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International Capital Market Association



NORDIC CAPITAL
MARKETS FORUM

ICMA & NCMF Seminar on Regulatory Reforms for the Capital Market

February 4, 2011
Copenhagen



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Welcoming Remarks Henrik Theil, Senior Director, Nordea



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Introduction from the International Capital Market Association

Ruari Ewing, Regulatory Policy Advisor



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Introduction from Nordic Capital Markets Forum

Kristin Selnes, Board Member, NCMF



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Financial regulation impact on a Nordic Bank

Per Vagn Jensen
Head of Credit Financial Institutions
Nordea Bank AB



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Agenda

• Why new bank regulation and Basel III

- What went wrong?
- Regulatory actions
- Basel III
- Potential impacts



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What went wrong?

Full steam ahead

- Loose monetary policy in US combined with excessive capital accumulation in China and oil producing countries distorted pricing of money and capital
 - In US households consumed and borrowed more than they could pay back, because money was too cheap
 - Other countries followed
 - China and oil producers financed the bubble in US to avoid one being created in their home markets
- Financial system and banks failed in their risk assessment
 - Low interest rate environment induced hunt for yields: optimism fed greed
 - Too loose credit risk management policies
 - Complex products became too complex to understand
 - In practice financial system mispriced *systemic risks*, including *liquidity risk*

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What went wrong?

Systemic risk – challenging issue

- The banking crisis e.g. in Denmark, Finland, Sweden and Norway in the beginning of 1990s was limited within the national borders – the issue was then too-big-to-fail
- This crisis has spread throughout the system – the issue is now too-big-to-be-saved
 - Institutions have grown very large as liquidity has been ample
- Argument from the authorities:

Financial institutions may care about certain types of systemic risk (e.g. counterparty, liquidity and pro-cyclicality risk) but they do not price the costs of their own failure to the system and economy

How to make the system better?

- We (banks and authorities) failed in the assessment of systemic risk but this has to be somehow included in the risk analysis
- Authorities are approaching this from top down:
 - More and better capital, liquidity requirements, countercyclical buffers...
 - Crisis resolution giving more powers to interfere with bank management and structures
 - Possible other SIFI regulation bringing capital surcharges, bail-ins to buffer big banks more
 - Taxes on size
 - New supervisors: EBA and ESRB
- Remains to be seen can banks be considered a private sector companies after regulatory wave
 - Huge challenge to banks to remain attractive to investors



Potential impact on banking industry

Illustrative scenario analysis performed by JP Morgan* on 16 global banks January 2010

| Impact on earnings, EURm | TOTAL AVERAGE (ALL SAMPLES) | |
|------------------------------------|-----------------------------|-------------|
| JP Morgan approach | JP Morgan scenario analysis | |
| 1. Separation | -1,556 | -16% |
| o.w. Narrow Banking | -683 | -7% |
| o.w. Volker | -873 | -9% |
| 2. Capital | 333 | 4% |
| o.w. BIS III | 219 | 2% |
| o.w. Higher Loss Absorption | -62 | -1% |
| o.w. Trading RWAs | 176 | 2% |
| 3. Liquidity | -1,351 | -14% |
| o.w. Liquidity Coverage Ratio | -161 | -2% |
| o.w. Net Stable Funding Ratio | -1,190 | -13% |
| 4. Leverage | -132 | -1% |
| 5. Accounting | -404 | -4% |
| 6. Taxes | -1,997 | -21% |
| o.w. Tobin Tax | -420 | -4% |
| o.w. Liability Tax | -1,577 | -17% |
| 7. Resolution | -1,755 | -18% |
| Grand Total (pre tax) | -6,862 | -72% |
| Current Estimate 2011E Net Income | 9,497 | |
| Tax Benefit | 1,997 | 21% |
| Adjusted Earnings Estimates | 4,632 | |
| Change in earnings estimate | -4,865 | -51% |
| Tangible Equity pre regs | 71,170 | |
| Cap req | 13,830 | |
| Tangible Equity post regs | 85,000 | |
| Change % | 19% | |
| Net inc pre regs | 9,497 | |
| Net inc post regs | 4,632 | |
| Change % | -51% | |
| RoE* pre regs | 13.3% | |
| RoE* post regs | 5.4% | |

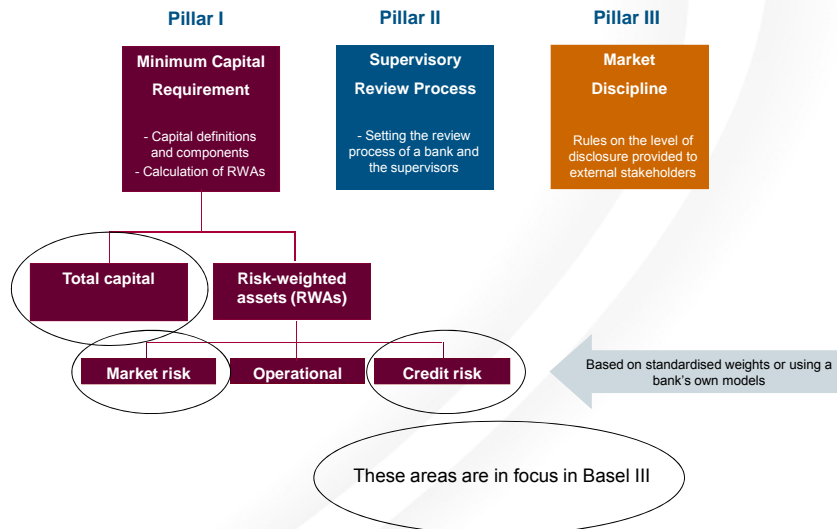
On average:

- Earnings is estimated to decrease 51%
- ROE is estimated to decrease from 13.3% to 5.4%
- Pricing would have to increase by 33% to keep the ROE on 15%
- \$221 bn more capital would be needed

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* Global banks – Too Big to Fail?



Basel III Framework



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Basel III - overview

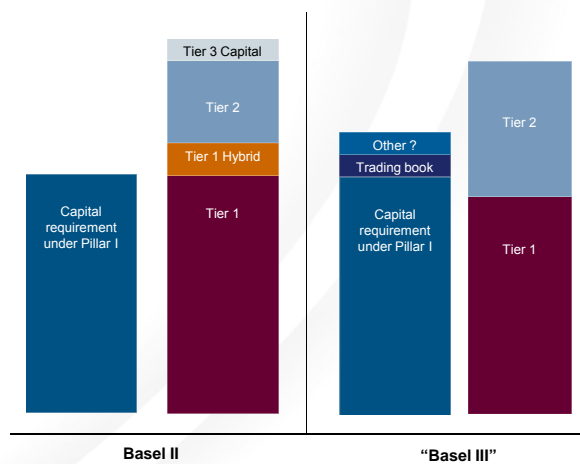
- The Basel Committee proposes new capital initiatives ...
 - Raising the quality of the capital base & reduce procyclicality
 - Enhancing risk coverage
 - Introducing a leverage ratio

- ... and two new liquidity measures
 - Liquidity Coverage Ratio (LCR or "the Bear Stearns rule")
 - Net Stable Funding Ratio (NSFR or "the Northern Rock rule")

Raising the quality of the capital base

- Tier 1 capital to increase
 - Reclassification of Tier 1 hybrid capital
 - Regulatory deductions

Emphasis on quality of capital



Raising the quality of capital base

More buffer

- New minimum thresholds. If these are breached, banks will lose their licence to operate
- Capital conservation buffers of 2.5% are required. Banks can draw upon these buffers during periods of stress, but will face constraints on earning distributions. In reality, this will likely become a minimum threshold
- Countercyclical buffers to be implemented within a range of 0% to 2.5%, as an extension of the conservation buffer range. These are still very uncertain.
- Increased loss absorbing capacity for systemically important banks are under development by the Basel Committee and Financial Stability Board. This can include a combination of capital surcharges, contingent capital and bail-in debt
- Remaining uncertainties
 - Countercyclical buffers (for example, interplay with pillar 2 and stress test buffers)
 - New loss absorbing instruments
 - Capital surcharges for systemically important banks
 - National authorities have the discretion to impose shorter transition period and should do so where appropriate

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Enhancing risk coverage

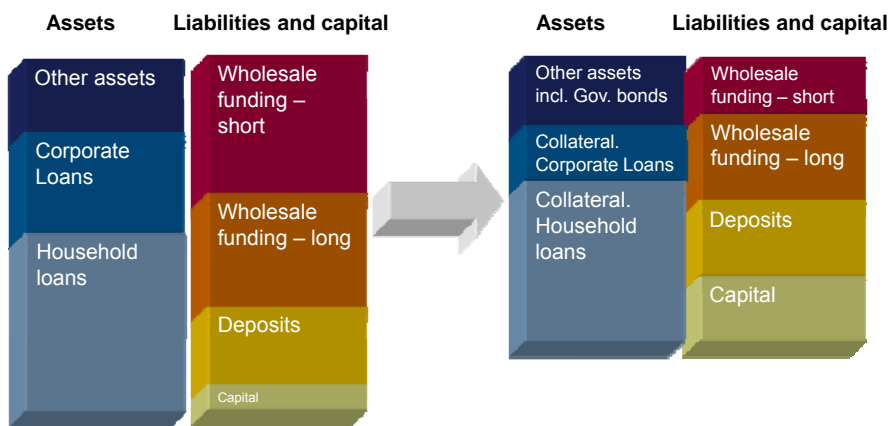
- Higher capital requirements for exposure to financial institutions
 - The RWA formula is adjusted (i.e. a higher correlation factor is suggested), which will lead to higher pillar 1 requirements. The capital requirements will be increased 13-36% on each transaction, depending on rating grade
- Higher capital requirement for OTC derivatives
 - Currently OTC derivatives are only subject to a capital requirement for the default risk (i.e. the risk of migration to the default risk grade but not to any other risk grade).
 - Now a capital add-on for credit value adjustment (CVA) is introduced to cover unexpected mark-to-market counterparty credit losses
 - A relatively complex method how to calculate this is suggested (the bond equivalent method)
- ..and some additional proposals

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Introduction of a leverage ratio

- In addition to the Basel II (risk sensitive) capital ratio a restriction on total assets in relation to capital may be introduced
- Meant to safeguard against attempts to game the risk based requirements
- A leverage ratio as a "hard" (Pillar I) limit is problematic and even counterproductive
- Business impact
 - will punish exposure to true low risk customers (mortgage, government, municipality, etc.)
 - Specific implementation details are uncertain, but mortgage margin compensation of 50-60 bp has been mentioned
 - Regulation to reduce leverage, increase capital and lengthen funding maturity will pressure banks' business model

Introduction of a leverage ratio



Banking business in old regulatory regime

New regulatory regime: towards "narrower" banking

Nordea Basel III – Liquidity Ratios

Liquidity Coverage Ratio (LCR)

Stock of high quality liquid assets
Net cash outflows over a 30-day time period > 100%

Main purpose
To ensure maintenance of an adequate level of liquidity for a 30 day period under an acute liquidity stress i.e. to survive post-Lehman type of liquidity crisis

- Stock of liquid Assets:**
 - Cash + government bonds + central bank reserves
 - Claims guaranteed by Sovereigns given
 - Assigned a 0% risk weight under Basel II
 - Deep repo markets exists for the securities
 - Not issued by financial institutions
 - High quality covered bonds and corporate bonds - subject to limit (40%) and haircut(15%)
- Net cash outflow over a 30-day time period:**
 - 5% of stable retail and SME deposits
 - 10% of less stable retail and SME deposits
 - 25% of funding from repo of illiquid assets
 - 100% of wholesale funding

Net Stable Funding Ratio (NSFR)

Available amount of stable funding
Required amount of stable funding > 100%

Main purpose
To promote more medium and long-term funding of the assets and activities of banks

- Available amount of stable funding:**
Stable funding is defined as those types of equity and liability financing expected to be reliable sources of funds over a one-year horizon under conditions of extended stress
 - Capital + term debt and deposits with maturities > 1yr + portion of demand and shorter deposits expected to stay
- Required amount of stable funding:**
The amount of stable funding required is a function of the liquidity characteristics of asset side
 - Weighted loans and other assets, eg. Cash (0%), >1y retail loans (100%)

Significant changes has been made to the original proposals

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Nordea Basel III – Capital Ratios and Implementation

Full implementation in 2019

| Capital | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | As of 1 January 2019 |
|--|--|---------------------------|---|------|-----------------------------|--------|-----------------------|----------------------------|----------------------|
| Leverage Ratio | Supervisory monitoring | | Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015 | | | | Migration to Pillar 1 | | |
| Minimum Common Equity Capital Ratio | | | 3.5% | 4.0% | 4.5% | 4.5% | 4.5% | 4.5% | 4.5% |
| Capital Conservation Buffer | | | | | | 0.625% | 1.25% | 1.875% | 2.50% |
| Minimum common equity plus capital conservation buffer | | | 3.5% | 4.0% | 4.5% | 5.125% | 5.75% | 6.375% | 7.0% |
| Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials) | | | | 20% | 40% | 60% | 80% | 100% | 100% |
| Minimum Tier 1 Capital | | | 4.5% | 5.5% | 6.0% | 6.0% | 6.0% | 6.0% | 6.0% |
| Minimum Total Capital | | | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% |
| Minimum Total Capital plus conservation buffer | | | 8.0% | 8.0% | 8.0% | 8.625% | 9.125% | 9.875% | 10.5% |
| Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital | Phased out over 10 year horizon beginning 2013 | | | | | | | | |
| Liquidity | | | | | | | | | |
| Liquidity coverage ratio | Observation period begins | | | | Introduce minimum standards | | | | |
| Net stable funding ratio | | Observation period begins | | | | | | Introduce minimum standard | |

- Minimum common equity increased from 2% to 4.5% (phased in by January 2015)
- Capital conservation buffer of 2.5% (that has to be met with common equity) bringing total common equity requirement to 7%
- Tier 1 requirement, which includes common equity and other qualifying instruments, will increase from 4% to 6% (Phased in by January 2015)
- A countercyclical buffer will be implemented within a range of 0-2.5% of common equity according to national circumstances
- Long transition period but "reporting period" starts soon and we believe banks will seek compliance at an early stage**

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Basel III – Impacts on Business Model Conditions

Fundamental conditions for Retail Banking Model Changed

- Leverage Ratio decreases: Lower return on equity
- Pool of liquid assets increases: Lower return on assets
- NSFR: Funding short investing long will be challenged to some degree

Fundamental conditions for Investment Banking Model Changed

- Leverage Ratio decreases: Lower return on equity
- Liquidity Coverage Ratio: More expensive to hold illiquid assets
- Capital requirements due to Counterparty Credit Risk are increased
- Ability to assume risk and produce tailor-made solutions are penalized
- Significant increases in Market risk requirement

However...

- Risk weights and capital requirements does not prohibit regulatory arbitrage and in particular the ability of banks to shift risk beyond the jurisdiction of bank regulators

And...

- In particular the July changes came out favorably for banks so the extend to which the business model will becomes less profitable is still to be seen

A retail business model with heavy reliance on short term funding will become more difficult

The investment banking business model is likely to become less profitable under the new conditions

Regulatory arbitrage and the use of the Shadow banking system is (as always) a risk

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Basel III – Financial Market Impacts

| Impact Area | Impact Descriptions |
|---|--|
| Government Bonds vs. covered bonds / Credit | Government bonds treated more favorably than mortgage bonds/covered bonds and corporate bonds. As examples, consider - The Asset side of the Net Stable Funding Ratio - LCR (Level II Assets: 40% limit plus haircuts 15%) |
| Liquidity Risk Premiums | It will become more expensive for banks to take liquidity risk and hence the price of liquidity risk will increase. The quantity of liquidity risk, however, is expected to fall if Basel III fulfills its purpose. The tendency of banks approaching liquidity rich investors with yield enhancing notes based on creative collateral structures will gain momentum |
| Market Infrastructure | In terms of market infrastructure we expect a major shift from bilaterally cleared OTC derivatives toward centrally cleared derivatives |
| Volatility Risk Premiums | Higher capital requirements from markets risk will reduce market risk capacity, which in turn will imply higher volatility risk premiums. Customized OTC hedging will become more expensive potentially "leaving" basis risk on the corporate balance sheet. This could induce more equity volatility |
| Regulatory Arbitrage | If business areas within regulated banks are treated to negatively, there is a likelihood that these services will be provided "underground" by others |
| Corporate Issuance | According to the IIF, Banks will have to issue USD 700bn of common equity and USD 5,400bn of long new term debt. Banks and Insurance companies will be less incentivized to hold equity going forward and hence equity risk premiums and corporate debt risk premiums might rise |

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Nordea Basel III – Central Clearing Counterparty

Basel III – Central Clearing of OTC derivatives

Problems

- The credit worthiness of one agent will be affected by the

Solutions

- Standardized characteristics will ease netting of positions
- Central clearing counterparties (CCP) should be used to clear all standard deals
 - Eases the monitoring of the overall risk in the market
- The default of one member will be born by the CCP (and by that all members – through margins, insurance pools and equity) and will have a lesser effect on the stability of the market (still a risk of free riding by rogue institutions)
- Improved bilateral collateral agreement
 - Should mirror the risk the position yields on the financial system
 - Should include a clear guideline for the resolution process

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Potential impact for our customers

- In general, increased cost of capital for all customers:
 - A general increase in pricing towards all customers (liquidity risk, leverage ratio, countercyclical measures), if the banks have the pricing power. Otherwise, a lower return on equity might become the new industry standard
- In specific, certain segments might see a relatively larger effect:
 - Low risk segments, if leverage ratio and NSFR is hit
 - i.e. lending with long maturity: Mortgage lending, lending to municipalities, lending to corporate with low risk etc. Less lending volumes, divestment of assets, securitisation or increased pricing might be needed
 - Large corporate segment, if generally higher margin on credits
 - Less lending volumes to banks, due to that more corporate will fund directly in market (increase usage of corporate bonds). There are both pros and cons with market funding

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Potential impact for our customers

- Derivatives, if increased capital requirements and unfavourable treated in liquidity and leverage ratio
 - How large portion of the OTC derivatives market can be standardised? Will there be a large p&l effect for investment banks (and CMP)?
 - Increased pricing on tailor made OTC derivatives can lead to a less use of these kind of instruments. Customers will be more exposed to risks
- Liquidity in the market can decrease, particular on certain bonds:
 - The repo market, due to unfavourably treated in several proposals, can decrease and effect the liquidity in certain bonds
 - Demand of assets qualified as liquid will increase (e.g. government debt), this liquidity will be locked up (and become paradoxically illiquid) and other assets are automatically considered as illiquid, due to the NCR.
 - Demand of private sector and financial institution assets will decrease as there is no incentive to hold those assets. Market will lack diversity in terms of available instruments

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Final outcome remains to be seen

Per Vagn Jensen
Nordea





EU Retail Bond Market Policies

Ruari Ewing, Regulatory Policy Advisor, ICMA



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Panel: PD, TD and PRIPS


Moderator: Ruari Ewing, Regulatory Policy Advisor, ICMA

Panellist: Adam Jacobs, Assistant Director, ISDA


Panellist: Michael Persson, Legal Counsel, Nordea

Panellist: Morten Bethe, Partner, Gorrissen Federspiel

Panellist: Jonathan Herbst, Partner, Norton Rose LLP



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Packaged Retail Investment Products – What does it mean in the debt capital markets context?

Jonathan Herbst
Partner
Financial Services

4 February 2010

Introduction and themes

- April 2009 Commission Communication on PRIPs
- The big picture: Key market failings:
 - Asymmetries of information between investors and those producing and selling investments to them
 - The manufacturing and distribution of these products leads to principal/agent issues
- Four key challenges:
 - Sufficiently precise definition of a PRIP: The bounds of retail
 - The concept of overarching disclosure: Some practical and legal lessons
 - How will it be effected - New horizontal measures versus incremental change

The definitional problems

- Product where amount payable to investor is exposed to fluctuations in market value of assets or payouts.....combination or wrapping or other non direct mechanisms
- Clearly covers structured products: straight debt is out
 - Definition will need to be airtight, eg What if issuer issues debt which invests in structured products?
- Key question of whether it is when products are “sold” to retail investors
 - Indirect sales at the end of the chain of intermediaries: can they force provider into the PRIIPs regime – idea of being able to label product a wholesale one
 - The pensions debate
- Move away from simple overarching definition has drawn criticism

Pre-contractual disclosure

- Commission consultation noted fragmented regulatory landscape:
 - Solvency II, UCITS Directive, Prospectus Directive, IMD and MiFID
 - Variation of approach and degree of harmonisation
 - No comparisons for different types of product
 - Structured deposits not covered
- Two options considered:
 - Aligning content of current legislation but keeping them separate
 - Introduction of a new cross-sectoral instrument
- Commission favours second option

Pre-contractual disclosure

- The cross-sectoral document - KIID:
 - Agreement that its focus is to aid investment decision making
 - Many agree that it should replace summary prospectus and Solvency II disclosures
- In UCITS case standalone concept may make sense: Here a lot of issues around how stand alone can realistically be given in light of base prospectus and programme reality
 - BBA argues that it should signpost additional and more detailed information with product providers/intermediaries ensuring this information is available
- Idea of detailed prescription for different asset classes may just be too ambitious and better to leave it to firms
- The non-liability principle for contents: what does this really mean in this context?

The responsibility conundrum


- Commission favours making product providers/issuers responsible
 - Very inflexible and non recognition of complexity of different selling approaches
 - Distinction between duty of production versus provision of document
- The UK slippery slope comparison under the TCF initiative where providers have ended up with a lot more responsibility

KIID - risk disclosure

- Broad adoption with little modification of UCITS KIID:
 - Numerical representation of market risk
 - Methodology underpinning numerical indicator
- Particular problems:
 - Significant challenge of producing a risk indicator capable of giving meaningful and comparable results whichever PRIP is being considered
 - Many PRIPs offer concentrated counterparty risk: how can you incorporate into a single indicator that if the counterparty fails all capital is lost
 - Numerical indicator that considers only market risk will provide distorted picture of risks faced by investors in different types of product

KIID – costs and performance


- Costs:
 - Key importance when comparing different PRIPs
 - Commission acknowledges the difficulty in assessing 'value for money' in different structures
 - Call for suggestions on appropriate metrics
 - The initiative fails if it does not tackle hidden provider charges
- Performance:
 - Commission notes sectoral approaches - for UCITS the KIID includes either past performance or for certain kinds of funds perspective 'performance scenarios'
 - Unclear how sectoral approaches can be applied
 - IMA has called on performance to be included in the PRIP KIID




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Panel: MiFID Review, MAD & Short Selling

Moderator: John Serocold, Senior Adviser, ICMA
Panellist: Erica Johansson, Partner, Delphi Law Firm
Panellist: Simon Crown, Partner, Clifford Chance
Panellist: Morten Bethe, Partner, Gorrissen Federspiel
Panellist: Jonathan Herbst, Partner, Norton Rose LLP



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MiFID Overview: Cash Markets

John Serocold
Senior adviser,
Regulatory Policy and Market Practice, ICMA

Copenhagen, 4 February 2011



1. Introduction

- Why MiFID matters
- The post-MiFID review process
 - Process
 - Topics
- ICMA's survey on liquidity and transparency

2. Why MiFID matters

- A Single Market measure (!!??)
 - Passporting and authorisation
 - Conduct of business rules
 - Organisational requirements

3. The post-MiFID review process: milestones

- 30 April 2004: Came into force
- 1 November 2007: Implemented
- Q1 2010: Review process starts
- April 2010: CESR consults on technical advice (TA)
- 29 July and 13 October 2010: CESR TA published
- EC publishes consultation paper: 8 December 2010
- Consultation period closes: 2 February 2011
- Next steps

4. The post-MiFID review process: topics

- Non-equity transparency
- Mechanisms for trade reporting
- Transaction reporting
- Underwriting and placing
- Client categorisation
- Investor protection
- Next steps

5. The post-MiFID review

- CESR's non equity transparency proposals

| Transaction size (net value) | Information to be published | Timing of publication |
|---|---------------------------------|--|
| Between €500,000 - €1 million | Price and volume of transaction | As close to real time as possible but no later than 15 minutes |
| Between €500,000/€1 million and over €5 million | Price and volume of transaction | End of day |
| Over €5 million | Price only | End of day |

5. The post-MiFID review (2)

- Commission's non equity transparency proposals: Pre-trade

| all trades in specific non-equity products | Information to be published | Timing of publication |
|--|--|--|
| differentiated by asset class | RMs, MTFs, OTFs publish their information | in a continuous manner |
| ? below a specific trade size (what size?) | investment firms executing trades OTC, pre-trade quotes reflect current market value and are binding | a real-time and continuous updating of available and actionable trading interest |

5. The post-MiFID review (3)

- Commission's non equity transparency proposals: Post-trade

| Scope (as before) | Information to be published | Timing of publication |
|--|---|--|
| all trades differentiated by asset class | RMs, MTFs, OTFs and firms trading OTC information | As prompt and precise as possible |
| properly calibrated to the class of financial instruments and to the type of instrument as well as underlying variable , as appropriate | data on transactions in terms of price, volume, time of trade, and the main reference characteristics of the traded instrument rather than aggregate data | a system of thresholds and delays, based on transaction size |

6. ICMA's survey on liquidity and transparency

| Ranking | Buy-side | Sell-side | Repo |
|----------------------------|----------|-----------|------|
| Liquidity | 1 | 1 | 1 |
| Certainty of execution | 3 | 2 | 2 |
| Evidence of best execution | 2 | 9 | 3 |
| Speed of execution | 6 | 3 | 7 |
| Tight bid-offer spreads | 4 | 5 | 6 |
| Pre-trade transparency | 5 | 4 | 8 |
| Post-trade transparency | 7 | 10 | 5 |
| Ticket size | 8 | 7 | 9 |
| Anonymity | 9 | 6 | 4 |
| Low market volatility | 10 | 8 | 10 |



Erica Johansson
 Partner, Advokat

EU Short Selling
 Regulations

Nordic Capital Markets Forum: Update on
 Regulatory Reforms for the Capital Market
 Copenhagen, 4 February 2011

EU Regulation on Short Selling and certain aspects of Credit Default Swaps

- During the financial crisis and more recently in the context of market volatility in euro denominated sovereign bonds, EU Member States have reacted differently to the issues raised by short selling and credit default swaps
- There is currently no legislative framework at European level to deal with these issues in a coherent way. A fragmented approach to these issues can limit the effectiveness of the measures imposed, lead to regulatory arbitrage and create additional costs and difficulties for investors
- The European Commission has adopted a proposal for a regulation on short selling and certain aspects of Credit Default Swaps (CDS)
- Its main objectives are to create a harmonised framework for co-ordinated action at European level, increase transparency and reduce risks.
- The new framework will mean regulators – national and European – have clear powers to act when necessary, whilst preventing market fragmenting and ensuring the smooth functioning of the internal market.

Short selling – what is it?

- **Short selling** – the sale of securities that the seller does not own with the intention of buying them back at a later point in time in order to deliver them.
- **Covered short selling** – the seller has borrowed the securities or made arrangements to ensure they can be borrowed, before the short sale.
- **Naked short selling** – where the seller has not borrowed the securities, or ensured they can be borrowed prior to the short sale.
- **CDS** – can be used as a means of shorting bonds. A buyer of a CDS is gaining from a rise in the credit risk of the underlying bond.





The Risks...

”In normal times, short selling enhances market liquidity and contributes to efficient pricing. But in distressed markets, short selling can amplify price falls, leading to disorderly markets and systemic risks.”

Michel Barnier, Internal Market and Services Commissioner



Proposal for a Regulation of the European Parliament and the Council on Short Selling and Credit Default Swaps

| | |
|--|---|
| Transparency | <ul style="list-style-type: none"> Private disclosure to the Regulator of any net economic short position (over a certain threshold) in: <ul style="list-style-type: none"> Shares (inc derivatives); or Sovereign debt (inc uncovered CDS). Public disclosure to the market of net economic short position (over a certain, higher, threshold) in: <ul style="list-style-type: none"> Shares (inc derivatives). |
| Marking of short orders | <ul style="list-style-type: none"> Applies to exchange listed equity instruments, traded on exchange. The trading venue shall – <ul style="list-style-type: none"> Mark short orders Publish, at least daily, aggregate short-selling volume in each individual share. |
| Locate Rule (restrictions on uncovered short sales) | <ul style="list-style-type: none"> Applies to all shares and EU sovereign debt instruments and requires: <ul style="list-style-type: none"> that the share or debt instrument has been borrowed, an agreement to borrow, or other confirmed arrangements with a third party that the share or sovereign debt instrument has been located and reserved for lending. |

Proposal for a Regulation of the European Parliament and the Council on Short Selling and Credit Default Swaps, contd

| | |
|----------------------------|--|
| Buy In Requirements | <ul style="list-style-type: none"> Applies to all equities and EU sovereign debt instruments. Requires trading venues with equities or EU sovereign debt admitted to trading to ensure it, or the relevant CCP, to have in place appropriate buy in procedures. The trading venue or CCP must buy in the instruments if the person who has the short position is unable to settle within – <ul style="list-style-type: none"> four trading days after the day on which the trade takes place, or six trading days after the day on which the trade takes place in the case of market making activities. If the trading venue or CCP is unable to buy in the instruments then it must settle the position in cash, including an amount for any damages incurred by the buyer. The person who was unable to settle must reimburse the trading venue or CCP for the cost of executing the buy in or cash compensation. |
| Circuit Breaker | <ul style="list-style-type: none"> Applies to all financial instruments. Triggered, at the discretion of the Competent Authority, in case of a significant price fall from the previous day's close (for shares 10%). Implements a temporary short selling prohibition for the remainder of the day and the following trading day. |
| Emergency Powers | <ul style="list-style-type: none"> Applies to all financial instruments. Contains a pre-defined action framework. Enables Member States or ESMA to prohibit or impose conditions relating to short selling. |



What happens next?

- The proposal passes to the European Parliament and the Council for adoption.
- Once adopted the regulation would apply from 1 July 2012.





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FINANCIAL INSTITUTIONS • ENERGY • INFRASTRUCTURE AND COMMODITIES • TRANSPORT • TECHNOLOGY

**Annual ICMA-NCMF Joint Seminar –
MiFID Review**

Jonathan Herbst
Partner
Financial Services Group

Norton Rose LLP
4 February 2011



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Themes: Inputs and outputs

- Fitting the jigsaw together is the challenge in 2011
- Particularly hard in UK given the domestic changes as well
- Focussing on the themes allows the bigger picture to be seen
- Devil in the detail

Technological change in trading methods,
regulation needs to keep up, e.g. BCS, high frequency

Risk management is a key driver post crisis,
e.g. on platform trading and use of CCPs

Power migration as the EU response, e.g. ESMA powers and increased depth of level 2 regulation

Cost increase of new requirements,
e.g. transaction reporting and transparency reforms

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How do the key proposals fit together?

MAD

- Broader scope to cover MTF traded instruments and related instruments
- Covers attempts at manipulation

EMIR

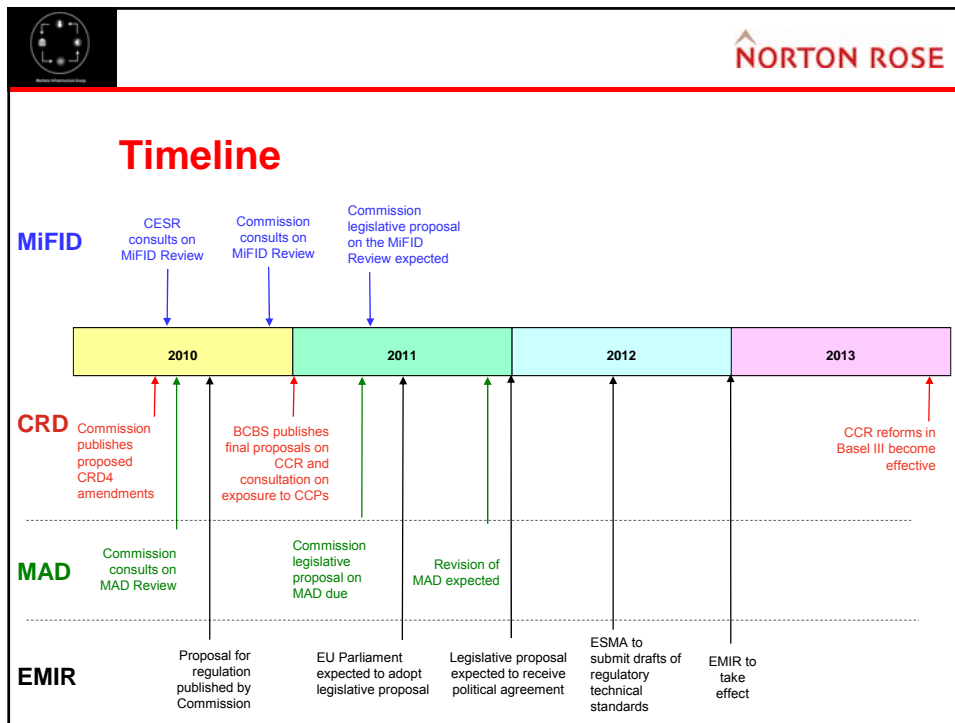
- Position reporting to repositories
- MiFID transaction reporting proposal to link with this
- Link between clearing eligible OTC derivatives and sub-category of platform traded derivatives

MiFID

- Link between transaction and position reporting
- Broader transaction reporting obligations in MTF traded and some OTC instruments
- Mandatory on platform trading
- Position management and limits
- MTF/RM regulatory standards revisited
- New trading categorisation of OTF

CRD



- Carrot to the EMIR stick
- New 2% risk charge on trading exposures to CCPs
- Layered approach to default fund exposures



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Issue 1: The OTF debate

- No fundamental critique of RM/MTF divide
- New category of organised trading facility and sub-category of broker crossing system
- OTF is any facility or system that on an organised basis brings together buying and selling interests or orders
- Key point is that this can cover bilateral and discretionary systems as well
 - Breaks new ground compared with CESR approach
 - Core requirements of notification to regulators, conflicts management, inclusion in suspension power
 - It appears that there will be unique identifier for transaction reporting and transparency purposes
- Sub-category of broker crossing system: Specific identifier for post-trade information and transaction reports but is this different to OTFs?
- If third party has ability to enter orders then the system flips into MTF category plus size test to delimit boundary with MTF



Issue 2: Trading methods

- Reflects recognition of how far technology has changed the world
- Automated trading category and high frequency trading sub-category
 - Risk controls, notification to competent authorities and fair access
 - Recognition of arguments for and against: Liquidity provision v potential withdrawal and order entry/deletion argument: Commission aware of some of the pressures in the Parliament
- Sponsored access/co-location
 - Fair and equal access
 - Tougher approach to non-authorized prop trading: Proposals confused but it appears that Article 2(1)(d) will not apply where “client” orders are executed
 - Note Parliament pressure for no unauthorised access: expect challenges to models here
- Maker/taker fees CESR proposals not reflected explicitly

Issue 3: Forcing trading on platform

- Standardisation of legal documentation and processes
 - Commission paper is light on this CESR discussion: CESR encouraged industry initiatives but called for ESMA powers to analyse legal barriers, monitor standardisation and have back up mandatory powers
- Organised platform trading
 - Unlike CESR no discussion of incentivisation of platform trading
 - Mandatory approach proposed: Platforms cover only RMs/MTFs per se plus sub-category of organised platform
 - Unclear which platforms will fall within test
- Definitions of eligibility will need a lot of work
 - Commission appears to make EMIR clearing eligibility a condition
 - Other factors to be consulted on, e.g. admission to trading on RMs/MTFs, depth of liquidity, pricing
 - ESMA decision




Issue 4: Wholesale COBS

- General theme is the lack of buy side knowledge and the idea that one size fits all client categorisation is not appropriate
- Application of honestly, fairly and professionally to ECPs – fair clear and not misleading to ECP business
- Limit EC business to exclude
 - Complex products
 - Non-financial undertakings and 'certain' financial institutions
- Abolish or limit experience-and-knowledge assumption for professional clients: Asset class assessments
- Enhanced information requirements even for professional clients



CFD-#9732646v1



MiFID review:

- transparency
- data consolidation
- transaction reporting

Simon Crown
Partner

4 February 2011

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Annual ICMA-NCMF Joint
Seminar, Copenhagen

MiFID review

Broad ranging MiFID review

| | |
|--|---|
| CESR Consultations and Technical Advice | <ul style="list-style-type: none"> • Equity Markets & Non-equity Markets Transparency (July 2010) • Standardisation and Organised Platform Trading of OTC Derivatives (Oct 2010) • Post-trade Transparency Standards (Oct 2010) • Additional requests for advice (Oct 2010) |
| EU Commission Consultation | <ul style="list-style-type: none"> • Consultation published 8 December 2010 • Consultation closed 2 February 2011 |
| Legislative proposal | <ul style="list-style-type: none"> • Expected H1 2011 • Directive or Regulation? Extensive roles for ESMA • Adoption 2012? Level 2 2013? Implementation 2014? |

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MiFID review

4 February 2011

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Transparency reforms (1): equities

Extend scope to cover:

- Depository receipts, ETFs, subordinated "certificates"
- Shares only traded on MTFs or OTFs

Pre-trade transparency

- Consistent rules for waivers
- Actionable IOIs to be treated as orders
- No dark trading of order stubs from large orders
- No embedded fees in reference price waiver

Post-trade transparency

- Reduce delay in post-trade publication
- As close to instantaneous as possible (< 1 minute)
- Shortening delay period on deferred publication regime

Transparency reforms (2): non-equities

Scope:

- Bonds/structured products with prospectus or admitted to trading on RM/MTF
- Derivatives eligible for clearing or reported to trade repositories

Pre-trade transparency

- All RMs, MTFs and OTFs must publish pre-trade information
- Firms trading OTC must ensure pre-trade quotes reflect current market value and are binding below specific size

Post-trade transparency

- Transaction based reporting, subject to thresholds and delays based on transaction size by asset class/underlying

Related proposals

Data consolidation

- Improving data quality: use of Approved Publication Arrangements for data
- Reducing cost: unbundling, free after 15mins, defining "reasonable cost"
- EU consolidated tape: mandate to operator (either public sector or after public tender)

Commodity derivatives

- Reducing exemptions, expanding scope of regulated instruments
- RMs, MTFs, OTFs to provide harmonised position information to regulators and market

Position limits/management

- Apply to all OTC derivatives and all market participants
- Regulators to have power to require information/ set position limits/require reduction of positions

Transaction reporting

- Extended to all MTF, OTF traded instruments and derivatives
- Plus enhanced content

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Questions & Discussion



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