

Financial Regulatory Developments Focus



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In this newsletter, we provide a snapshot of the principal European, US and global financial regulatory developments of interest to banks, investment firms, broker-dealers, market infrastructures, asset managers and corporates.

Our latest quarterly Governance & Securities Law Focus newsletter is available at:

<http://www.shearman.com/~media/Files/NewsInsights/Publications/2014/07/Governance-and-Securities-Law-Focus-Europe-CM-071114.pdf>.

Derivatives

European Commission Responds to Frontloading Issue Raised by ESMA

On July 17, 2014, the European Securities and Markets Authority (“ESMA”) published a letter from the European Commission (dated July 8, 2014) in response to ESMA’s letter on May 8, 2014 regarding the frontloading issue under the European Market Infrastructure Regulation (“EMIR”). Frontloading is the requirement under EMIR for OTC derivatives to be cleared which are entered into after a central counterparty (“CCP”) has been authorized/recognized under EMIR to clear certain classes of derivative but before the application of the clearing obligation. The European Commission acknowledges the issues that the frontloading obligation might present but points out that EMIR provides for the potential adjustment of the application of the frontloading obligation through the determination of minimum remaining maturities as adapted for each asset class. The Commission’s view is that the frontloading obligation should not be applied before parties could reasonably foresee that contracts would need to be cleared due to the frontloading obligation. Further market participants will only be able to foresee that obligation once the regulatory technical standards (“RTS”) on the clearing obligation are published in the Official Journal of the European Union. ESMA’s consultation paper on proposed draft RTS on the clearing obligation, released last week, effectively eliminates this as an issue: (i) for derivatives which have at least one non-financial counterparty as a party; (ii) for any transactions entered into prior to the publication in the Official Journal of an RTS specifying an asset class subject to the clearing obligation; and (iii) for instruments of less than six months maturity as at the time of publication in the Official Journal of the European Union of the relevant RTS.

The European Commission's letter is available at:

<http://www.esma.europa.eu/content/European-Commission-response-ESMA-letter-regarding-frontloading-requirement-under-EMIR>.

You may also like to see our related client note on the clearing obligation under EMIR, "Timing and Scope of EU Clearing Obligation for Derivatives" available at:

<http://www.shearman.com/~media/Files/NewsInsights/Publications/2014/07/Timing-and-Scope-of-EU-Clearing-Obligation-for-Derivatives-FIAFR-071614.pdf>.

Compensation

EBA Revised Guidelines on Compensation Information Collection

On July 16, 2014, the European Banking Authority ("EBA") published its revised Guidelines on the data collection exercise regarding high earners and on the remuneration benchmarking exercise. The EBA is obliged to collect this information under the Capital Requirements Directive. The updated Guidelines, which repeal those published on July 27, 2012, provide for the higher quality of collected data and increase the transparency of remuneration that is paid to high earners. The new guidelines will apply to data that is to be collected for performance for the period of 2013.

The Guidelines are available at: <http://www.eba.europa.eu/-/eba-publishes-revised-guidelines-on-high-earners-data-collection-and-remuneration-benchmarking>.

Bank Prudential Regulation and Regulatory Capital

ECB Decision on SSM Reporting

On July 19, 2014, a Decision of the European Central Bank ("ECB") dated July 2, 2014 on the reporting of information and data collected from individual banks and investment firms by national regulators was published in the Official Journal of the European Union. Banks are subject to regular reporting requirements to national regulators for their regulatory capital under the Capital Requirements Regulation ("CRR"). The ECB Decision sets out procedures applicable to national regulators falling within the scope of the Single Supervisory Mechanism ("SSM") for reporting such information to the ECB.

The Decision is available at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.214.01.0034.01.ENG.

ECB Publishes Note on the Comprehensive Assessment

On July 17, 2014, the ECB published a note on the process for disclosure of results of the Comprehensive Assessment, including the templates showing how the results will be presented, and an update of progress made in the asset quality review and stress test exercise. The results of the Comprehensive Assessment will

be published in October. The ECB is conducting a Comprehensive Assessment of 128 banks incorporated in countries within the SSM before it assumes its supervisory role under the SSM in November this year.

The note is available at:

<http://www.ecb.europa.eu/press/pr/date/2014/html/pr140717.en.html>.

Proposed Guidelines for Determining Systemic Importance of Banks

On July 18, 2014, the EBA began a consultation on proposed Guidelines for national regulators to assess whether a firm should be classified as an ‘other’ systemically important institution (“O-SII”). Under the CRR, a national regulator may require an O-SII to hold an additional buffer of up to 2 percent of Common Equity Tier 1 capital. The proposed Guidelines establish a two-step process for the determination of whether an institution is an O-SII: (i) using a set of mandatory quantitative indicators; and (ii) using the supervisory judgment of the national regulator. The consultation is open until October 18, 2014.

The consultation paper is available at: <http://www.eba.europa.eu/regulation-and-policy/own-funds/guidelines-on-criteria-to-to-assess-other-systemically-important-institutions-o-siis-/-/regulatory-activity/consultation-paper>.

EBA Published Updated Validation Rules for Supervisory Reporting

On July 17, 2014, the EBA published an updated list of validation rules in the implementing technical standards (“ITS”) on supervisory reporting. The updated list indicates the rules which have been deactivated. The EBA announced in April 2014 that inaccuracies had been detected in the validation rules included in the ITS on supervisory reporting.

The updated validation rules are available at:

<https://www.eba.europa.eu/regulation-and-policy/supervisory-reporting/implementing-technical-standard-on-supervisory-reporting-data-point-model->

FDIC Issues Guidance Regarding Application of the Basel III Capital Conservation Buffer to S-Corporation Banks

On July 21, 2014, the Federal Deposit Insurance Corporation (“FDIC”) clarified how it will evaluate requests by S-Corporation Banks to make dividend payments that would otherwise be prohibited under the Basel III capital conservation buffer. Under the Basel III capital rules, finalized on April 8, 2014, a bank would be prohibited or limited in the amounts of dividends it can pay when its risk-based capital ratios fall below certain thresholds. These rules, imposing a capital conservation buffer, would be scheduled to be phased in during the years 2016-2018, and be fully effective in 2019. The capital conservation buffer requirements allow a bank to request approval from its primary federal regulator to make a dividend payment that would not otherwise be permitted by the rules. The regulator may approve such request if warranted based on safety-and-soundness considerations. Under the new guidance issued by the FDIC

and absent significant safety-and-soundness concerns about the requesting bank, the FDIC announced that it generally would expect to approve exception requests by well-rated S-corporation banks that are limited to the payment of dividends to cover shareholders' taxes on their portion of an S-corporation's earnings.

The full text of the FDIC guidance is available at:

<http://www.fdic.gov/news/news/financial/2014/fil14040.html>.

OCC Proposes New Rules for Annual Stress Tests

On July 17, 2014, the Office of the Comptroller of the Currency ("OCC") proposed new rules aimed at adjusting the timing of the annual stress testing cycle and clarifying the method used to calculate regulatory capital in the stress tests. The proposal shifts the dates of the annual stress testing cycle by approximately three months. For example, a stress testing cycle that, under the current rule, begins on October 1, 2015, would instead begin on January 1, 2016. In addition, the proposal would provide that no covered institution would be required to use the advanced approaches capital methodology in its stress testing projections until the stress testing cycle scheduled to begin on January 1, 2016.

The full text of the OCC proposal is available at:

<http://www.gpo.gov/fdsys/pkg/FR-2014-07-01/pdf/2014-14416.pdf>.

Federal Agencies Announce Technical Revision of Risk-Based Capital Rules

On July 16, 2014, the Board of Governors of the Federal Reserve System ("Federal Reserve Board"), the FDIC and the OCC jointly finalized a technical correction of the definition of "eligible guarantee" in the agencies' risk-based capital rules. The correction clarifies the definition of "eligible guarantee" by elaborating on the types of guarantees that can be recognized for purposes of calculating a banking organization's regulatory capital. The correction impacts banking organizations that calculate their regulatory capital ratios under the advanced approaches framework, which generally applies to large international banking organizations with at least \$250 billion in total consolidated assets or at least \$10 billion in total on-balance sheet foreign exposures. The final rule becomes effective on October 1, 2014.

The full text of the final rule revising the definition of "eligible guarantee" is

available at: http://www.fdic.gov/news/board/2014/2014-07-15_notice_sum_b_fr.pdf.

Recovery & Resolution

EBA Publishes Final Draft RTS and Guideline under BRRD

On July 18, 2014, the EBA published the following which are required under the Banking Recovery and Resolution Directive ("BRRD"):

- final draft RTS on the content of recovery plans which must include a summary, information on governance, strategic analysis, a communication plan and a description of preparatory measures;
- final draft RTS on criteria to be applied by a national authority when assessing a recovery plan for completeness, quality and credibility; and
- guidelines on the range of scenarios which firms should use to test the adequacy of the options included in their recovery plans.

The documents are available at: <http://www.esa.europa.eu/-/eba-publishes-final-draft-technical-standards-and-guidelines-on-recovery-plans>.

Secondary Legislation Enacted to Extend UK Special Resolution Regime

On July 14, 2014, secondary legislation was made and published which extends the Special Resolution Regime (“SRR”) under the Banking Act 2009 to recognized central counterparties (those clearing houses recognized under EMIR), systemically important investment firms and group companies. The secondary legislation comes into force on August 1, 2014.

The legislation is available at:

http://www.legislation.gov.uk/ukxi/2014/1847/pdfs/ukxi_20141847_en.pdf.

Credit Ratings

ESMA Proposes Guidance on Reporting Information by Credit Rating Agencies

On July 16, 2014, ESMA published a consultation paper on proposed new Guidelines on the information to be submitted by EU-authorized credit rating agencies to ESMA. ESMA is proposing: (i) to harmonize the level of detail provided and require additional information for periodic reporting; (ii) further clarification as to what ESMA considers to constitute a material change to a credit rating agency’s initial conditions for registration; and (iii) further clarification on the information to be provided to ESMA to ensure accurate and appropriate allocation of ESMA’s supervisory fees. Responses to the consultation are due by the end of Q3 2014. ESMA is expected to publish final Guidelines by the start of January 2015.

The consultation paper is available at: <http://www.esma.europa.eu/news/ESMA-consults-credit-ratings-agencies-periodic-information?t=326&o=home>.

ESMA’s Technical Advice on a European Creditworthiness Assessment for Sovereign Debt

On July 18, 2014, ESMA published its technical advice to the European Commission on the appropriateness of the development of a European creditworthiness assessment for sovereign debt. Under the EU Credit Rating Agency Regulation, the European Commission must report to the European Parliament and the Council of the EU by the end of 2014 on the issue. ESMA’s advice sets out the following essential criteria for consideration of the

appropriateness of the development of a European creditworthiness assessment for sovereign debt: (i) the independence of the rating process; (ii) the independence of the review function (responsible for annual review of methodologies) from those responsible for the credit rating activities; (iii) confidentiality of pre-rating information; and (iv) the need to have sufficient resources to undertake both the rating and the on-going monitoring.

ESMA's advice is available at: <http://www.esma.europa.eu/news/ESMA-advises-Commission-creditworthiness-assessment-sovereign-debt?t=326&o=home>.

Insurance

Law Commissions Recommend Reform of UK Insurance Law

On July 17, 2014, the Law Commission of England and Wales and of Scotland published recommendations for the reform of UK insurance law. The reforms cover the duty of disclosure in business and other non-consumer insurance, warranties, insurers' remedies for fraudulent claims and late payment of insurance claims. The recommendations are included in the Insurance Bill, which was introduced to the House of Lords on July 17, 2014, and will become law if that Bill is enacted.

The report is available at:

<http://lawcommission.justice.gov.uk/publications/insurance-contract-law.htm>.

Financial Services

ESMA Consults on Level 2 and 3 Measures for Market Abuse Regulation

On July 15, 2014, ESMA published two consultation papers under the new Market Abuse Regulation ("MAR"), which will apply from July 2016, on draft technical standards and draft technical advice to the European Commission. The draft RTS/ITS cover: (i) buy-backs and stabilization - conditions for and disclosure of buy-back programs and transaction stabilization; (ii) market soundings - disclosures, timings, investor consent, record keeping requirements, internal processes and controls; (iii) accepted market practices - scope, status of rims, process and requirements to establish and terminate an AMP; (iv) prevention and detection of market abuse, including suspicious transactions and order reporting: reporting obligations, detection, content of STORs and record keeping; (v) disclosure of inside information, including possible exemptions and delays; (vi) insider lists: format, language, procedures; (vii) managers' transactions - notification, disclosure and content; and (viii) investment recommendations - scope, dissemination, recommendations, avoidance of conflicts of interests.

The draft technical advice covers: (i) indicators of market manipulation; (ii) exemptions from disclosure obligations for certain emission allowance market participants; (iii) manager's transactions; and (iv) reporting infringements. Both consultations are open for feedback until October 15, 2014.

The consultation papers are available at: <http://www.esma.europa.eu/news/Press-release-ESMA-details-new-market-abuse-regime?t=326&o=home>.

UK Inquiry Launched into EU Financial Regulatory Framework

On July 16, 2014, the House of Lords EU Economic and Financial Affairs Sub-Committee launched a call for evidence to inform its enquiry into the EU financial regulatory framework. The purpose of the inquiry is to assess progress made in reforming the financial system since the 2008 financial crisis, assess the functioning and effectiveness of the EU regulatory framework, consider any gaps, overlaps or unintended consequences of the EU regulatory agenda, assess the balance of powers between the EU and Member States, including evaluating the impact of the Single Rulebook and access of third countries to European markets and, in particular, the implications for the UK such as gauging any inconsistencies in regulation of the Eurozone and the wider European Union. Written evidence should be provided by September 30, 2014. A report and recommendations to the House of Lords is expected in January 2015.

The call for evidence is available at:

<http://www.parliament.uk/business/committees/committees-a-z/lords-select/eu-economic-and-financial-affairs-and-international-trade-sub-committee-a/inquiries/parliament-2010/eu-financial-regulatory-framework/>.

FSB Proposed Recommendations for Reform of FX Benchmarks

On July 15, 2014, the Financial Stability Board (“FSB”) published for consultation proposals to reform FX benchmarks. The FSB established a working group in February 2014 amid concerns about the integrity of FX benchmarks to conduct a review of FX benchmarks and analyze market practices. The FSB intends to submit recommendations to the G20 leaders ahead of the Brisbane summit in November this year. The recommendations proposed in the consultation paper published last week cover the calculation methodology of the WM/Reuters benchmark rates, the publication of reference rates by central banks, market infrastructure for the execution of fix trades and behavior around the time of the major FX benchmarks. The consultation is open until August 12, 2014.

Enforcement

UK SFO Investigates FX Market Fraud

On July 21, 2014, the UK Serious Fraud Office announced that it had begun a criminal investigation into alleged fraudulent conduct on the FX market.

The announcement is available at: <http://www.sfo.gov.uk/press-room/latest-press-releases/press-releases-2014/forex-investigation.aspx>.

People

SEC Names New Chief Economist and Director of Economic and Risk Analysis Division

On July 21, 2014, the SEC named Mark J. Flannery as the new SEC Chief Economist and Director of Economic and Risk Analysis Division.

Events

July 23, 2014: “Assessing the Impact of the Dodd-Frank Act Four Years Later” (US House Committee on Financial Services).

July 24, 2014: “Oversight of the SEC’s Division of Corporation Finance” (US House Committee on Financial Services).

July 31, 2014: Financial Conduct Authority (“FCA”) - Getting authorized: designing an incubator for small innovators.

August 5, 2014: FCA - Non-Regulated Businesses: how an Innovation Hub could support innovation.

August 20, 2014: FCA - Regulated firms: how large, existing players could engage with an Innovation Hub.

This newsletter is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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