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Coming up

EU Public debt and deficit

Greece granted next tranche from first bailout and Eurozone leaders make further decisions

Following the break-down in talks in September between Greece and the troika (the International Monetary Fund (IMF), the European Central Bank (ECB) and the European Commission), in mid-October it was agreed that Greece would receive the sixth tranche of the €8 billion from its first bailout. This came alongside the Greek parliament's vote to adopt austerity measures on 19 October. However the GDP in Greece has fallen more rapidly than predicted and this has meant that Greece will miss the 2011 deficit reduction target. The transfer of the next tranche from the first bailout will be discussed in December.

Further to this, a deal was reached between EU leaders in the early hours of 27 October to allow Greece to default on 50% of its debt with private lenders and to fund an additional €100 billion by the end of 2011. These additional funds will be provided by the EU and the IMF and the exact details are yet to be released. The agreement with private lenders will be voluntary in nature but due to existing fears on Greece's ability to pay, it is expected that, despite their initial reluctance, many of the largest banks will participate. These private sector funds will be guaranteed by €30 billion in public funds from the eurozone nations.

Eurozone leaders reach some conclusions on eurozone crisis

Following the postponement of the scheduled meeting between eurozone leaders from 17-18 October to 23 October and then the subsequent addition of a meeting on 26 October, some progress was made in the early hours of 27 October. However, many of the planned actions will still be subject to technical analysis and drafting.

- Further action on Greek crisis: Decisive action was taken with regard to Greece but the extent to which private sector lenders will partake in the scheme remains to be seen. In light of deteriorating market conditions since July, the EU and the IMF will set up a programme to provide additional funding of €100 billion by the end of 2011. Private creditors will also be asked to make a voluntary contribution by taking a 50% loss on their held Greek debt. This is with a view to reducing Greece's debt to 120% of GDP (Italy's current level) by 2020.
- Combating contagion by re-enforcing the bailout fund: Decisions were made but these will still be subject to technical analysis and drafting. The size of the European Financial Stability Fund (EFSF) will be increased to €1 trillion. The changes to its operation will include buying up the sovereign bonds of Member States and setting up Special Purpose Vehicles (SPVs) to finance the operations and to isolate financial risk. These will be subsidiary entities that will raise finance without posing a risk to the entire EFSF.
- Recapitalising the banking sector: While the eurozone leaders came to decisions, the exact details are still to be fleshed out. Banks will have to increase their core capital reserves to 9% with a view to withstanding possible future shocks. However, this could pose serious problems for the banks that will have to write-down a large amount of their held Greek debt. In light of this, the IMF has predicted that European banks will need between €200 billion and €300 billion to cover their exposure to the sovereign debt of weak eurozone countries.
- National fiscal reform in Italy: During this summit Italy made the commitment to achieve a balanced budget by 2013 and to maintain its objectives for sustaining its public finances.

Eurozone leaders discuss further economic governance

In the course of talks between eurozone leaders, some additional points were raised in the context of possible future action. This was largely derived from the European Commission's 11 October proposal for [a roadmap for stability and growth](#). The five areas of the proposal are: responding to Greece's problems; enhancing the eurozone's rescue funds; strengthening banks in the EU; enhancing the policies for stability and growth and creating more robust economic governance. This proposal has been welcomed and backed by the four largest political groups

in the European Parliament. These possible actions and the actions set out in the previous section will be addressed by the EU Finance Ministers in November and at the next EU summit on 9 December.

- More regular meetings and deficit limits: As has been previously discussed, the eurozone leaders decided to meet twice a year and to enshrine deficit limits into their national laws.
- Eurogroup President: The European Council on 23 October decided to appoint Council president Herman Van Rompuy as the next Eurogroup president to succeed the current Eurogroup presidency which is held by Luxembourg Premier, Jean-Claude Juncker. This comes in the wake of dissatisfaction by Premier Juncker and other EU heads of state with regard to the bi-lateral meetings between France and Germany concerning the eurozone crisis.

The possibility of strengthening the role of the Commissioner for Economic Affairs has also been discussed and this approach is favoured by the European Parliament as it wants the Commission and not the Council to oversee economic governance.

The exact details of the changes to the top level of governance are still being fleshed out and it remains to be seen whether any such changes would necessitate a change to the EU treaties.

- Alternative to the ECB's purchasing of weak sovereign bonds: Currently the ECB is the only institution which takes on the price of the weak eurozone bonds (Greece, Ireland, Portugal, Italy and Spain) and its purchase have reached approximately €163 billion. The eurozone leaders have to further discuss alternatives and this will probably be the subject of meetings of finance ministers in November. One possibility is the use of the EFSF to lend pre-emptively by buying up bonds in the primary and secondary markets and to perhaps financing bank recapitalisation. The former was addressed in the decisions of the eurozone leaders following the 26 October meeting.

Extent of private sector involvement in future bailouts increased

It was originally envisaged that the private sector would take a 21% loss on all future bailouts including the second bailout to Greece. During negotiations in the wings of the EU summit on 26 October between EU officials and the Institute of International Finance (IIF), the banks agreed, under German pressure, to take a 50% loss. In exchange for this, the banks will receive €30 billion in funds from the European Financial Stability Fund (EFSF).

Eurozone leaders discuss changes to the eurozone bailout system

Following agreement at the EU summit in the early hours of 27 October, the EFSF will be increased from its current €440 billion to €1 trillion. This is with a view to avoiding debt contagion and to acting pre-emptively in some situations. Additionally weaker banks will receive aid from the EFSF. However, the exact details of this have not been drawn up and will be the subject of a meeting of EU finance ministers on the 8 and 30 November.

EU Member State officials have also debated the prospect of treating the EFSF as a bank which would have the ability to boost its own lending capacity. However this idea, which was being pushed by France, has been blocked by the ECB which is the body which would be providing such lending. The Germany plan of using the EFSF to boost bond purchases of weaker eurozone states was the chosen course of action by eurozone leaders following the 26 October summit.

Upcoming G20 summit adds pressure to eurozone talks

The next G20 summit is scheduled to take place on 3-4 November in Cannes and this has meant even more international pressure on the eurozone countries to resolve the eurozone crisis. US Treasury Secretary Timothy Geithner has voiced his admiration for the French and German determination to find a lasting solution to the eurozone crisis. Further to this, China has said that it will support the eurozone by purchasing more sovereign debt on the condition that there are more budget cuts and austerity measures. Brazil has also proposed that the BRIC

nations (Brazil, Russia, India, and China) could purchase more debt in exchange for a greater voice in the IMF.

Further to this, the G20 has called for decisive action following a meeting of the finance ministers in Paris on 16 October. The group is looking at a list of banks which could potentially default and it expects to publish this list at the G20 summit in Cannes. This will inevitably necessitate more capital reserves for banks.

Agreement on the Six Pack legislative proposals on economic governance

After one year of negotiations, the European Parliament and the Council have both adopted the six legislative measures which make up the six pack of legislation on economic governance. This includes three regulations which overhaul the Stability and Growth Pact, two regulations which set out alert systems and sanctions for economic governance and a directive with common standards for public accounts. A main area of contention in this legislative package was the extent to which sanctions can be enforced automatically. The final result was a system of reverse qualified majority voting (12 out of 17 states) or simple qualified majority (9 out of 17 states) for overturning sanctions. The bulk of these measures will apply from 2012 with the exception of the directive, which will apply from 2014. Here is an overview of the main aspects of each piece of legislation:

- [Regulation on Budgetary Surveillance](#): Member States will not be able to increase their spending beyond GDP growth in a specified period.
- [Regulation on Excessive Deficits](#): If a Member State fails to meet the set medium-term budgetary objective, the Commission will issue a warning. If the country fails to take action in seven months, a penalty of a minimum of 0.2% of GDP will be placed on the government. This amount will be deposited with the Commission and will accrue interest. These sanctions can be overturned by a simple majority (9 out of 17 Member States).
- [Regulation on fines for deficit countries](#): This sets the deficit limit at 3% of GDP and the borrowing limits at 60% of GDP. Those countries that are in excess of this when this Regulation comes into force in 2012 will have a grace period of three years. Those countries that exceed this limit will be expected to reduce the limit by 0.5% of GDP over 3 years. In the event that this debt comes from pension costs or other essential economic reforms, these reduction levels will not apply. If a state fails to reduce as prescribed twice, a penalty of 0.2% of GDP will apply. This sanction could be overturned by a qualified majority as represented in Council (14 out of 17 states).
- [Regulation on macroeconomic imbalances](#): A scoreboard will be put in place which will look at the thresholds for public and private indebtedness. An imbalance would lead to a recommendation from the Commission and after 6 months and two warnings from the Commission; the country will be fined 0.1% of GDP. As in the above regulation, this can only be overturned by a qualified majority (12 out of 17 states).
- [Regulation on Sanctions for Excessive Imbalances](#): In order to tackle excessive imbalances, a country will receive a warning from the Commission which will mean that money will have to be deposited and will earn interest. If after two warnings no progress has been made, the deposit will be converted to a fine of 0.1% of GDP and can only be overturned by a qualified majority of states (12 out of 17).
- [Directive on the budgetary framework](#): This sets out budgetary and statistical standards for national accounts which will cover all state agencies and also public corporations. The states accounts will have to be published monthly and regional accounts will have to be published quarterly. Debt and deficit limits will apply to all Member States except the UK and independent auditors will have to be appointed to look into all government accounts. This will come into effect in 2014.

Ireland progressing on bailout criteria as Portugal prepares for the next review

The latest review of Ireland by the troika resulted in a positive report that Ireland is expected to surpass the next deficit target and that as a result, the next tranche of €8 billion can be drawn down.

In Portugal, the government has presented its austerity budget which involves significant cuts to public sector pay and an increase in working hours. Despite this, the economy is still predicted to contract in 2012 following revelations of serious debt problems in the Portuguese island of Madeira. The troika will conduct its check of Portugal's progress in early November.

Spain and Italy still face hurdles to financial stability

It was a month where uncertainty remained as to the financial situations in both Spain and Italy despite actions to address the debt problems. Moody's downgraded both Spain and Italy by three notches to A1 and A2 respectively. The main reason cited was low growth prospects.

The IMF has offered to buy up Spanish and Italian bonds from the primary and second markets, but this has not proved to be sufficient to prevent downgrades. Following agreement of eurozone leaders on 27 October, the EFSF will now be able to buy up these sovereign bonds.

During the meeting of European heads of state on 23 October, Italian Prime Minister Berlusconi had a meeting with French President Sarkozy and German Chancellor Merkel to discuss the Italian debt situation. It is understood that during this meeting, Berlusconi was asked to make even further economic reforms, despite the voting in of the austerity budget towards the end of the summer. In the 26 October eurozone meeting, Italy made the commitment to achieve a balanced budget by 2013 and to maintain its objectives for sustaining its public finances. With regard to Spain, Sarkozy has remarked on the progress that has been made.

EU Financial Markets Regulation

Short Selling and CDS: finally a deal has been reached

Protracted negotiations between Member States (represented by the Polish Presidency of the Council) and the European Parliament on a Regulation on Short Selling and CDS finally led to a deal on 18 October.

The major issue of contention was a ban on naked CDS in relation to sovereign debt. The final deal on this does indeed prohibit naked CDS position on sovereign debt from the date of entry into force of the Regulation: 1 November 2012. Nevertheless, competent authorities are empowered to suspend this ban in certain circumstances, when they feel it negatively impacts on the sovereign debt market. Any suspension can then subsequently be renewed for another six months.

Other issues in the new Regulation have been dealt with as follows:

- Restrictions on naked short selling have been dealt with by inserting what amounts to a 'soft locate', with the buyer needing to have a "reasonable expectation" of obtaining the securities.
- Market making has been exempted.
- Buying in provisions, originally in the Commission proposal, will now be dealt with in the upcoming Regulation for Central Securities Depositories (proposal due 30 November).
- Flagging or marking of short orders, originally an obligation in the Commission proposal has been deleted.

Meanwhile bans on short selling in a number of Member States have again been extended, with the EU Securities and Markets Authority (ESMA) coordinating these efforts.

OTC derivatives and markets infrastructure: Member States come to a joint position, negotiations ongoing

The Polish Presidency of the Council has managed to secure an initial deal (a 'General Approach') between the Member States, which now constitutes their opening gambit for informal negotiations with the MEPs and the European Commission on 'EMIR' (the upcoming European Markets Infrastructure Regulation).

As has widely been reported, the Chancellor himself joined in tough negotiations until the end, securing a number of points for the UK.

- The clearing obligations and access provisions will be limited to OTC derivatives only - and not cover all exchange-traded derivatives. However, the UK secured an agreement from the Commission that this would be part of its proposals for a reviewed MiFiD (see below).
- ESMA will not take a leading role in colleges of supervisors of CCPs, instead only participating in colleges without voting rights.
- On dealing with third countries however, Member States have not come to an agreement. This will now be amongst the issues which will have to be worked through in the informal negotiations with MEPs and the Commission.

The final outcome is still at least a few months off. As mentioned before, the rules are unlikely to be ready before January. This jeopardises the G20 deadline for enforcement of the new regime by the end of 2012.

European Commission proposes reviewed MiFiD regime

On 20 October, the European Commission published its long awaited proposals for a reviewed MiFiD. The Commission's text contains a large number of hotly debated items, which promise intense political negotiations now that the Member States and the European Parliament will have their say on them:

- Access provisions underscore the Commission's commitment to fair competition in trading and post-trading: this includes mandating access to indexes through licenses and access to CCPs and trade feeds;
- In trying to regulate High Frequency Trading, the Commission has proposed a number of measures, including circuit breakers, systems and controls, and principles for trading venues in controlling HFT, but also order-to-trade ratios and a market making requirement for algorithmic traders;
- The Commission proposes a specific SME growth market regime;
- For data, the Commission proposes measures to improve the quality and to harmonise requirements and multiple consolidated tape providers;
- Transparency requirements will under the Commission's text now be extended to all asset classes and all venues;
- Proposals for trading venues (Regulated Markets, MTFs and the new category, Organised Trading Facilities) are meant to capture all trading (including prop trading) and deal with all venues in the same way as regards systems and controls and transparency requirements.

The proposals will now go into political negotiations in the Council of Ministers and the European Parliament. Deliberations are likely to go on well into 2012.

European Commission proposes reviewed Market Abuse regime

Alongside its MiFiD proposal on 20 October, the Commission also published its proposals for a reviewed Market Abuse regime. The proposals are less politically sensitive than the ones in MiFiD. The most important changes the Commission envisages are these:

- The scope of the rules is expanded to include MFTs and OTFs (see above under MiFiD), with harmonised definitions of insider trading and market manipulation;
- Minimum rules for administrative fines and sanctions are foreseen. However, Member States such as the UK are allowed to maintain stricter provisions;
- The Commission wants to abolish 'Accepted Market Practices';
- Commodity derivatives fall within the scope of the proposal, including additional disclosure requirements.

These proposals will now also go into political negotiations in the Council and the Parliament, much of which will take place in 2012.

- COMING UP -

- **November 2011:** European Commission legislative proposal on **crisis management and bank resolution**
- **November 2011:** European Commission proposal for a review of the **Credit Rating Agencies Regulation**
- **3-4 November 2011:** G-20 summit in Cannes, France
- **9 November 2011:** Meeting of EU Finance Ministers
- **30 November 2011:** Meeting of EU Finance Ministers
- **30 November 2011:** European Commission proposal for a **Central Securities Depositories Regulation**
- **9 December 2011:** European Council - Summit of EU leaders
- **January/February 2012:** European Commission proposal for a reviewed **Securities Law Directive**

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