and regulatory authorities, the aim of the Commission's current work is to examine existing measures carefully and to propose an appropriate approach to ensure comprehensive supervision of the shadow banking system, coupled with an adequate regulatory framework.

In this context there are five key areas, relating to (i) banking, (ii) asset management, (iii) securities lending and repurchase agreements, (iv) securitisation, and (v) other shadow banking entities, where the Commission is further investigating options and next steps. Stakeholders are invited to respond to the 15 consultation questions before 1 June 2012; and a conference on shadow banking will take place in Brussels on 27 April.

Contact: David Hiscock
david.hiscock@icmagroup.org

Macro-prudential regulation

On 16 January, the ESRB published its recommendation on the macro-prudential mandate of national authorities. Under the recommendation, Member States should designate an authority in national legislation to conduct macro-prudential policy with the ultimate objective of safeguarding the stability of the financial system. The ESRB recommends that Member States bestow such macro-prudential authorities with the powers to conduct macro-prudential policy on their own initiative or as a follow-up to recommendations or warnings from the ESRB. Cooperation between the national macro-prudential authorities and the ESRB would be warranted, particularly to enable the timely identification and subsequent discussion of relevant cross-border issues. In order to perform its tasks (ie identifying, monitoring, assessing and addressing potential risks to financial stability), the national authority should have full access to all the necessary statistical information and policy instruments.

Also on 16 January, the ESRB published its recommendation on funding of banks in US dollars; and Mario Draghi appeared before ECON in his capacity as Chair of the ESRB. His introductory comments started with some comments on the current situation, including an ESRB call for immediate action. In particular he noted the needs to restore confidence in sovereigns and ensure that EU firewalls are operational and well equipped with an effective and flexible mandate; and for clarification about the robustness of the EU financial system. Moving on he discussed the ESRB's two newly published recommendations, on macro-prudential mandates for national authorities and on US dollar funding. Finally he commented on the macro-prudential relevance of certain regulatory initiatives, including the CRD/CRR and EMIR proposals.

In February, the ESRB issued a macro-prudential commentary paper entitled *The ESRB at Work*- its Role, *Organisation and Functioning.* This commentary portrays the role, organisation and functioning of the ESRB a year into its existence. It opens by examining the reasons for setting up the ESRB and its major tasks. It then turns to the institutional set-up and the processes underlying the ESRB's work and decisions. Finally, it reviews the work carried out by the ESRB in its first year.

On 22 March, the General Board of the ESRB held its fifth regular meeting. In the subsequent press release it is stated that: "The key systemic risk remains the mutual negative feedback loops between three main risks, namely: (i) persistent uncertainties on sovereign debt; (ii) pressures on bank funding and excessive and/or disorderly bank deleveraging in some countries; and (iii) subdued growth prospects." The ESRB considers that "it is therefore crucial that:

- countries make further progress towards restoring sound fiscal positions and implementing the structural reform agenda in order to strengthen their growth potential, increase employment and enhance competitiveness;
- banks strengthen their resilience further – the soundness of banks' balance sheets is a key factor in exiting from current dependence on central bank support measures and facilitating an appropriate provision of credit to the economy."

Looking ahead the ESRB considers that the main issue is how to ensure the provision of credit to the economy in the current environment and has identified a series of areas that might warrant macro-prudential policy measures. ESRB work is also continuing on structural issues, such as developing a sound basis for macro-prudential policy and instruments in the EU and at the national level. The next ESRB General Board meeting will take place on 21 June.

On 16 March, the UK's Interim Financial Policy Committee (FPC) held its latest quarterly meeting. The related press release reports that it discussed its advice to HM Treasury regarding the macro-prudential tools over which the statutory FPC should have powers to Direct action by the Prudential Regulation Authority and the Financial Conduct Authority, distinct from its powers of Recommendation that could be used in addition to powers of Direction. It is considered that the statutory FPC should initially have powers of Direction over the following tools:

- the countercyclical capital buffer;
- sectoral capital requirements; and
- a leverage ratio.

In addition to banks, the range of institutions to which these tools would apply could include building societies, investment firms, insurers and a variety of funds and investment vehicles.

Other possible powers of Direction might include: a time-varying liquidity tool; control over the terms of collateralised transactions by financial institutions; disclosure requirements; and loan to value (LTV) / loan to income (LTI) restrictions. More work is required before conclusions can be reached regarding whether and how to proceed on these possibilities. The next quarterly FPC meeting will take place on 22 June.

Contact: David Hiscock
david.hiscock@icmagroup.org

OTC (derivatives) regulatory developments

On 17 January, the CPSS and the IOSCO Technical Committee published their final report on *OTC Derivatives Data Reporting and Aggregation Requirements*. The report addresses Recommendation 19 in the October 2010 report of the FSB, *Implementing OTC Derivatives Market Reforms*, which called on the CPSS and IOSCO to consult with the authorities and the OTC Derivatives Regulators Forum in developing:

(i) minimum data reporting requirements and standardised formats, and

(ii) the methodology and mechanism for data aggregation on a global basis. A final report is due by the end of 2011.

The requirements and data formats will apply both to market participants reporting to trade repositories (TRs) and to TRs reporting to the public and to regulators. The report finds that certain information currently not supported by TRs would be helpful in assessing systemic risk and financial stability, and discusses options for bridging these gaps. The report also covers the mechanisms and tools that the authorities will need for the purpose of aggregating OTC derivatives data.

On 29 February, the IOSCO Technical Committee published a final report on *Requirements for Mandatory Clearing,* which outlines recommendations that authorities should follow in establishing a mandatory clearing regime for standardised OTC derivatives in support of the G20's Leaders commitments to improve transparency, mitigate systemic risk and protect against market abuse in these markets. These recommendations are in relation to:

- determination of whether a mandatory clearing obligation should apply to a product or set of products;
- consideration of potential exemptions to the mandatory clearing obligation;
- establishment of appropriate communication among authorities and with the public;
- consideration of relevant cross-border issues in the application of a mandatory clearing obligation; and
- monitoring and reviewing on an ongoing basis of the overall process and application of the mandatory clearing obligation.

On 6 March, the BIS published a working paper, *Collateral Requirements for Mandatory Central Clearing of Over-The-Counter Derivatives.* Based on potential losses on a set of hypothetical dealer portfolios, this paper estimates the amount of collateral that CCPs should demand to clear safely all interest rate swap and credit default swap positions of the major derivatives dealers. The results suggest that major dealers already have sufficient unencumbered assets to meet initial margin requirements, but that some of them may need to increase their cash holdings to meet variation margin calls. It is also found that default funds worth only a small fraction of dealers' equity appear sufficient to protect CCPs against almost all possible losses that could arise from the default of one or more dealers. Finally, it is found that concentrating clearing of OTC derivatives in a single CCP could economise on collateral requirements without undermining the robustness of central clearing.

> "Concentrating clearing of OTC derivatives in a single CCP could economise on collateral requirements without undermining the robustness of central clearing.

The OTC Derivatives Regulators' Forum (ODRF) met on 22-23 March in Hong Kong. Topics of discussion during the meeting included updates from other relevant international OTC derivatives work; on OTC derivatives reform in jurisdictions; and CCPs and TRs. Recent supervisory experience from market disruptions was reviewed alongside cooperation among authorities. A progress report on plain language summaries was discussed, as was a report on CCP public disclosure.

Contact: David Hiscock
david.hiscock@icmagroup.org

Credit rating agencies

In the ICMA Quarterly Report for the First Quarter (page 18) there was a report on ESMA having announced the successful registrations of DBRS, Fitch Ratings, Moody's Investors Service, and Standard & Poor's (S&P) as EU-authorised credit rating agencies (CRAs); and on certain related questions concerning the use of third country ratings.

A crucial next step in this story came on 15 March when ESMA announced that it considers the regulatory frameworks for credit rating agencies (CRAs) of the United States of America, Canada, Hong Kong and Singapore to be in line with European rules. This allows European financial institutions to continue using for regulatory purposes credit ratings issued in these countries after 30 April 2012.

ESMA is currently working to finalise where possible the assessments of Argentina, Mexico and Brazil and to conclude the necessary cooperation agreements as soon as possible. In December 2011, ESMA decided to extend until 30 April 2012 the initial transitional period of three months for credit ratings issued outside the European Union. However, it is currently not possible to anticipate whether this can be finalised for all of the three countries mentioned above by that deadline.

With regard to the other countries for which CRAs have applied for endorsement (Chile, China, Costa Rica, Dubai, India, Indonesia, Israel, Panama, Russia, South Africa, Sri Lanka, Taiwan, Thailand, Tunisia, Turkey, and Venezuela), market participants should take precautionary measures before 30 April 2012, as it is likely that credit ratings issued in these countries cannot be endorsed after that date.

Additionally ESMA will shortly provide its technical advice to the European Commission on the equivalence of the regulatory regimes for CRAs in the USA, Canada and Australia. Once the Commission has declared a third-country regime to be equivalent to the EU regime, CRAs which are only established in that specific country can submit their application to ESMA to be certified in the EU in accordance with the CRA Regulation. This will allow for their ratings to be directly used by EU financial institutions.

Whilst ESMA's 15 March announcement has largely resolved a significant uncertainty which was hanging over the market, there is nevertheless a concern that this may only be a temporary state of affairs. On 15 November 2011, the European Commission put forward its proposals to further toughen the EU's CRA framework (which are discussed in more detail in the asset management section of this quarterly report). An important question which this gives rise to is whether the adoption of further measures pursuant to these proposals will have any impact on the endorsement and equivalence decisions which are in place at that time, with consequent implications for the continued use for regulatory purposes of ratings prepared by non-EU CRAs.

Separately, on 2 February, ESMA launched a Central Repository of Credit Ratings. The ESMA Central Rating Repository (CEREP) provides information on credit ratings issued by those 15 CRAs which are either registered or certified in the European Union. The CEREP database will allow investors to assess for the first time on a single platform the performance and reliability of credit ratings on different types of ratings, asset classes and geo-graphical regions over the time period of choice.

Contact: David Hiscock
david.hiscock@icmagroup.org

Financial Transactions Tax

In its press release of 28 September, the European Commission announced its proposals for a Financial Transaction Tax (FTT) in the 27 Member States of the EU. The proposed tax would be levied on all transactions on financial instruments between financial institutions when at least one party to the transaction is located in the EU. With effect from 1 January 2014, the exchange of shares and bonds would be taxed at a rate of 0.1%; and derivative contracts, at a rate of 0.01%. This proposal has sparked significant debate, including in the European Council and the European Parliament, but for now it appears that achieving the necessary unanimity of support, across all 27 Member States, is unlikely to happen – so the proposal could not be adopted in its current form.

One assessment of this proposal comes in a report dated 22 December 2011 and published by Oxera, entitled, *What would be the Economic Impact of the Proposed Financial Transaction Tax on the EU? Review of the European Commission's Economic Impact Assessment.*

> ESMA announced that it considers the regulatory frameworks for credit rating agencies of the United States of America, Canada, Hong Kong and Singapore to be in line with European rules.

This report finds that, as stated in the executive summary, "The proposed FTT is likely to have a significant and highly uncertain negative impact on the economy of the EU – not just for international financial centres like London but for all business and investors in the EU." More broadly, the City of London has recently published a report prepared for the International Regulatory Strategy Group. This provides a review of 10 impact assessments and analyses (IAAs), including the Commission's and the Oxera study. First and foremost this review finds that these "… IAAs refute that the proposed EU FTT will effectively address key policy objectives regarding systemic risk, high frequency trading (HFT) and the perceived under taxation of the financial services sector…".

In the meantime, new French domestic FTT proposals received definitive parliamentary adoption on 29 February, pursuant to which three different taxes are introduced as from 1 August 2012. These relate to the acquisition of listed shares issued by large French companies; HFT; and certain sovereign CDS.

Contact: David Hiscock
david.hiscock@icmagroup.org

Collective action clauses

The ESM Treaty was signed by euro-area Member States on 2 February 2012. The ESM Treaty includes a couple of specific points concerning collective action clauses (CACs). First, Recital 11 reports that the detailed legal arrangements for including CACs in euro-area government securities were finalised by the Economic and Financial Committee (EFC). ICMA's work in relation to this was discussed in the ICMA Quarterly Report for the First Quarter (page 23). The EFC's EU Sovereign Debt Markets Group (SDMG) has recently published the agreed text of the model CACs for the euro area, together with some explanatory notes. Secondly, Article 12.3 states that "Collective action clauses shall be included, as of 1 January 2013, in all new euro area government securities, with maturity above one year, in a way which ensures that their legal impact is identical", the timing for adoption having been advanced from the originally envisioned date in mid-2013.

Meanwhile, during March, CACs featured in two ways in the Greek debt exchange (which is more fully discussed in the Quarterly Assessment earlier in this ICMA Quarterly Report) First, Greek law was changed to retroactively provide a form of CAC applicable to those Greek law bonds subject to the debt exchange proposal. This new provision was then subsequently exercised in order to achieve an effective 100% exchange level in respect of the applicable Greek law bonds. We note that the euro-area authorities have stated that the Greek case is exceptional; and do not consider that the exceptional use of retroactive legislation in the Greek case should be permitted to create a general precedent. Secondly, the new bonds provided by the Hellenic Republic in the debt exchange, which are governed under UK law, include CAC language broadly consistent with that agreed for euro-area adoption from 2013.

As the euro area's adoption of CACs proceeds, ICMA will continue its dialogue with the SDMG. In doing so it will address points specifically related to these CACs, whilst also more generally continuing to promote the importance of enhanced transparency regarding the full terms and conditions of all sovereign debt issues.

Contact: David Hiscock
david.hiscock@icmagroup.org

> "IAAs refute that the proposed EU FTT will effectively address key policy objectives

Short-Term Markets

European repo market

Repo margin practices: On 15 September 2005, ICMA's ERC published a *Best Practice Guide to Repo Margining.* Consistent with its on-going commitment to promote best market practices, the ERC has recently been reviewing this document and has identified some scope to make improvements. In particular changes are now recommended to:

- provide that margin be based on actual rather than assumed settlement;
- ensure mutual agreement of margin calculation methods, since GMRA 2011 now embraces two alternatives;
- provide guidelines on minimum transfer amounts and interest;
- avoid netting of consecutive day's margin movements; and
- encourage migration towards same-day settlement of margin calls.

Accordingly, revised guidance is being prepared and will shortly be published, alongside a recommendation for adoption as from 1 July 2012. The ERC believes that these incremental changes will significantly assist in embedding the most up-to-date margin risk management practices across the repo market.

Shadow banking: On 19 March, the European Commission published its Green Paper on *Shadow Banking.* The Green Paper, which invites comments before 1 June, specifically identifies "securities lending and repo" as being significant shadow banking activities, in which regard section 7.3 of the Green Paper is particularly relevant. First and foremost, ICMA's ERC is continuing to actively engage with the FSB's shadow banking working group on repos and securities lending, led by the FSA's David Rule. The most recent step in this process of engagement has been the publication of Richard Comotto's papers, *Haircuts and Initial Margins in the Repo Market* and *Shadow Banking and Repo* (which are more fully reviewed in a separate article in this Quarterly Report). The European Commission is represented on the FSB's working group and its work is closely aligned with what the FSB is already doing. Whilst the ERC will be looking at the specific questions in the Commission's Green Paper, it seems likely that a key part of its response will consist in drawing attention to these recent Comotto papers.

2012 ICMA GMRA legal opinions update

The 2012 ICMA GMRA legal opinions update will shortly conclude with updates of the 2011 legal opinions being obtained in over 60 jurisdictions. ICMA is the sole provider of industry standard opinions on the GMRA 1995, 2000 and 2011 versions, as well as the 1995 version as amended by the Amendment Agreement to the 1995 version and the 1995 and 2000 versions as amended by the 2011 ICMA GMRA Protocol. The 2012 GMRA opinions have been obtained by ICMA, for the benefit of ICMA and its members (excluding associate members).

The 2012 GMRA opinions cover both the enforceability of the netting provisions of the GMRA as well as the validity of the GMRA as a whole. Furthermore, the opinions address the issue of recharacterisation risk (in respect of both the transfer of securities and the transfer of margin). While all 2012 GMRA opinions cover, as a minimum, companies, banks and securities dealers, the opinions for 29 jurisdictions additionally cover insurance companies, hedge funds and mutual funds as parties to the GMRA.

Publication of GMRA 2011 Guidance Notes, Bills Annex to the GMRA 2011 and Buy/Sell Back Annex to the GMRA 2011

In addition to the 2012 ICMA GMRA opinions, ICMA will also publish the GMRA 2011 Guidance Notes, the Bills Annex to the GMRA 2011 and the Buy/Sell back Annex to the GMRA 2011. The Guidance Notes to the GMRA 2011 are designed to assist users of the GMRA 2011 in completing the agreement and arranging transactions under the agreement. The Buy/Sell back Annex to the GMRA 2011 is used to document buy/sell back transactions, reflecting that: (i) buy/sell back transactions are terminable on demand; (ii) buy/sell back transactions are subject to repricing rather than margin maintenance; (iii) the Purchase Price and Sell Back Price are quoted exclusive of accrued interest; and (iv) Income payments are factored into the Sell Back Price. The Bills Annex to the GMRA 2011 is used to document transactions in Treasury bills, local authority bills, bills of exchange and certificates of deposit. In particular, the annex amends the definition of Equivalent Securities for these types of transaction and requires that the maturity date of the instrument be beyond the Repurchase Date.

Contact: Lisa Cleary
lisa.cleary@icmagroup.org

ECP market

Shadow banking: On 19 March, the European Commission published its Green Paper on *Shadow Banking,* which is broadly consistent with the FSB's October 2011 report on *Recommendations to Strengthen Oversight and Regulation of Shadow Banking.* There are five key areas, relating to (i) banking, (ii) asset management, (iii) securities lending and repurchase agreements, (iv) securitisation and (v) other shadow banking entities, where the Commission is further investigating options and next steps. In context of ICMA ECP Committee's work, it is noted that included amongst the possible shadow banking entities and activities on which the Commission is currently focussing its analysis are:

- Special purpose entities which perform liquidity and/or maturity transformation: for example, securitization vehicles such as ABCP conduits, Special Investment Vehicles (SIV) and other Special Purpose Vehicles (SPV);
- Money Market Funds (MMFs) and other types of investment funds or products with deposit-like characteristics, which make them vulnerable to massive redemptions ("runs"); and
- Securitisation.

Money market funds (MMFs): During her remarks at the Practising Law Institute's SEC Speaks on 24 February, SEC Chairman Mary Schapiro discussed the need to move forward with some concrete ideas to address the perceived structural risks associated with US MMFs. She said: "There are two serious options we are considering for addressing the core structural weakness: first, float the net asset value; and second, impose capital requirements, combined with limitations or fees on redemptions." Going on to stress the need to complete this outstanding work, she said: "To the extent that there's a deadline, it's the pressure that we should feel from living on borrowed time." ICMA ECP Committee will continue to collaborate closely with IMMFA to fully understand any more definitive US MMF proposals since, albeit that ESMA has put in place standard EU MMF definitions, it is expected that the EU will carefully watch any US rule changes and might well then follow them.

“ the need to move forward with some concrete ideas to address the perceived structural risks associated with US MMFs

ABCP update: On 20 February, the Technical Committee of IOSCO published a consultation report, *Principles for Ongoing Disclosure for Asset-Backed Securities* (ABS Ongoing Disclosure Principles). The consultation report (comments are sought by 20 April) enumerates 11 ABS Ongoing Disclosure Principles, intended to enhance investor protection by facilitating a better understanding of the issues that should be considered by regulators in developing or reviewing their ongoing disclosure regimes for ABS (including ABCP). The ABS Ongoing Disclosure Principles were developed as a complement to the *Disclosure Principles for Public Offerings and Listings of Asset-Backed Securities,* issued in April 2010, which provides guidance on disclosure regimes for offerings and listings of ABS but do not expressly address continuous reporting disclosure mandates or requirements to disclose material developments.

Contact: David Hiscock
david.hiscock@icmagroup.org

Issue 25 | Second Quarter 2012
www.icmagroup.org

Shadow banking and repo

Personal view by Richard Comotto

Shadow banking is back in the limelight. And repo is centre stage. The Financial Stability Board has had a work stream looking at repo (and securities lending) for some time and the European Commission issued its Green Paper on 19 March.

ICMA is keen to ensure that policy makers understand how repo and the repo market works, and that they recognise the role repo plays in traditional banking, as well as in supporting the efficiency and stability of the financial system. It therefore commissioned two studies, the first on collateral haircuts, the latest on issues such as asset encumbrance and transparency.

Mandatory collateral haircuts: Mandatory haircuts seek to address the risk of excessive leverage and the perceived instability of repo and other collateralised funding instruments.

The risk of excessive leverage is thought to arise because collateral, in theory, allows infinite leverage (repo out assets to borrow cash, use the cash to buy new assets, repo out the new assets to borrow more cash, and so on). Haircuts are seen as a way of reducing this money multiplier. If you can only borrow 80% of the value of collateral when you repo out assets, you get less cash each time.

A mandatory haircut is very undesirable, as a blunt tool which could reduce liquidity across the market.

In practice, banks cannot borrow as much as they want from the market, even if they have collateral. Lenders have credit limits and monitor borrowers' activity to detect signs of over-borrowing, whether unsecured or secured. This is why Lehmans did Repo 105 and MF Global did repo-to-maturity – to disguise their levels of borrowing.

The idea that lenders are indifferent to counterparty risk if they get collateral completely misinterprets its role. Even the best collateral is not risk-free, so the primary credit risk to a repo buyer is the repo seller, not the collateral. The role of collateral is *not* to permit lending to new and riskier counterparties but to allow lending to existing counterparties to be conducted more capital efficiently and within the normal credit risk management framework.

A mandatory haircut is therefore unlikely to work. But it is also very undesirable, as a blunt tool which could reduce liquidity across the market, just to deal with a problem specific to individual institutions.

As regards the use of mandatory haircuts to stabilise the repo market, the working premise is that the crisis was driven by a haircut-collateral price spiral: bad news about structured securities increased haircuts, which withdrew liquidity from borrowers, who had to sell off assets, which caused prices to fall and haircuts to increase again, and so on. However, structured securities were a minor component of repo collateral in 2007. Most collateral did not suffer severe increases in haircuts during the crisis. Our estimates suggest the impact of rising haircuts was less than 3% over 2007-09.

Other issues: The question has been asked as to whether repo "encumbers" assets given as collateral, in other words, leaves unsecured creditors with less assets if the borrower becomes insolvent. But as cash is received against collateral, the value of the borrower's estate in insolvency is not diminished by repo.

Encumbrance could arise where collateral is subject to a haircut. But haircuts are not universally applied, nor are they generally significant. Where they are deep, for example, in long-term repo, the buyer typically pledges back the haircut to the seller, which eliminates encumbrance.

Another question is about the transparency of repo. This seems to have arisen because some commentators mistakenly assume that the US accounting loopholes exploited by Lehman and MF Global to get assets off balance sheet represent the standard method of accounting for repo. In fact, the proper treatment clearly signals leverage by expanding the balance sheet.

There has also been concern about the transparency of the repo market. Despite a wide range of available statistics, including the semi-annual ICMA European repo market survey, there is a case for greater disclosure, but how much needs careful consideration. The regulatory value of the information gathered must justify the cost of reporting. Whether the case for more transparency extends to a repo trade repository is debatable. It would be no small undertaking, so a thorough cost-benefit analysis is essential.

Copies of the two papers *Haircuts and Initial Margins in the Repo Market* and Repo and *Shadow Banking* are both available from www.icmagroup.org .

Richard Comotto
Senior Visiting Fellow, ICMA Centre

Treatment of securities in the Basel III Liquidity Coverage Ratio

Whilst debates proceed regarding details of the implementation of Basel III in Europe, ICMA has been reviewing the treatment that securities receive under the new liquidity rules. As explained in past Quarterly Reports, the new Liquidity Coverage Ratio (LCR) is set for implementation from January 2015, and requires banks to hold enough liquid assets to cover expected net outflows during a 30-day period of extreme stress. It is foreseeable that banks significantly engaged in repo-style transactions and other similar securities financing activities will suffer more than others from this new requirement. On the other hand, Basel III may precipitate greater demand for corporate bonds.

The objective of this article is to highlight the way in which corporate bonds, repos, securities borrowing and commercial paper are treated under the new rules.

Corporate bonds: Corporate bonds rated AA- or above may be considered for Level 2 of the stock of high-quality liquid assets, subject to a minimum 15% haircut, as long as the following conditions are satisfied: (i) not issued by financial institutions; (ii) traded in large, deep, and active repo or cash market characterised by a low level of concentration; and (iii) proven record as a reliable source of liquidity in the market during stressed conditions. Naturally any bond holdings with coupon and maturity dates falling during the 30-day stress period will give rise to cash inflows; and conversely coupon and maturity dates on bonds issued will give cash outflows.

Repos, reverse repos and securities borrowing: Although only unencumbered assets may be included in the stock of high-quality liquid assets, assets received in reverse repo and securities financing transactions that are held at the bank and have not been re-hypothecated can be considered as part of the stock. Additionally, applicable assets pledged to the central bank but not used may be included in the stock. Client pool securities or cash received from a repo backed by client pool securities, however, should not be treated as liquid assets.

For the purposes of the cash outflows, loss of secured funding on short-term financing transactions with maturities within the 30 calendar-day stress horizon is considered. Under the stressed scenario, the BCBS assumes that maturing secured funding transactions backed by Level 1 assets would be rolled over, therefore no reduction in funding availability against these assets is assumed to occur. The same assumption applies for those transactions which are backed by Level 2 assets, though a 15% reduction is applied. Furthermore, a reduction factor of 25% is considered for central bank repos that are neither backed by Level 1 nor Level 2 assets. Finally, all other maturing transactions will be included for 100% of the amount of funds raised through the transaction.

Conversely, reverse repos and securities borrowing are considered for cash inflows according to the type of collateral used. The BCBS assumes that maturing reverse repurchase or securities borrowing agreements which are secured by Level 1 assets will be rolled over will not give rise to any cash inflows. In case the collateral used is included in the Level 2 assets, 15% of cash inflows is taken due to the reduction of funds extended against the collateral. A bank is also not assumed to roll over maturing reverse repo or securities borrowing agreements secured by non-Level 1 and non-Level 2 assets, and can assume to receive back 100% of the cash related to those agreements. There is an exception, however, when the collateral is re-used to cover short positions. In this case, a bank should assume that the reverse repo will be rolled over and this will not give rise to any cash inflows.

Commercial paper: With regard to cash outflows, banks having structured financing facilities that include the issuance of short term debt instruments, such as asset-backed commercial paper (ABCP), should fully consider the potential liquidity risk arising from these structures and thus include 100% of their maturing amount, together with the 100% of the assets that could potentially be returned from the transaction. Other CP owned or issued will give rise to full inflows or outflows in line with applicable contractual maturity provisions.

As the composition of the LCR liquidity buffer remains the subject of debate, ICMA will continue to monitor closely the implementation of the new liquidity standards in the EU.

Contact: Serena Vecchiato
serena.vecchiato@icmagroup.org

Primary Markets

Public Sector Issuer Forum

As referred to in the Quarterly Report for the First Quarter, ICMA is supporting the establishment of the new Public Sector Issuers Forum (PSIF). The PSIF held its first meeting, hosted by the Agence France Trésor in Paris on 9 February, with more than 20 senior participants from SSAs divided almost equally between sovereigns, supranationals and agencies.

The PSIF's objective is to act as an information exchange that will bring together all of the SSAs actively issuing in the European capital markets. The participants will share experience and concerns from their capital markets activity focusing both on market practice and on the impact of increasing regulation in Europe, as well as from the US (with respect to extraterritorial implications).

Going forward, the PSIF will develop its activities alongside other ICMA councils and committees, and will contribute a major new building block to ICMA's ambition to interact with all participants in the capital markets. SSAs will indeed provide a considerable share of debt capital market issuance in the foreseeable future, and are therefore a voice to which ICMA could not fail to provide a stage. The PSIF will also generally aim to be a bridge between the SSA sector and all the other participants in the capital markets.

The PSIF's membership is open to all issuers from the SSA sector, with a particular focus on those with active securities issuance programmes in the European markets. A Steering Committee was established for the governance of the PSIF with three senior members representing each of the three SSA constituencies. Working groups will also be created going forward and when required.

ICMA's support for the PSIF will take the form of its Paris-based Secretariat, strategic input from its Market Practice and Regulatory Policy Department, and access to expertise from all of its committees and councils. The PSIF will meet quarterly. Regulatory and market issues will be explored by inviting recognised market, legal and regulatory specialists to the PSIF's meetings to help inform its discussions.

It is clear that the forthcoming regulations in Europe and from the US are a major theme of interest for the PSIF. This focus on regulatory issues arises both with respect to its direct impact on SSAs, as well as indirectly inasmuch as new regulations may impact banks and other providers' services to SSAs. Participants will also exchange on market practice as it relates to the SSA sector. There is also great interest in monitoring financial market developments that are pertinent to SSA issuance.

Contact: Nicholas Pfaff
nicholas.pfaff@icmagroup.org

by Ruari Ewing

Prospectus Directive regime

Interest continues to be intense in the run-up to the 1 July national transposition deadline for the EU's amended Prospectus Directive (PD) regime, with several developments following on from the various PD review aspects discussed on pages 28-30 of the ICMA Quarterly Report for the First Quarter.

At Level 1, work continues to ensure the national laws of EU Member States are amended in line with the provisions of the PD Amending Directive. In this respect, ICMA submitted a short response to the Financial Services Authority and HM Treasury's joint Consultation Paper CP11/28, focusing just on the technical definition of a "qualified investor". In Italy meanwhile, CONSOB published Resolution No. 18079 to amend its Regulation No. 11971/1999 on issuers. ICMA engages in some aspects of national transposition when most relevant but does not proactively monitor national transposition in all EEA Member States.

At Level 2, ESMA published the anticipated *Final Report on the Second Instalment of its Level 2 Advice.* Regarding consent to use an issuer's prospectus, the advice helpfully seeks to account for feedback from the preceding consultation – acknowledging that market practice differs in several respects from ESMA's prior understanding. In this respect, ESMA advises consent information (confirmations of consent and reliance thereon; acknowledgements of responsibility; time periods, locations and other conditions; details of intermediaries involved; terms of sub-offers) must be disclosed in a prospectus, base prospectus, final terms, issuer website, intermediary website or otherwise by the intermediary under MiFID – depending on whether the consent is (i) given in relation to a "stand-alone" issue prospectus or an "issuance programme" base prospectus, (ii) is "general" or "specific" to certain intermediaries and (iii) known at the time of the prospectus / base prospectus or final terms. Though many individual information items are advised to be "Category A" under the general A/B/C categorisation developed by ESMA for PD information, it is worth recalling that ESMA's *First Instalment of Level 2 Advice* (October 2011) stated that a base prospectus "can contain options with regard to *all* the information required" (emphasis added), with final terms then determining which of this optional information is applicable for an individual issue.

The second instalment of advice proposes generally maintaining the current PD positions in relation to tax withheld at source, indices composed by the issuer and the number of required years of audited historical financial information, whilst purporting to introduce some flexibility in relation to the nuance between profit forecasts/estimates and preliminary statements. Incidentally (and similarly to the provisions of the first instalment of advice), the substance of the advice is recommended to be

The Prospectus Directive (PD) regime: First implemented in 2005, the PD regime governs the content, approval and publication of prospectuses for the admission of securities to trading on EEA-regulated markets and their non-exempt offering in the EEA. It consists of the Level 1 Directive itself (transposed by EEA national laws) and a Level 2 PD implementing Regulation (which is directly applicable under EEA national laws, without specific transposition being required). A first review of the PD regime has been under way since 2009.

"

The looming very short timeline for issuers to review the adopted delegated acts and implement them into their issuance programmes without compromising their ability to access the markets will be challenging.

brought into effect by 1 July. However, unlike the first instalment of advice, the second instalment of advice makes no reference to any grandfathering provisions.

The actual effect of ESMA's two instalments of advice will depend mainly on how they are implemented by the European Commission as Level 2 delegated acts. Many practitioners were expecting (at the time of writing this article) the Commission to adopt and publish (hopefully including on the Commission's PD webpage), by the end of March, two supplemental Regulations to the existing PD implementing Regulation, one in respect of each of the two instalments of advice (with the underlying advice expected to be quite closely followed). It is however conceivable that the short time since publication of the second instalment of ESMA advice may cause any related supplemental Regulation to be slightly delayed. In terms of the 1 July target date, the European Parliament and European Council might be willing to waive some the basic three month objection period they are formally entitled to as they have already been involved in the Level 2 process on an informal preliminary basis.

The actual effect of the expected grandfathering of the general A/B/C categorisation developed by ESMA for PD information will also partly depend on any developments in regulator interpretations of the existing PD regime. Many practitioners have been expecting a publication on this by the FSA shortly.

The looming very short timeline (three months at most) for issuers to review the adopted delegated acts and implement them into their issuance programmes without compromising their ability to access the markets will be challenging. In this respect, many in industry are likely to be grateful should the Commission extend a uniform grandfathering approach across both supplemental Regulations. ICMA will, in any case, seek to facilitate discussions for those involved in advising issuers as to the impact of the Level 2 delegated acts once they are adopted and published.

Contact: Ruari Ewing
ruari.ewing@icmagroup.org

US Foreign Account Tax Compliance Act (FATCA)

The US Internal Revenue Service has published in February draft regulations on FATCA for comment by 30 April. The aspect most likely to be of immediate interest to bond issuers is that the proposed regulations exclude from the definition of withholdable and passthru payments any payment made under an obligation outstanding on 1 January 2013, and any gross proceeds from the disposition of such an obligation – a welcome push back of the initial grandfathering deadline of 18 March by nine months. ICMA will watch for member feedback in terms of whether to submit any comments on the draft regulations.

The FATCA regime: Enacted in the US in March 2010 as part of the Hiring Incentives to Restore Employment Act, the FATCA regime will notably:

- *require intermediaries effecting US source payments to enter into more substantial account reporting agreements with the US Internal Revenue Service (backed by a 30% withholding obligation on payments by compliant intermediaries to non-compliant accounts); and*
- *repeal (except for non-US issuers seeking to avoid the US excise tax on bearer debt) the Tax Equity and Fiscal Responsibility Act (TEFRA) exemptions relating to bonds in bearer form (with substantial resulting fiscal sanctions on bearer bonds of US issuers, namely loss of portfolio interest exemption from 30% withholding tax and non-deductibility of interest for corporation tax) – however, bonds held in a dematerialised book-entry system, or other system specified by the US Treasury, will be deemed to be in registered form for US tax purposes.*

The change of grandfathering date did not, however, extend to the effective repeal, regarding US issuers (including certain non-US members of US groups), of the TEFRA safe harbour that enabled bonds to be issued in bearer form without being subject certain substantial financial penalties applicable under US tax law to bonds not issued in registered form. In this respect, the IRS published advance notice 2012-20 (in "advance" of official publication in the Internal Revenue Bulletin) that seems to provide that bonds in contractual global bearer form will be deemed to be in "registered" form for US tax purposes (and so not subject to the penalties) where, *inter alia:*

(a) they are effectively held by a clearing system or its depositary "under arrangements that prohibit the transfer of the global securities except to a successor clearing organization subject to the same terms";

(b) underlying beneficial interests therein are transferable by book entry in the clearing system; and

(c) delivery of individual "definitive" form bond certificates to investors can occur only (i) on termination of the clearing system's business without a successor, (ii) on issuer default or (iii) further to a change in tax law adverse to the issuer but for the issuance of physical securities in bearer form (deemed registered status ceases to apply following the occurrence of any of these three circumstances).

It is not yet entirely certain what will constitute "arrangements" in (a) above, and so, in the meantime, US issuers may well seek to issue in contractual registered form. As the TEFRA safe harbour effectively continues to apply to non-US issuers, such issuers may well seek to continue to rely upon TEFRA and its related procedures. Certainly US issuers contemplating bearer issuance deposited into either of the two ICSDs, Euroclear or Clearstream, may wish to contact the relevant ICSDs sufficiently in advance to clarify procedural practicalities concerning any reporting and/or withholding requirements.

Contact: Ruari Ewing
ruari.ewing@icmagroup.org

ICMA CoCo Survey

As reported in the 2012 First Quarter edition of the ICMA Quarterly Report, the European Banking Authority (EBA) published on 8 December 2011 its formal recommendation, together with a supplementary Q&A and the final figures, relating to banks' recapitalisation requirements. The recommendation states, *inter alia*, that national supervisory authorities should require certain credit institutions to establish an exceptional and temporary buffer so that Core Tier 1 capital ratios reach a level of 9% by the end of June. Newly issued private contingent convertibles (CoCos) are eligible to be considered as a part of the buffer if consistent with the common termsheet, as devised by the EBA for this purpose.

One of the key advantages of issuing CoCos to meet the stress capital requirements induced by the EBA recapitalisation exercise is that it gives issuers access to certain fixed income investors to raise the relevant Core Tier 1 capital. Market appetite for equity, particularly in current static conditions, would not competitively provide issuers with the relevant capital, and therefore the possibility of using CoCos to tap supplementary investor sources for Core Tier 1 capital is welcomed.

However, as well as achieving the regulatory objectives, in order for the CoCos to be fit for purpose, the characteristics of the CoCo host instrument should be sufficiently attractive to relevant investors. While the host

In brief

In December 2011, the European Banking Authority (EBA) confirmed that, provided that they are consistent with the EBA's common termsheet, contingent convertibles (CoCos) are eligible to be considered as a part of the exceptional and temporary buffer which national supervisory authorities should require banks to establish. Amid concerns surrounding their suitability, ICMA conducted a survey on the marketability of the EBA CoCos among major market participants.

assigned to the CoCo may be less important for stress capital and stress testing purposes, it is of vital importance to the issuer in terms of marketability and, therefore, the price and amount of CoCo capital they can raise in order to meet their stress capital requirements.

The EBA CoCo host is a perpetual instrument with deferrable, non-cumulative coupons – characteristics which are more akin to a Basel Additional Tier 1-style host. Amid concerns surrounding the suitability of the host, ICMA conducted a survey on the marketability of the CoCos among 48 major market participants (among them issuers, intermediaries and investors), in which we posed a series of questions comparing the market impact of CoCos with an Additional Tier 1-style host with otherwise identical CoCos with a Tier 2 host (being a dated security which carries non-deferrable coupons, and which would still otherwise meet the EBA CoCo minimum requirements).

The results in full of our survey and correspondence with the EBA can be viewed on our website. In summary however, according to the results of our survey, the potential issuing capacity for an issuer issuing a CoCo with an Additional Tier 1-style host is considered to be significantly lower than for a CoCo with a Tier 2 host, particularly in the case of lower-rated issuers (BBB). Additionally, market participants estimate the coupon commanded by a CoCo with an Additional Tier 1-style host to be significantly higher than the coupon of an otherwise identical CoCo with a Tier 2 host.

In conclusion, there would appear to be significantly more appetite in the market for a CoCo with a Tier 2 host than for a CoCo with an Additional Tier 1-style host with otherwise identical characteristics. In particular, issuers with lower ratings who cannot readily access alternative sources of EBA Core Tier 1 (such as retained earnings, reduced bonus payments and new issuance of common equity) are likely to require access to the market in CoCos but will find it more difficult, or at least economically non-viable, to issue CoCos with an Additional Tier 1-style host. However, assigning a Tier 2 host to the CoCos, as well as being be a more widely accepted form of capital, would allow issuers access to a broader fixed income investor base, either on a new issue basis or through a liability management exercise, without compromising the loss absorption characteristics required in the event of a regulatory stress event (ie a Contingency Event or a Viability Event, as defined in the EBA termsheet).

With the technical provisions for Additional Tier 1 capital as envisaged under CRR IV still subject to further review within the EU, there is residual concern among the survey participants surrounding compliance and potential inconsistencies between the EBA CoCo and CRR IV Additional Tier 1 capital. However, if the EBA CoCo had a Tier 2 host, the characteristics of which are familiar to market participants, the risk of any such inconsistencies would be eliminated, thereby giving issuers more certainty on future eligibility under CRR IV. Conversely, while the EBA termsheet is currently confined to CoCos to be issued pursuant to the recapitalisation plan and to the banks affected thereby, there is a danger that it might by stealth pave the way for the emergence of a similar instrument under CRR IV, which would likewise lead to the same issues in terms of marketability.

In response, the EBA noted that the choice of host instrument has been a source of concern for some investors in terms of attractiveness and marketability. Nevertheless, the Board of Supervisors of the EBA, considering all the options and taking into account all available information, including the information collected from market participants, concluded that the instrument needs to maintain strong features in terms of permanence, loss absorbency and flexibility of payments, which is achieved by assigning the CoCo an Additional Tier 1-style host with the afore-mentioned characteristics. The EBA is however confident that the efforts to provide some regulatory benchmarks could help the market for contingent capital to develop in the future.

ICMA continues to maintain open channels of communication with the EBA and hopes to be able to have a general exchange with them in the near future on certain aspects of the CoCo termsheet and other related issues.

Contact: Katie Kelly
katie.kelly@icmagroup.org

Other primary market developments

Securitisation: In February, ICMA participated in joint association comments on aspects of the Volcker Rule that impact securitizations and on proposed Rule 127B under the US Securities Act of 1933.

Retail structured products: In January, ICMA participated in the Joint Associations Committee response to the FSA consultation on retail product development and governance. The FSA has published a feedback statement and final guidance in this area.

Contact: Ruari Ewing
ruari.ewing@icmagroup.org

Asset encumbrance

One effect of the €1 trillion of secured ECB funding under the 3 year LTRO programme has been to prompt some further comment across the markets on the appropriate level of asset encumbrance at European banks. Research reports, investor inquiry and regulatory interest are all converging and heightening around a subject which in reality is still poorly understood and largely undefined.

As the market for financial institution debt became more challenging, banks in some parts of Europe had increasingly to rely on offering collateral as part of their funding strategies. At the most obvious level, covered bonds involve mortgage portfolios to provide the source of collateral, but there are other forms of encumbrance, such as securitisation and OTC derivatives (although to a lesser degree). Investors and bond analysts have increasingly taken note of this as, logically, pledging good assets to one class of creditor reduces the stock of good assets available to other classes of unsecured creditors.

However, the analysis is not so straightforward. Asset encumbrance levels are a function of the business mix and funding disposition of many banks coloured also by traditional regional funding practices, such as the presence of well developed local covered bond mortgage funding tools. Furthermore, the degree of risk investors might be exposed to will be a function of the rules governing the resolution regimes for banks, including the extent to which senior debt might be subject to a bail-in and the impact of any depositor preference regime.

All of this suggests that there is a lot of work to be done in terms of defining the nature of encumbrance, what constitutes encumbrance and whether there is even an appropriate level of encumbrance. Recent informal discussions suggest that investors would certainly welcome higher levels of disclosure, but even then technical work needs to be completed so that encumbrance is correctly qualitatively and quantitatively measured.

ICMA will be working with interested parties to deepen understanding of the issue, examine ways of enhancing transparency and promoting flexibility in the potential regulatory response in order to avoid the law of unintended consequences, which would likely come into play in the event of any premature and precipitous regulatory or legislative intervention. Hence we note with interest recent proposed amendments to CRD IV from Vicky Ford MEP, which address aspects of this issue.

Contacts: Nathalie Aubry-Stacey and Katie Kelly
nathalie.aubry-stacey@icmagroup.org
katie.kelly@icmagroup.org

by John Serocold

Secondary Markets

MiFID II and MiFIR

Significant political pressure continues to complete the Level 1 text of the revision of MIFID (MIFID II) and the accompanying EU Regulation (MIFIR) by the end of 2012. This pressure derives partly from G20 commitments (for example on mandating centralised trading of standardised derivatives).

The official European Parliament timetable is consistent with this ambition: the rapporteur's draft report at the end of March; amendments to be proposed by mid-May; an ECON Committee vote in July; a plenary vote in September. The latest ECOFIN Council conclusions also renewed Member States' commitment to an end-2012 completion of the Level 1 legislation.

Some commentators suggest that the timetable may slip, because of the length of the MIFID II and MIFIR proposals, the number and economic significance of proposed changes to MIFID I and new provisions, and the volume of other legislative business in Council and European Parliament. We understand that the Council consideration of detailed drafting is not yet well advanced. It remains to be seen how extensive amendments proposed by MEPs will be.

Regardless of whether the end-2012 target is met, and especially if pressure of time means that the amendments to the Level 1 proposal are at a high level of generality, it seems likely that much of the detail of new MIFID requirements, with important bearing on the structure and conduct of fixed income markets, will be left to the subsequent revision of the Level 2 implementing measures, or to ESMA regulatory standards. In this context, ICMA has been stressing how crucial it is to allow enough time for the European Commission and ESMA, in consultation with ICMA and other market participants, to determine requirements that meet the particular needs of users of the international capital market. In principle, Commissioner Barnier acknowledged the importance of this point in his response to the recent letter from ICMA and other associations.

MiFID is wide-ranging and, from a pure ICMA perspective, the direct impact on members is relatively limited. ICMA's priorities are in the following areas:

- *Organised Trading Facilities* (OTFs): Keep this new category of regulated trading venue flexible enough to accommodate clients' needs, including by not prohibiting a firm operating an OTF from committing its own capital to facilitate client trades.
- *Pre-trade transparency:* Ensure that new requirements on non-equity pre-trade transparency in Regulated Markets (RMs), Multilateral Trading Facilities (MTFs) and OTFs can accommodate the existing diversity of pre-trade information and trading practices without disruption to client service.
- *Post-trade transparency:* Ensure that new requirements on non-equity trade reporting take account of clients' needs for deferral of reporting of large or illiquid trades.
- *Systematic Internalisers* (SIs): Ensure that extension of quoting and trading obligations from equity to non-equity markets takes account of specific

features of the international capital market, and does not inhibit firms' ability to deal in size with clients in illiquid instruments.

- *Third country firms:* Maintain the openness of EU markets to worldwide participation, without inappropriate restriction on EU entities' ability to access third country services, or third country entities' ability to access the EU.

ICMA has continued to work with other associations across Europe, representing both buy and sell sides of the market, with a view to agreeing the priorities for users of the market, and suggesting to the Council and European Parliament approaches to legislation in the fixed income market which, while remedying deficiencies where they have arisen, preserve the aspects of current arrangements that market users value.

Contacts: John Serocold and Timothy Baker
john.serocold@icmagroup.org
timothy.baker@icmagroup.org

CSD Regulation and settlement fails

On 7 March, the European Commission published a proposed Regulation (the CSD Regulation) which will have an effect on ICMA and our market when it comes into force. Links to the Commission press release, the proposal for the CSD Regulation and the impact assessment can be found on the Commission's CSD home page.

The Commission's statement of the issues being tackled in the CSD Regulation is as follows:

"Settlement is an important process, which ensures the exchange of securities against cash following a securities transaction (for instance an acquisition or a sale of securities). CSDs are systemically important institutions for the financial markets because they operate the infrastructures (so-called securities settlement systems) that enable the settlement of virtually all securities transactions. CSDs also track how many securities have been issued, by whom, and each change in the holding of such securities. Finally, they play a crucial role for the financing of the economy, as almost all the collateral posted by banks to raise funds flows through securities settlement systems operated by CSDs. However, CSDs are still regulated only at national level, and cross-border settlement is less safe (failure for cross-border transactions can reach up to 10% in certain markets) and efficient than domestic settlement: costs are up to four times higher. The proposed Regulation will complete the European regulatory framework for securities markets."

We are analysing the proposal, and its implications for ICMA's Secondary Market Rules and Recommendations, and will work closely with members and our settlement partners, the ICSDs, as it develops, evaluating and responding as appropriate. We will report further in the usual way in due course.

The main points to bring to members' attention now are:

- for all securities traded on regulated markets, MTFs and OTFs, the intended settlement date (ISD) is to be no later than T+2;

In brief

This article notes the main features of the proposal from the European Commission for a CSD Regulation, outlines ICMA's work and summarises the ERC's initial views and concerns.

- a CSD must have measures to prevent and address settlement fails for each securities system it operates. On settlement discipline, the proposal requires that all CSDs must have a settlement discipline regime which provides:
  - "sufficiently deterrent" daily penalties from ISD;
  - a buy-in regime whereby the securities shall be bought in the market *no later than four days after ISD.* The pricing and costs of a buy-in must be specified and disclosed to participants; and
  - where a buy-in is not possible, the amount of cash compensation must be higher than the price at which the trade was done and the last publicly available price on the trading venue where the trade took place;
  - the ERC has begun to develop its thinking ahead of the publication of the proposal and an outline of their views is in the box.

Our analysis is still developing, but it may be that the current settlement convention will have to change and we shall need to agree practical arrangements with the ICSDs in relation to settlement discipline. The Secondary Market Practices Committee will be in the lead on this.

The ICSDs are potentially heavily affected. We shall be working with them to understand how the impact of the regulation on them will affect our members who are the ICSDs' users.

Next steps: The CSD Regulation will be considered by the European Parliament and the European Council in the usual way. The rapporteur is Dr Kay Swinburne, a British MEP who issued a statement on publication.

Contact: John Serocold
john.serocold@icmagroup.org

ICMA ERC's approach to the CSD Regulation

The ICMA ERC's position is broadly as follows:

- For the European repo community, the current arrangements generally work well and should be preserved. Disruptive change at a time of crisis is undesirable, however desirable the objectives. The repo market is a vital and increasingly important part of the financial markets infrastructure and should not be disrupted. Market users and their suppliers are working together to develop the infrastructure and harvest efficiencies; but public sector involvement is needed to support this effort. In particular, the Commission should take into account the continuing settlement issues in some CSDs and the resulting inefficiencies, directly resulting in a higher cost of cross-border settlement; these are clearly identified in the ERC White Paper of 2010 and subsequent updates. (The latest update is dated 25 March 2011.)
- The ERC is concerned about the intrusive proposals in relation to failed settlements. This needs to be studied very carefully as it will almost certainly affect the ICMA's buy-in procedures for both cash and repo markets. The proposed obligation to proceed to buy-in after four business days is also a major issue.
- Market users have helped to develop the infrastructure to create beneficial changes. Examples include:

  (i) The development of the interoperability "bridge" between the ICSDs to support daytime processing and a wider range of transaction types; and

  (ii)The development and enhancement of new products like tri-party repo (and, prospectively, the rise of credit claims as collateral);
- In relation to safety, we believe the success of the current arrangements demonstrates that the architecture is robust.

Short Selling Regulation

In respect of the ESMA consultations on technical standards and delegated acts in relation to the Short Selling Regulation, ICMA has done what was possible in the very short time available to respond, collaborating with AFME, ISDA and ISLA; and with relatively little direct feedback from member firms. Copies of the responses, dated 13 February and 10 March 2012, can be found on our website.

Background: In November 2011 the Council and the Parliament voted on a Regulation on short selling and certain aspects of credit default swaps (the Short Selling Regulation or SSR). This had not been published at the time of the first consultation and will be applicable from 1 November 2012. According to the Regulation, ESMA has to submit its technical standards to the Commission by 31 March 2012. Further, on 24 November 2011, ESMA received a request from the Commission for advice on all the delegated acts contained in the Regulation by the same deadline.

Our letter of 17 January to the Presidency of the EU, the European Commission and the European Parliament raised serious concerns about the pace of reform and in particular the need for time to be allowed to the new European authorities to carry out their allotted tasks. It was co-signed by senior officers of six other associations.

The first consultation: The purpose of the first consultation was to seek comments on the draft technical standards which will bind the domestic regulators in the EU (and certain other countries which are members of ESMA). Our principal points in response to the first consultation were:

- The use of the MiFID “liquid shares” definition in Article 6 is inappropriate and would cause significant costs to the market place and ultimately to long term investors who lend securities. It would also materially worsen liquidity in shares that are less liquid. Our analysis shows that there are significant differences between what is liquid in the cash market and what is liquid in the securities lending market (the most relevant market for this purpose). We have suggested alternative approaches which would lessen the negative impacts of the proposal.
- We do not believe it is appropriate or necessary for the Implementing Technical Standards to provide for exhaustive lists of “Agreements, Arrangements etc.” or of “Third Parties”. The lists provided in the draft in fact do not include certain agreements or entities that are very commonly used for covering of short sales and we have made suggestions as to what should be included. Importantly we do not believe that the definition of Third Party should preclude the use of a specialist internal repo or securities lending desk. Whilst we understand that

In brief

The extremely brief consultation periods on measures for the implementation of the Short Selling Regulation (SSR) posed challenges for trade associations and for market participants. We worked with AFME, ISDA and ISLA on common responses. We set out a summary of the points we made. There were two consultations: one from 24 January to 10 February, covering technical standards; and one from 16 February to 9 March, covering secondary regulations to be made by the European Commission, known as “delegated acts”. The next step is for ESMA to provide its report and advice to the European Commission. We shall continue to track the progress of the new regulations and raise concerns as appropriate.

there may be certain legal issues, requiring that a third party is a separate legal entity only serves to increase costs of business and will have a detrimental effect on liquidity.

- We consider that the limited timeframe ESMA has had to prepare the technical requirements, and the three week consultation period available to market participants, has not provided sufficient time to thoroughly consider the impact the ESMA proposals will have on the market.
- The proposed interpretation of the grandfathering rule could result in retrospective effects of the ban on uncovered sovereign CDS, which could introduce legal uncertainty, increase prices of the sovereign CDS protection or significantly reduce its availability and consequently increase funding costs for the sovereign and corporate debt markets.

The second consultation: The purpose of the second consultation was to seek comments on the technical advice that ESMA proposes to give to the European Commission in relation to a number of possible delegated acts concerning the Short Selling Regulation as listed in the Commission request for advice of 24 November 2011. These delegated acts should then be adopted in accordance with the process foreseen by the Lisbon Treaty. Our principal points in response to the second consultation were:

- We support ESMA in trying to offer market participants guidance on how to interpret the concept of “correlation”. However, we do not support the introduction of a firm quantitative test for correlation. A level of 90% – as proposed by ESMA – is inappropriately high.
- A backward-looking test for correlation, based on historic data, is too restrictive; in dynamic markets and particularly during periods of volatility it would prevent market participants from deploying hedging techniques based on developing or anticipated correlations between assets.
- Any guidance on the assessment of correlation must recognize that price correlation (whether historic or expected) will not always be an appropriate measure. Sovereign risk may be an indirect, or only partial, contributor to price movements in a given asset, and yet such asset may still serve as coverage for a CDS. This principle is specifically acknowledged in Recital 21 of the Regulation.
- A geographic restriction on the use of sovereign CDS for hedging purposes is not justified by the Level 1 Regulation, will prevent legitimate hedging strategies that nevertheless meet the tests of correlation and proportionality from being employed, and is thus a disproportionate restriction on the operation of the EU Single Market.
- The introduction of a mandatory time limit within which sovereign CDS position holders must offload a proportion of their position when it becomes partially uncovered is inappropriate, and has the potential to significantly increase volatility in the sovereign CDS market.
- We are concerned that the provisions on grandfathering are unclear and will leave market participants facing considerable uncertainty about the legal status of particular trades.

Next steps: We will continue to follow the progress of the technical standards and the delegated acts as they make their way through the new legislative process, in cooperation with the associations with whom we responded to the consultations.

Contact: John Serocold
john.serocold@icmagroup.org

by Nathalie Aubry-Stacey

Asset Management

Corporate governance

In the ICMA Quarterly Report for the First Quarter, an article was dedicated to the UK Kay Review on UK *Equity Markets and Long-Term Decision-Making*, to which the ICMA Asset Management and Investors Council (AMIC) responded.

The independent review is examining investment in UK equity markets and its impact on the long-term performance and governance of UK quoted companies. The review's principal focus is to ask how well equity markets are achieving their core purposes: to enhance the performance of UK companies by facilitating investment and enabling effective governance and decision making in support of long-term profitability and growth; and to enable investors to benefit from this corporate activity in the form of returns from equity investment.

On 29 February 2012, Professor Kay published the Interim Report of his independent review to examine investment in UK equity markets and its impact on the long-term performance and governance of UK quoted companies. The Interim Report summarises the responses to the review's call for evidence and presents a broad discussion of the issues raised. The comments and proposals discussed in the report signal areas of interest for the final report but do not represent its provisional conclusions. Professor Kay is not making any recommendations at this stage. He will present his final report, including recommendations for action, to the Secretary of State for Business in the summer.

Contact: Dr. Nathalie Aubry-Stacey
nathalie.aubry-stacey@icmagroup.org

Covered bond transparency

The ICMA Covered Bond Investor Council (CBIC) is nearing the end of its second round of consultation focusing on the different themes identified as key in the consultation: investors' needs and additional fields; clarification of definitions and concepts; and format, frequency and access to the data.

CBIC members have already highlighted some of the key elements of the transparency project going forward. Some important basic points were agreed:

- The information should be freely available for all investors.
- It must be presented in an Excel sheet format.
- Data should be reported on a half-yearly basis and shortly after issuers' results are published.
- The CBIC through the ICMA owns the template. ICMA is to draft appropriate disclaimers.
- The issuers will post a link to the CBIC European transparency standards webpage – and can add or remove the link, should they want to.
- This link must give access to the CBIC template with information provided by the issuer.
- Issuers are responsible for the information posted. Additionally issuers may wish to consider giving access to additional information to investors through the link.

The CBIC has also responded in detail to the feedback from national issuers' associations, and providing high-level guidelines. General points regarding the CBIC's expectations on the template and detailed responses to issuers' questions have been published on the CBIC webpages. CBIC members replied in detail to the feedback statements from the Norwegian FNO, the French CFF and the UK RCBC. The responses, publicly available, provide an indication of the amendments that will be made to the template. CBIC members also considered investors' comments received throughout the process.

The CBIC has postponed the publication of its final template to ensure all parties are adequately consulted and have a chance to raise their concerns. The CBIC is hoping to present its final template ahead of the conference it is organising with the Covered Bond Report in Frankfurt on 10 May.

The ECBC has also progressed with its labelling project and published its new label convention and transparency requirements.

Contact: Dr. Nathalie Aubry-Stacey
nathalie.aubry-stacey@icmagroup.org

CRA3: an investor perspective

On 15 November 2011, the European Commission published proposals for further regulating credit rating agencies in the EU. The proposal follows the consultation paper published in November 2010 to which the AMIC responded. In our response, we highlighted that most institutional investors do not rely exclusively on ratings. While it is true that credit ratings are part of the mosaic of information considered as part of the investment process, they are generally not an appropriate sole source for making decisions. Ultimately CRA regulation from an investor's point of view should ensure that there are globally consistent, comparable, reliable high-quality information points about an issuer's credit worthiness.

The financial crisis exposed the limitations of credit ratings and the systemic consequences that can be triggered by unforeseen and abrupt downgrades. The FSB has led global work for the G20 to reduce the hard-wiring of ratings in regulation and to encourage market participants to not mechanistically rely on ratings in an effort to strengthen markets and mitigate systemic concerns. The first two sets of European proposals, which have only recently come into force, largely affected the internal running of credit rating agencies, with provision which included strengthening existing rules on managing conflicts of interest and the assessment of third-country regimes under the endorsement and certification provisions in the CRA Regulation. As part of this set of legislative actions, ESMA also conducted an examination to monitor compliance with the Regulation and to better understand the business of the three large groups of registered CRAs.

The new proposals go further, and impact the way the European debt capital markets operate. There are over thirty specific proposals in the new text. The European Parliament has been discussing these proposals, following the publication of the Domenici report. The amendments will be considered in committee until 24 April. The Domenici report is to be put to a committee vote on 21 May.

Some of the main topics discussed currently are:

- *Mandatory rotation – forcing corporate debt issuers to rotate their credit ratings amongst various agencies:* The Commission proposal rightly focuses on ending the "hardwiring" of ratings in regulation. The proposed mandatory rotation requirement may however create uncertainty for investors. Indeed under rotation, repetitive stopping and starting of ratings coverage would lead to more frequent ratings changes. At portfolio level, since ratings define certain investment risk parameters, changes to those ratings may trigger buying or selling activity of the assets with which portfolios are composed. Frequent buying or selling of assets would not only raise the cost of investing. It would also create uncertainty in the investment process for pensioners and savers and could accelerate client redemptions.
- *Civil liability regime – establishing an EU-wide liability standard for registered ratings firms:* The proposed civil liability regime reverses the current burden of proof arrangements which may reduce the number of issues rated and increase the cost of using ratings. Ultimately rating agencies issue opinions. Since all assigned ratings include an element of forward looking assumptions and events in the future may vary from original assumptions upon which the opinion was drafted. More importantly, a liability standard could be perceived as an "insurance policy" for investors who could claim that reliance on a rating resulted in a loss. Thus investors would have an artificial incentive to over-rely on ratings, contrary to the Commission's stated objective of encouraging investors to do their own analysis.
- *Regulatory involvement in ratings – requiring regulatory approval of proposed changes in ratings criteria or methodologies:* Requiring regulatory approval for new methodologies and criteria, and the requirement to publish standardised ratings may lead to more homogeneous methodologies and therefore less diversity of views of European credit risk. There are many ways to interpret raw data, trends and perceived patterns. Investors benefit from the diversity of these product outputs. In addition regulatory involvement may undermine the perceived independence and therefore credibility of ratings on EU issuers, and call into question the comparability of EU ratings with non-EU ratings.

The European Commission's proposals for reform of the Regulation governing credit rating agencies in Europe are far reaching and may result in global inconsistency. The AMIC supports the objectives of enhancing transparency, discouraging over-reliance on credit ratings and ensuring rating integrity and independence. The proposal should ensure that ratings are still a useful tool to use.

Contact: Dr. Nathalie Aubry-Stacey
nathalie.aubry-stacey@icmagroup.org

ETFs: future regulatory framework and other UCITS issues

On January 30, ESMA published a consultation paper setting out future guidelines on UCITS Exchange-Traded Funds (ETFs) and other UCITS-related issues. The proposals cover both synthetic and physical UCITS ETFs and detail the obligations to come for UCITS ETFs index-tracking UCITS, efficient portfolio management techniques, total return swaps and strategy indices for UCITS.

ESMA's proposals go wider than ETFs and cover such areas as the use of total return swaps by any UCITS, for which ESMA envisages additional obligations with respect to the collateral to be provided, or UCITS investing in strategy indices, where the requirements on eligibility of such indices have been tightened. The proposals also include placing an obligation on UCITS ETFs to use an identifier and facilitating the ability of investors to redeem their shares, whether in the secondary market or directly with the ETF provider.

“

The Working Group highlighted the importance of ETFs being seen as part of the general investment landscape rather than unique and distinct from other forms of investment.

In the summer of 2010, ESMA started looking into the operation of UCITS making use of the new investment freedoms introduced by the UCITS III Directive and the Eligible Assets Directive in order to identify the possible impact on investor protection and market integrity. As part of this work, ESMA published a discussion paper on *Policy Orientations on Guidelines for UCITS Exchange-Traded Funds and Structured UCITS* on 22 July 2011. This consultation paper represents the next stage in the development of ESMA guidelines in this area.

The AMIC set up in 2011 an ETF Working Group to highlight issues related to the evolution of the product under the leadership of John Nugée of State Street Global Advisors. The Working Group is composed of providers as well as investors. It presented a report in three main parts: Part 1, a descriptive section, with 4 sub-sections A-D which set out the current state of the ETF market; Part 2, an assessment section, with 3 sub-sections E-G which look at the trends and assess how the ETF market is likely to continue to develop, and considers the consequences for markets, investors and regulators alike; and Part 3, a concluding section with conclusions and recommendations.

The Working Group highlighted the importance of ETFs being seen as part of the general investment landscape rather than unique and distinct from other forms of investment. Rules and regulations applied to ETFs should therefore not be out of line with those applied to other investment vehicles, as was mentioned in the AMIC response to the ESMA Discussion Paper.

The Working Group has prepared a detailed response to the consultation paper. ESMA will take into account responses to this consultation paper in finalising the guidelines for adoption in the 2Q 2012.

Contact: Dr. Nathalie Aubry-Stacey
nathalie.aubry-stacey@icmagroup.org

Shadow banking: an investor perspective

Shadow banking was identified as an area of potential financial instability, owing to its size and interconnectedness with the traditional banking sector, by the G20 in 2011. The FSB was tasked with examining shadow banking to develop recommendations on the oversight and regulation of these entities and activities. The FSB task force on shadow banking has set up five work streams to examine the issue; which are due to report back in the second half of 2012.

On 19 March, the European Commission published its Green Paper on *Shadow Banking* with the aim of contributing to the global debate on how to improve the regulation and oversight of the shadow banking sector.

The Green Paper explores the following areas of interest to the asset management industry:

- the definition of shadow banking and the entities and activities which should be covered;
- the potential risks associated with shadow banking;
- the need for monitoring and supervising of the shadow banking sector;
- measures to limit opportunity for global regulatory arbitrage;
- current measures to regulate the shadow banking sector such as AIFMD, UCITS and Solvency II;
- outstanding issues where additional regulatory reform may be needed. These are broken down into five areas, which include asset management regulation (focusing on MMFs and ETFs).

Responses to the consultation are due on 1 June. The Commission is holding a stakeholder conference on 27 April.

Contact: Dr. Nathalie Aubry-Stacey
nathalie.aubry-stacey@icmagroup.org

Solvency II: reporting requirements

Since the last Quarterly Report, the ICMA Solvency II Working Group has further considered the impact of the Solvency II Pillar III proposals on the asset management industry, and notably regarding reporting requirements.

As anticipated by the last Quarterly Report, the Working Group responded to both the EIOPA Consultation Paper on the proposal for Quantitative Reporting Template and on proposal for Quantitative Reporting Template for Financial Stability Purposes.

The responses highlighted some key issues for asset managers:

- *Clarification regarding the operation of the threshold* which is supposed to determine whether the detailed list must be provided on a quarterly or annual basis by small and medium-sized insurers: From an asset manager, IT system and reporting requirement point of view, it is important that the thresholds are clearly established to ensure proportionality with a long term view of their activities. It is also critical that, once an insurance company has been exempted it remains exempted for a certain period of time.

- *The use of a CIC classification and the promotion of greater homogeneity and simplification of reporting:* The Working Group recognises that, as of today, such a CIC does not exist. Indeed, different actors (insurers as well as asset managers) are using different classifications in their portfolios management and risk management activities. There are various ways of establishing and reporting a CIC, and members would be happy to discuss this topic further with EIOPA. Once the classification is established, members believe its value would be in assessing risk in an aggregate way rather than using the "look-through" requirement.

- *Comprehensive reporting of small positions:* The Working Group believes that providing and analysing all small positions would be time-consuming, for all parties, and may not even be relevant. This is even truer when the financial product is supposed to come to maturity just after quarterly reporting. In other cases, obtaining information from hedge funds on a global market can be delicate and difficult.

- *The "look-through" approach:* The Working Group has pointed out that reporting on a CUSIP-level basis for investments instead of providing data on an aggregate basis could increase dramatically the costs already carried by the asset managers' clients. In fact the increasing complexity of cross-border security transactions and assets management may impede timely data retrieval and consistency in data format (given probable multi-party involvement) expected by the look-through approach. It may also conflict with the disclosure policies of the various parties involved. The Working Group would be happy to work with the regulator to find an acceptable means of aggregation which would be informative for the regulator and efficient from an industry point of view.

The Working Group has also expressed concerns about the responsibility for certifying the accuracy of data and about the difficulty of obtaining data from third parties.

Some members of the Working Group also had the opportunity to meet the Autorité de Contrôle Prudentiel (ACP), the French insurance regulator in January. The ACP welcomed the input received from the asset management industry on Solvency II issues. It was interested for example in the monitoring of the quality of the data provided by asset managers and the possible stamp of approval on reporting.

Since then, two meetings of the Working Group have been held, and during the meeting in March, the members suggested setting up two Working Groups, focusing on the certification and the "look- through" approach. Members have been invited to answer a short survey in order to determine more precisely what the topics of each dedicated Working Group should be.

Contacts: Nathalie Aubry-Stacey and Nelly Cotelle
nathalie.aubry-stacey@icmagroup.org
nelly.cotelle@icmagroup.org

Market infrastructure

European Market Infrastructure Regulation (EMIR)

Published on 15 September 2010, the European Commission's EMIR proposal is a Regulation on *OTC Derivatives, Central Counterparties and Trade Repositories*. The aim is that, in line with G20 commitments, the new rules should be fully in place and operational by the end of 2012. Following the reaching of a principle agreement, the Danish Presidency has published a final compromise text.

In the meantime the ESAs are moving ahead with their work on the applicable technical standards, with three discussion papers having been published. The first, from ESMA, was released on 16 February, with a comment period ending 19 March. ICMA's ERC contributed a short comment letter focussed on repo-oriented considerations. The subsequent two were released on 6 March as joint ESA papers, with ESMA coordinating one, regarding risk mitigation techniques for OTC derivatives not cleared by a CCP, and EBA coordinating the other, regarding capital requirements for CCPs. Comments in each case were requested by 2 April and ICMA ERC submitted a short response to the former.

Contact: David Hiscock
david.hiscock@icmagroup.org

Other market infrastructure developments

ECB: TARGET2-Securities (T2S)

On 1 March, a new issue of T2S OnLine was published by the ECB. In this the Chairman of the T2S Programme Board discusses the forthcoming signature of the Framework Agreement and Currency Participation Agreement; and the need to step up cooperation so that there is a "T2S Community" working together towards its common goal. The T2S Community already expanded in January, when SIA/Colt and SWIFT signed agreements appointing them as the Value-Added Network Service Providers for T2S; and this T2S OnLine introduces them in a double interview. The T2S project update reports on the latest developments in the T2S project; and Bayle's view provides some reflections on the T2S Programme Plan and its targets for 2012.

A dedicated T2S "Info Session" on getting ready for cross-CSD settlement was held on 15 March in Milan; and the next T2S Info Session will be on 18 April, in Malta. The T2S Advisory Group (AG), which is an advisory body that reports directly to the ECB's decision making bodies on the T2S project, last met on 27 March (and next meets on 18-19 September). The T2S Harmonisation Steering Group (HSG), which is supporting the AG in formulating its harmonisation

the need to step up cooperation so that there is a "T2S Community" working together towards its common goal

agenda, met on 5 March (and next meets on 25 June). Discussions covered harmonisation monitoring methodology; and a review of the T2S harmonisation list and activities.

The TFAX (Task Force on adaptation to cross-CSD settlement in T2S) was set up by the AG in its September 2011 meeting. TFAX is mandated to propose common solutions for adaptation to cross-CSD settlement in T2S, met on 24 January, 15-16 February and 16 March. On 1 March, TFAX launched a mini-consultation, responses to which are to be sent by 30 April. ICMA's ERC Operations Group is providing input in relation to the mini-consultation paper on CSD ancillary services, which focuses on the processes involved in repo; triparty repo; and securities lending and borrowing from the perspective of the cross-CSD settlement.

Global Legal Entity Identification numbers

On 12 January, the FSB called for the nomination of a small number of experts to a private sector panel advising an FSB Legal Entity Identifier (LEI) Expert Group of key stakeholders from the global regulatory community, taking forward work on the LEI initiative. The membership of this private sector panel was subsequently determined and announced.

On 7 March the FSB issued a short statement on *Technical Features of the Legal Entity Identifier (LEI).* This statement has been issued to provide early clarity on two technical points. First, the Expert Group has agreed that a 20-character alphanumeric code is a good basis for the global LEI code. Second, the Expert Group has agreed that the following six data elements will all form part of the minimum set of reference data attributes that will be required by the regulatory community on the launch of the LEI: (i) official name of the legal entity; (ii) address of the headquarters of the legal entity; (iii) address of legal formation; (iv) date of the first LEI assignment; (v) date of last update of the LEI; and (vi) date of expiry, if applicable. As the Expert Group completes its work, it expects to propose additional elements both for reference data attributes, and for the audit trail of changes and updates to the LEI, in order to meet various regulatory needs.

There are quite a number of LEI resources readily available on the internet, for example through the GFMA's LEI "Resources" page, including access to an LEI test file provided to GFMA by DTCC and SWIFT.

CPSS Chair

At their meeting in Basel on 5 March, the Central Bank Governors of the Global Economy Meeting appointed Paul Tucker, Deputy Governor, Financial Stability, Bank of England, as Chairman of the Committee on Payment and Settlement Systems (CPSS). Paul Tucker's appointment is for a term of three years. He succeeds William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, who has been CPSS Chairman since May 2009 and who was recently appointed Chairman of the Committee on the Global Financial System (CGFS).

Collateral Initiatives Coordination Forum (CICF)

The CICF is more fully described in an article in the ICMA Quarterly Report for the First Quarter (pages 46-47). Thus far CICF has held one meeting, at ICMA's office on 30 January; and ICMA has established a simple website page for CICF, which we will be looking to build up over coming months. At the inaugural CICF meeting it was agreed that CICF has a role to develop in information sharing and education; and that CICF may have a role to play in developing common positions on official proposals and in producing proactive discussion papers.

Contact: David Hiscock
david.hiscock@icmagroup.org

diary

ICMA organises over 100 market-related events each year attended by members and non-members. For full details see www.icmagroup.org.

17 APR

China Securities Summit, London 17 April

The National Association of Financial Market Institutional Investors (NAFMII) and ICMA will jointly host a one day conference in London on the increasing internationalisation of Chinese financial markets and opportunities for international cooperation. Guest speakers from China and Europe will discuss: developments in the Chinese bond and derivatives markets; opportunities for cooperation between Chinese and global financial institutions; offshore RMB markets and the role of Chinese banks in the global financial system.

Register here

25-26 APR

The Global Master Repurchase Agreement (GMRA) 2011 - briefing calls for members

The GMRA is the most widely used standard documentation for the cross-border repo market. It is supported by associated legal opinions obtained by ICMA in more than 60 jurisdictions, which are updated annually. The most recent version of the Agreement, the GMRA 2011, is the result of a market driven process and wide consultation; it represents over a year's worth of detailed discussion and debate involving market participants and legal specialists.

ICMA supports the use of the legal agreement by running a series of explanatory briefing calls tailored for different legal jurisdictions. These are led by Lisa Cleary, ICMA Associate Counsel. The calls are free of charge for ICMA members but registration in advance is essential.

Sao Paulo, 25 April - 10.00 local time

Australia, 26 April - 08.30 local time
Oslo / Stockholm / Amsterdam / Luxembourg - 10.00 London time

Register here

10 MAY

Covered Bond Investor Conference, Frankfurt , 10 May

The ICMA Covered Bond Investor Council and The Covered Bond Report will be jointly hosting the Covered Bond Investor Conference at the InterContinental Frankfurt, the first industry event designed to air and address investors' concerns

Panel discussions will take in the ICMA Covered Bond Investor Council's transparency standards initiative as well as secondary market liquidity, new issue procedures, and legislative, regulatory and structuring developments.

Register here

23-25 MAY

ICMA Annual General Meeting and Conference 2012, Milan, 23 - 25 May

The full agenda for the ICMA AGM and conference is now available, featuring the following key note speakers:

- Jonathan Faull, Director General Internal Market and Services, European Commission
- Klaus Regling, Chief Executive, European Financial Stability Facility
- Xavier Rolet, Chief Executive, London Stock Exchange Group
- Verena Ross, Executive Director, European Securities and Markets Authority (ESMA)

Major conference themes are:

- *Developments in global capital markets:* including regulatory change, the economic environment, bank and sovereign funding requirements.
- *The investor perspective:* Will the deleveraging of the banking system imply a major shift in assets to the asset management industry and, if so, how will the industry have to change? Has the asset management industry emerged successfully from the financial crisis, what lessons have been learnt? Is asset management "shadow banking" and if so, what regulatory issues will the industry have to face? How can the insurance sector generate returns with low bond yields and the new Solvency II rules and how can pension funds meet their demographic liabilities?
- *The sovereign debt crisis:* the issues that still need to be resolved and the possible means of achieving resolution, where do we stand in the second quarter of 2012?
- The evolving framework for collateral management in Europe
- *Secondary markets:* How has liquidity in the secondary markets been affected by the international financial crisis, and how will proposed regulatory measures, such as MiFID II and MiFIR, which are designed to enhance transparency, affect liquidity and the structure of OTC markets in future?

The conference is open to all financial market participants, with free passes and concessionary rates for ICMA members.

Register here

12-14 JUN

Global Master Agreements for Repo and Securities Lending Workshop, London, 12 - 14 June

The ICMA and ISLA master agreements are the essential legal underpinnings for repo and securities lending markets respectively. The workshop will include 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.

The Global Master Agreements for Repo and Securities Lending Workshop is an accredited course under the Solicitors Regulation Authority's (formerly The Law Society) CPD Scheme. Solicitors may claim 18 hours CPD credit for their attendance on the whole course.

Register here

15 JUN

Understanding the ICMA Primary Market Handbook (IPMA Handbook), London, 15 June

The half-day workshop on ICMA's Primary Market Handbook for the issuance of international debt and debt related instruments will give an overview of the scope and application of the recommendations and will also review recent developments and changes. The workshop is open to ICMA members and non-members.

Understanding the ICMA Primary Market Handbook (IPMA Handbook) is an accredited workshop under the Solicitors Regulation Authority (formerly The Law Society's) CPD Scheme. Solicitors may claim 2.5 hours CPD credit for their attendance at this workshop.

Register here

Financial News - ICMA Regulatory Snapshot Survey 2012

Coinciding with the ICMA AGM and Conference, Financial News, in association with ICMA will publish the results of the third annual survey of capital market participants regarding regulatory reform in Europe.

All capital market participants are invited to record their individual views on the progress and effectiveness of current regulatory initiatives by responding to the survey at the link below.

Participate in the Financial News - ICMA Regulatory Snapshot survey

ICMA Executive Education in 2012

Register now for these courses

ICMA Executive Education will be holding its flagship International Fixed Income and Derivatives (IFID) Certificate Programme for the first time in Hong Kong. This one week residential course will be held at the Cyberport Hotel from 26 August - 1 September 2012.

We will also be holding a week of Operations courses in Iskandar, Malaysia at the University of Reading's new campus there. This builds on the very successful ICMA Executive Education partnership, which is a joint venture between ICMA and the ICMA Centre at Henley Business School, University of Reading. The Operations courses will comprise our three day Securities Operations Foundation Course (SOFC), 11-13 June 2012 and our two day Derivatives Operations programme, 14-15 June 2012.

Contact: David Senior
david.senior@icmagroup.org

Part I: Introductory Programmes

Financial Markets Foundation Course (FMFC
London: 29-31 May 2012
Luxembourg: 24-26 September 2012
London: 26-28 November 2012

Securities Operations Foundation Course (SOFC)
Malaysia: 11-13 June 2012
London: 24-26 September 2012
Brussels: 12-14 November 2012

Part II: Intermediate Programmes

International Fixed Income and Derivatives (IFID) Certificate Programme
Sitges, Barcelona: 22-28 April 2012
Hong Kong: 26 August – 1 September 2012
Sitges, Barcelona: 28 October – 3 November 2012

Primary Market Certificate (PMC)
London: 14-18 May 2012
London: 19-23 November 2012

Part III: Specialist Programmes

Corporate Actions - Operational Challenges
London: 3-4 May 2012

Credit Default Swaps (CDS) – Features, Pricing and Applications
London: 18-19 June 2012

Credit Default Swaps (CDS) - Operations
London: 20 June 2012

Derivatives Operations
Malaysia: 14-15 June 2012

Securities Lending and Borrowing
London: 19-20 April 2012

Technical Analysis and Inter-Market Trading
London: 18-19 June 2012

Additional specialist programmes will be added in the second half of 2012.

See www.icmagroup.org/Training-Development/

Glossary

ABCP	Asset-Backed Commercial Paper
AFME	Association for Financial Markets in Europe
AIFMD	Alternative Investment Fund Managers Directive
AMF	Autorité des marchés financiers
AMIC	ICMA Asset Management and Investors Council
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
CAC	Collective action clause
CBIC	ICMA Covered Bond Investor Council
CCBM2	Collateral Central Bank Management
CCP	Central counterparty
CDS	Credit default swap
CoCo	Contingent convertible
CPSS	Committee of Payments and Securities Settlement
CRA	Credit rating agency
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
CSD	Central Securities Depositary
DMO	Debt Management Office
EBA	European Banking Authority
ECB	European Central Bank
ECOFIN	Economic and Financial Ministers (of the EU)
ECON	Economic and Monetary Affairs Committee of the European Parliament
ECP	Euro Commercial Paper
EEA	European Economic Area
EFAMA	European Fund and Asset Management Association
EFC	Economic and Financial Committee (of the EU)
EFSF	European Stability Facility
EGMI	European Group on Market Infrastructures
EIOPA	European Insurance and Occupational Pensions Authority
EMIR	European Market Infrastructure Regulation
ERC	ICMA European Repo Council
ESA	European Supervisory Authority
ESMA	European Securities and Markets Authority
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
ETF	Exchange-traded fund
FPC	UK Financial Policy Committee
FSA	UK Financial Services Authority
FSB	Financial Stability Board
G20	Group of Twenty
GDP	Gross Domestic Product
GMRA	Global Master Repurchase Agreement
G-SIBs	Global systemically important banks
G-SIFIs	Global systemically important financial institutions
HFT	High frequency trading
ICMA	International Capital Market Association
ICSA	International Council of Securities Associations
ICSDs	International Central Securities Depositaries
IMMFA	International Money Market Funds Association
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISDA	International Swaps and Derivatives Association
ISLA	International Securities Lending Association
LCR	Liquidity Coverage Ratio (or Requirement)
L&DC	ICMA Legal & Documentation Committee
LTRO	Longer-Term Refinancing Operation
MiFID	Markets in Financial Instruments Directive
MiFID II	Proposed revision of MiFID
MiFIR	Proposed Markets in Financial Instruments Regulation
MTF	Multilateral Trading Facility
NSFR	Net Stable Funding Ratio (or Requirement)
OTC	Over-the-counter
OTFs	Organised trading facilities
PMPC	ICMA Primary Market Practices Committee
PRIPs	Packaged Retail Investment Products
PSI	Private sector involvement
PSIF	Public Sector Issuer Forum
RM	Regulated Market
RPC	ICMA Regulatory Policy Committee
SBWG	ICMA Sovereign Bonds Working Group
SGP	Stability and Growth Pact
SI	Systematic Internaliser
SMPC	ICMA Secondary Market Practices Committee
SRO	Self-regulatory organisation
SSAs	Sovereigns, supranationals and agencies
T2S	TARGET2-Securities
TRs	Trade repositories

ICMA welcomes feedback and comments on the issues raised in the Quarterly Report. Please e-mail: regulatorypolicynews@icmagroup.org or alternatively the ICMA contact whose e-mail address is given at the end of the relevant article.

 Published by: Corporate Communications International Capital Market Association Limited, 23 College Hill, London EC4R 2RP Phone: + 44 207 213 0310 info@icmagroup.org

ICMA
International Capital Market Association

International Capital Market Association (ICMA)
Talacker 29, 8001 Zurich, Switzerland
Telephone +41 44 363 4222 Fax +41 44 363 7772
www.icmagroup.org