

OVERSIGHT

REGULATORY UPDATE

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Only time will tell...

I was pleased to see the positive response to our first edition of Oversight sent out just before Christmas. There is clearly a significant desire to receive information on the regulatory environment and the potential implications to you and the Swiss Financial Centre.

In addition to the growth in different types of securities legislation, we are seeing regulators become more involved in risk issues. In this context, we cover the impact of the Alternative Investment Fund Management Directive, initiatives in relation to capital (banks' exposure to CCPs) and the CPSS-IOSCO consultation on Principles for Market Infrastructures.

Needless to say, a lot of this edition is devoted to issues that will directly impact you, as our clients, and us, as your infrastructure. Together, they constitute a further regulatory stage which will affect our respective roles in the industry and the we interact with each other.

Only time will tell, how much.

Throughout this process, however, we will continue to analyse, inform and consult with the Swiss market to ensure that the issues most likely to impact the Swiss Financial Center are raised – and addressed – in a timely, planned and effective way.

Thomas Zeeb
Chief Executive Officer
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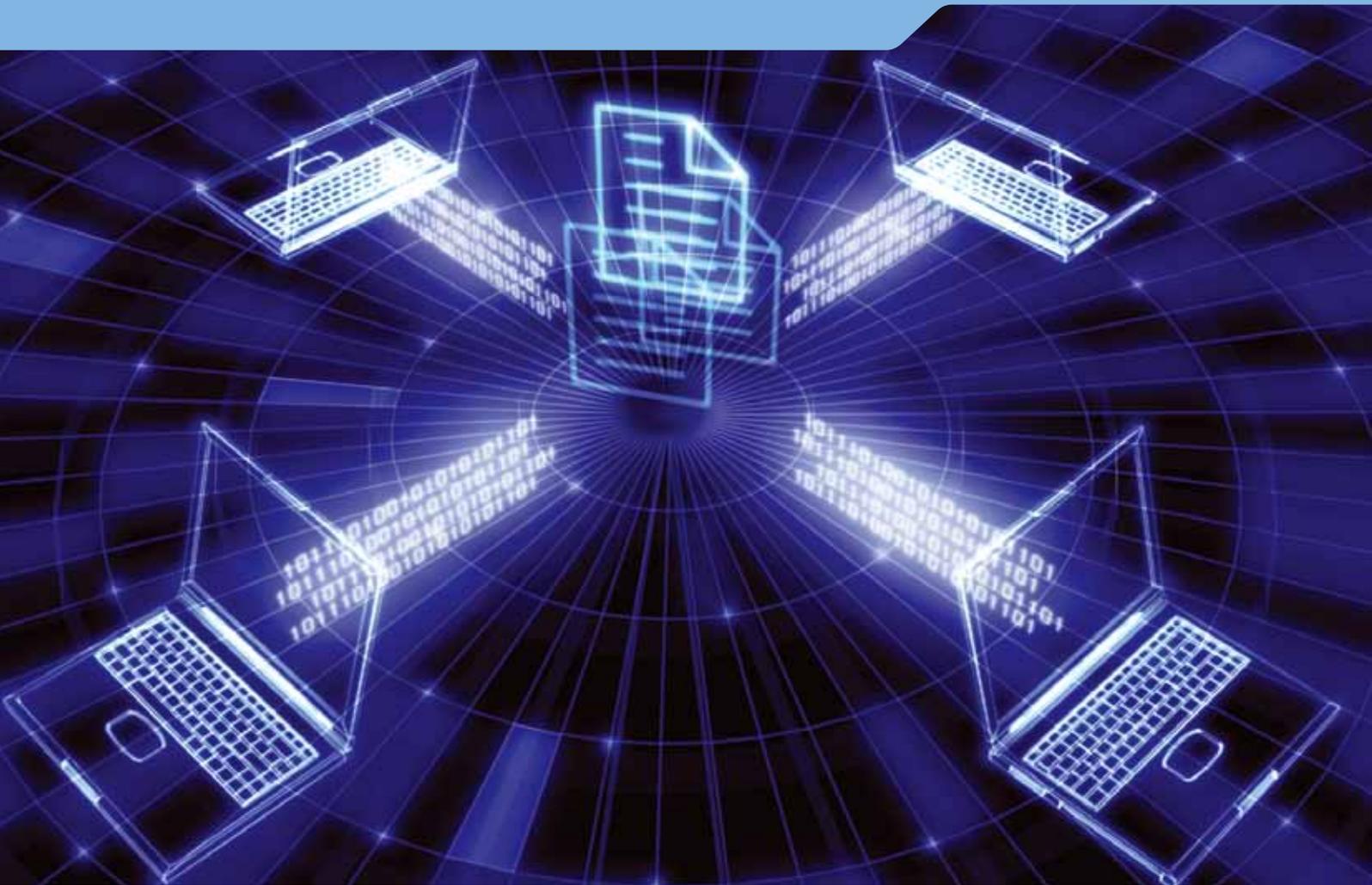
> Target 2 Securities	02
> The EU legislative programme	03
> Changes in the EU institutional landscape	05
> Increasing emphasis on risk mitigation	05



Oversight
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Welcome to Oversight - our quarterly update on market policy developments and the regulatory landscape. If you would like to subscribe to this newsletter electronically please send an e-mail to oversight@six-group.com

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Target 2 Securities (T2S)

Following the consultation exercise initiated jointly with the SNB last year, we are now working to further examine the implications of the various T2S options. The goal is to arrive at a joint decision for the Swiss market by working with the SNB, high-level representatives of the industry and the Bankers' Association.

Our involvement in the T2S project continues. We have set up an internal project management team to coordinate the next steps. We continue, too, to refine the options available to us in linking SIX Securities Services (through SIX SIS Ltd) to T2S.

For its part, the ECB has set up a Task Force on Smooth Cross-CSD Settlement, under the chairmanship of Jesús Benito of Iberclear who is expected to elaborate concrete solutions for issues that could hamper safe and efficient interoperability between CSDs in T2S.

The launch of the T2S solution is still expected to be September 2014: Monte Titoli, as well as the Romanian and Greek CSDs have announced that they will join T2S in its first wave. A particular concern for CSDs in general is to ensure that successive migration waves do not create an uneven competitive environment.

For now, working with the SNB, the Swiss market and the Bankers' Association, we await further developments from Frankfurt.



The EU legislative programme on market infrastructure

EMIR is now almost through the EU legislative cycle. Consultations on the three other key sectoral initiatives mentioned last month (MiFID, RCSD & SLD) have now closed.

(i) European Market Infrastructure Regulation (EMIR)

The passage of EMIR through the EU legislative process is approaching its conclusion. On 7 February, the Hungarian Presidency put forward a Compromise Proposal, which is currently being discussed by Member States.

Rather more controversially, the European Parliament (EP) drafted its report on EMIR. The Rapporteur has proposed, *inter alia*, extending the scope of exclusions, for instance, to public banks, and to delete provisions for the facilitation of CCP inter-operability in both cash and derivatives clearing – a position which is likely to be rejected by Member States.

These issues were discussed in the EP's ECON Committee on 28 February and a final Committee vote on the report and proposed amendments is now not expected until Easter. Also less positively, the Council Legal Service issued an opinion at the end of December that ESMA does not have the power on its own to determine the designation of OTC standardised contracts that would qualify for central counterparty clearing.

The opinion argues that this power falls to national Member State regulators. The intention is for all parties (Commission, Council and EP) to agree on the final shape of EMIR by the end of the Hungarian Presidency; this is looking increasingly unlikely, so we may not see the final shape of legislation until after the summer break.

(ii) Review of MiFID

With input from SIX Securities Services, our colleagues at SIX Swiss Exchange (SWX) took the lead in responding to the Commission's consultation which closed on 2 February. SWX's main comments centred around:

1. The non-alteration of the regulatory landscape for equity markets (with new categories of operators, such as OTFs)
2. Seeking greater clarity and transparency in best execution
3. Urging caution on setting the bar too high on bond transparency and in measuring liquidity
4. Opposing the introduction of a mandatory consolidated tape

SWX also advocated greater engagement from, and co-operation between, national regulators to ensure that risk controls are standardised at trading venues and that reciprocal arrangements are put in place to mitigate regulatory arbitrage.

SWX has also contributed to consultation responses from its European association, FESE, and from the World Federation of Exchanges. A legislative proposal (an Amending Directive) is still expected in June/July.

(iii) Future EU legislation on CSDs (RCSD)

The European Commission launched its anticipated consultation on 13 January. This closed on 1 March, and SIX Securities Services has responded. The main points in our response, which should soon be publicly available, relate to

1. The authorisation and supervision regime
2. Certain aspects of the proposed risk management framework.

In the former we have advocated for provisions to be made to ensure Third Country CSDs can continue to access the EU market (paralleling a clause in EMIR). We have also stressed the need for an appropriate and proportionate supervisory system.

On the proposed risk management framework, we have emphasised the continued requirement for CSDs to be able to offer settlement in commercial bank money, as well as pointed out the pitfalls of being too restrictive on the method of collateralising clients' intra-day exposure.

Other aspects of our response centred around the Commission's questions relating to the harmonisation of settlement cycles and settlement discipline, as well as financial sanctions. We also supported the lifting of Barrier 9.

The next steps are for the Commission to hold two meetings with Member States on 15 March and 8 April and the formal legislative proposal, which we expect to be a regulation, should be issued in late June/early July.

We will continue to monitor the situation carefully and engage as appropriate in tandem with our European association, ECSDA, to whose consultation response, we have also contributed. We have kept our

stakeholders, such as the Swiss Post-Trading Council (SPTC), as well as authorities in both the Confederation and the Principality of Liechtenstein, apprised of our views.

(iv) Securities Law Directive

The Commission consultation closed on 21 January and it recently published its feedback statement on market comments. While market participants agreed with the Commission's analysis, there was considerable divergence about the solutions, notably definitions of book-entries, and ultimate account holders, as well as the integrity rule, and the applicable conflict of law rule. A legislative proposal is still expected in Q2, with Member States expected to transpose the Directive into national law by end-2013.

(v) Further EU initiatives in the post-trade space possible

The European Commission is planning a conference in Brussels on 31 May, where it intends to discuss the way forward on the future of post-trading with interested market and other participants. This would build on the work of its post-trading advisory group, EGMI.

Extrapolating from some of the EGMI discussions, and other pronouncements, we have made a best guess assessment of what might lie in store for us in the post-trade industry. You will find this in the table below.

These initiatives build on the twin objectives of consolidating the safety and soundness of market infrastructure, as well as continuing to remove some of the remaining Giovannini Barriers.

It is too soon for us to be taking a formal position given the lack of detail at this stage. We will do so in future editions of Oversight.

Subject	Purpose	Affecting
Netting	Tidying-up conflicting EU measures	CCPs
Crisis Management	Dealing with a failing market infrastructure	CCPs, CSDs
Resolution	Living wills regime	CCPs, CSDs
Insolvency	Dealing with a failed market infrastructure	CCPs, CSDs
CESR-ESCB Recommendations	Revision of Risk Management Standards, following CPSS-IOSCO	CCPs, CSDs
Corporate actions	Harmonising processing	CSDs
Tax	Removing tax barriers such as Stamp Duty	CSDs
Tax	Use of Withholding Agents: follow-up to recommendation	CSDs
General meetings	Efficient processing of info requests, investor participation	CSDs



Changes in the EU institutional landscape

(i) European Securities & Markets Authority (ESMA)
ESMA has opened its doors with a new Chairman and Executive Director. It has also produced a comprehensive work plan, including developing technical standards arising from EMIR.

All three European Supervisory Authorities (ESAs) and the European Systemic Risk Board (housed in the ECB) came into being on 1 January, and the first set of appointments have been made. Stephen Maijor, from the Dutch markets authority, AFM, will chair ESMA with the UK FSA's Verena Ross as Executive (aka Managing) Director. ESMA has released its work plan for 2011, which includes work on no less than 17 sets of technical standards emanating from EMIR, including capital, collateral, margining and other risk mitigation issues, and a further 8 other potential post-

trading mandates, involving advice to the Commission for such issues as settlement discipline, the SLD and the forthcoming legislation on CSDs.

As part of its technical standards work, ESMA released a consultation on 10 February addressed to Member States and CCPs. These cover CCP policies relating to key aspects such as margining, liquidity risk, collateral requirements and investment policy, as well as prudential requirements and stress-testing. Replies are sought by 25 March. The ESMA work plan also mentions the objective of a bi-annual dialogue with Third Country regulators, such as FINMA.

We plan to establish regular and direct dialogue with ESMA in the future.

Increasing emphasis on risk mitigation

This quarter's spotlight falls on the AIFMD, moves to risk-weight banks' exposure to CCPs, and CPSS- IOSCO's work.

(i) Alternative Investment Fund Manager Directive
This measure sometimes dubbed "the Hedge Funds Directive" was finalised on 26 October 2010, and is expected to come into force by end-2012. As part of the finalisation process, the Commission asked CESR/ESMA to provide technical advice on 26 different aspects. CESR/ESMA's consultation closed on 14 January. Before we can fully interpret the impact of AIFMD, we have to await its final publication in the

Official Journal, this is now not expected until June. However, the main objectives can already be outlined as follows:

- It lays down the rules for the authorisation, ongoing operation and transparency of managers (AIFMs), Alternative Investment Funds (AIFs), including Private Equity Houses (PEHs)

Continued on page 6

- It applies to any AIFM that is either registered in the EU, manages any EU-based AIF, or markets any AIF in the EU. It also applies to the marketing of any AIF in the EU, even when the AIF or AIFM has no connection with the EU
- It introduces a strict liability for the depositaries of AIFs, including the reversal of the burden of proof. (This is a potentially huge issue for depositaries: some implications are outlined below).



There are two key sets of over-arching issues.

The first, is over-complexity. With numerous (at least eight) different permutations being possible (just two examples: an EU-based AIFM, marketing EU AIFs, with an EU-based depository; and a non-EU AIFM marketing non-EU-based AIFs in the EU, with an EU depository), it would appear that only EU-based AIFMs and AIFs will initially be able to offer funds to investors via the Passport.

Any permutation involving a Non-EU entity will have to wait to obtain the Passport until a certain period after the entry into force of the Directive (confusingly, it is not clear how long this will be, and the Commission will need to report back). Until then, non-EU based AIFMs will have to offer AIFs via the private placement regime.

The second issue concerns depository liability. While there were once fears that the liability clause would be drawn up inflexibly, and make depositaries – including custodians – liable for all non-investment losses, it would appear that custodian liability has fallen somewhat short of this.

Notably this is where the liability can be discharged to a sub-custodian, and where the latter has agreed a contract with a fund manager. This is balanced against the fact that the burden of proof has shifted so that custodians will have to demonstrate that losses incurred are not the result of their negligence and that they will still be liable in the event that a sub-custodian becomes insolvent.

Further clarity is needed on these points (not least on the definition of “losses”), and the fear is that the scope of these provisions can only really be tested through the courts.

Depository liability also featured in the Commission’s consultation on UCITS V, which closed at the end of January. In its feedback statement, the Commission noted market respondents’ overwhelming desire to see a common definition of depository liability between UCITS V and the AIFMD.

(ii) Banks’ exposure to CCPs

There have been two consultations in this area, one from the Basel Committee (BCBS) and one from the European Commission. We responded to the BCBS consultation, which proposed a 2% risk weight for banks’ exposure to CCPs, together with a further capital charge for contributions to the CCP’s default fund.

In our response to the consultation which closed on 4 February, we pointed out the need for the authorities to scope more precisely the type of exposure to be captured, and the overlap between capital requirements, collateralisation and default fund contributions. We also contributed to the EACH submission which notably stressed the punitive nature of the Committee’s 1250% default fund risk weighting. The EC Consultation launched on 9 February covers much of the same ground as the BCBS one, with the addition of a proposal on Credit Valuation Adjustments. The consultation closed on 9 March.

(iii) CPSS-IOSCO revise infrastructure standards

And, finally, the BIS Committee on Payment and Settlement Systems (CPSS) jointly with the technical Committee of IOSCO issued its long-awaited consultation, reviewing three sets of core standards for payment and settlement systems, namely:

- (i) Core principles for systemically important payment systems
- (ii) Recommendations for securities settlement systems
- (iii) Recommendations for central counterparties

Now dubbed the “Principles for Financial Market Infrastructures”, CPSS-IOSCO are seeking notably to tighten up some of the risk mitigation characteristics of transaction-handling in CCPs and CSDs, particularly in relation to credit, liquidity and business risks.

The consultation runs until end-July and we will be taking the views of the Swiss market place before responding on its behalf.