

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.

Bank Prudential Regulation & Regulatory Capital

Federal Reserve Board Proposes Additional Capital Surcharge for Global Systemically Important Banks

On December 9, 2014, the US Board of Governors of the Federal Reserve System (“Federal Reserve Board”) issued proposed amendments to its risk-based capital rule. The proposed amendments would impose a risk-based capital surcharge on eight US global systemically important banks (“G-SIBs”). The proposal is based on the international standard adopted by the Basel Committee on Banking Supervision (the “Basel Committee”) in November 2011 and would amend the Federal Reserve Board’s risk-based capital rules. However, the US G-SIB surcharge would exceed the amount established by the Basel Committee and would be based in part on a firm’s reliance on short-term wholesale funding. The stated goal of the G-SIB surcharge is to internalize the negative externalities posed by G-SIBs, including those arising from the perception that they are too-big-to-fail, protect the financial system from spillover risks due to the G-SIB’s failure and correct for competitive distortions created by a G-SIB banks’ systemic nature. The G-SIB surcharge, if adopted as proposed, would become effective on the same timeline as the capital conservation buffer and thus would be phased in beginning in 2016 and become fully effective on January 1, 2019.

The proposal is available at:

<http://www.federalreserve.gov/aboutthefed/files/bcreg20141209a1.pdf>.

Federal Reserve Board Issues Proposal to Provide Additional Capital Information for Non-Stock Entities

On December 12, 2014, the Federal Reserve Board proposed amendments to its risk-based capital framework in relation to depository institution holding companies with non-traditional capital structures. The proposed rule sets out examples of instruments issued by non-stock entities, characteristics that prevent these instruments from counting towards tier 1 common equity capital, and

provides suggestions on alterations that would allow them to count towards the requirements. The proposal would also add provisions relating to savings and loan holding companies and extend the deadline to January 1, 2016 from January 1, 2015 to allow for compliance with the new rules by the relevant entities.

The proposal is available at:

<http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20141212a1.pdf>.

Adoption of Direct Recapitalization Instrument for Eurozone Banks

On December 8, 2014, the Board of Governors of the European Stability Mechanism (“ESM”) announced that it adopted the Direct Recapitalization Instrument (“DRI”) applicable to Eurozone banks, following the formation of the Banking Union (which consists of the Single Supervisory Mechanism (“SSM”), the Single Resolution Mechanism as well as funding arrangements which include the DRI). Previously, the ESM was only able to recapitalize financial institutions indirectly. The DRI now allows the ESM to recapitalize systemic and viable financial institutions directly, as a last resort measure and under certain specific circumstances, by providing a loan to the government of the relevant member state, who will then in turn recapitalize the bank.

For further details on the SSM, you may want to read our client note at:

<http://www.shearman.com/~media/Files/NewsInsights/Publications/2014/11/Banking-Supervision-Within-the-Eurozone-The-Single-Supervisory-Mechanism-FIA-FR-111714.pdf>.

The press release and FAQs are available at:

<http://www.esm.europa.eu/press/releases/esm-direct-bank-recapitalisation-instrument-adopted.htm> and
<http://www.esm.europa.eu/pdf/2014-12-08%20FAQ%20DRI.pdf>.

European Banking Authority Overview on Implementation and Transposition of CRD IV

On December 10, 2014, the European Banking Authority (“EBA”) published all of the information disclosed by EU competent authorities under the EBA’s implementing technical standards on supervisory disclosure. The information published is in an aggregated format and organized in four sections, covering: (i) the rules and guidance adopted by each member state to implement and transpose the Capital Requirements Directive IV (“CRD IV”) across the EU; (ii) the options and national discretions used by member states; (iii) the supervisory review and evaluation process; and (iv) the aggregate statistical data on the EU banking sector as at the end of 2013. The information disclosed covers all EU member states other than Cyprus, Lithuania, Poland and Portugal, for which updates are expected shortly.

The overview is available at:

<http://www.eba.europa.eu/-/eba-provides-overview-on-the-implementation-and-transposition-of-the-crd-iv-package>.

Commission Lists Jurisdictions with Equivalent Supervisory and Regulatory Arrangements for Exposures to Credit Institutions, Investment Firms and Exchanges

On December 12, 2014, the European Commission published the Implementing Decision it has adopted on the equivalence of the supervisory and regulatory requirements of certain third countries for the treatment of exposures according to CRD IV, together with related FAQs. The Implementing Decision deems six jurisdictions have equivalent supervisory and regulatory arrangements for treatment of exposures to credit institutions, investment firms and exchanges: Brazil; Canada; China; Singapore; South Africa; and the US. The Implementing Decision will enter into force on 1 January 2015.

The Implementing Decision and FAQs are available at:

http://ec.europa.eu/finance/bank/docs/regcapital/acts/implementing/141212-implementing-decision_en.pdf and
<http://email.practicallaw.com/c/13bkHHzeQikFy21MiGYxsFLbWd>.

Basel Committee Consultation on Net Stable Funding Ratio Disclosure Standards

On December 9, 2014, the Basel Committee issued a consultative paper on the net stable funding ratio (“NSFR”) disclosure standards, following the publication of the NSFR standard in October 2014. The NSFR is a ratio structure requiring banks to address any liquidity mismatches and seeking to align the funding of longer-term illiquid assets with more stable financing, so as to reduce the risk of a bank’s failure, which could potentially lead to broader systemic stress. The disclosure requirements aim to improve liquidity risk management, enhance the transparency of regulatory funding requirements and strengthen market discipline. In order for market participants to be able to consistently assess the funding risks of banks, it is important that a common disclosure framework be adopted. The disclosure standards are expected to come into effect from January 1, 2018 and would apply to all internationally active banks on a consolidated basis, though may be used for other banks and on any subset of entities of internationally active banks. Disclosure would be required as often as financial statements are published, and common templates will be used. The consultation closes on March 6, 2015.

The consultation document is available at: <http://www.bis.org/bcbs/publ/d302.pdf>.

Consultation to Identify Simple, Transparent and Comparable Securitizations

On December 11, 2014, the Basel Committee and International Organization of Securities Commissions jointly published a consultative document on criteria to identify simple, transparent and comparable securitizations. Fourteen criteria have been identified for the development of such securitizations, aiming to assist involved parties in evaluating the risks of certain securitizations when carrying out due diligence. The proposed criteria relate to key types of risk in the securitization process: (i) asset risk; (ii) structural risk; and (iii) fiduciary and servicer risk. The consultation closes on February 13, 2015.

The consultation document is available at: <http://www.bis.org/bcbs/publ/d304.pdf>.

Basel Committee Publishes Revisions to Basel II Securitization Framework

On December 11, 2014, the Basel Committee published revisions to the Basel II securitization framework which take effect in January 2018 and form part of the broader Basel III agenda to reform regulatory standards and create a more resilient banking sector. The revisions mainly relate to changes in: (i) the hierarchy of approaches; (ii) the risk drivers used in each approach; and (iii) the amount of regulatory capital banks must hold for exposures to securitizations.

The revisions are available at: <http://www.bis.org/bcbs/publ/d303.pdf>.

Bank Structure

Regulation on Provisional Contributions for Expenditures of Single Resolution Board Published in Official Journal of the European Union

On December 11, 2014, the Delegated Regulation on the provisional system of installments on contributions to cover the administrative expenditures of the Single Resolution Board was published in the Official Journal of the European Union. The contributions are payable by entities notified to do so and considered to be “significant” by the European Central Bank. The Delegated Regulation excludes significant entities that are subsidiaries of groups already considered for these purposes, and this provisional system of installments does not aim in any way to determine the future set-up of the final system of contributions. The Delegated Regulation entered into force on December 11, 2014.

The Regulation is available at:

http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_2014_354_R_001&from=EN.

Bank of England Proposals to Increase Transparency, Accountability and Governance

On December 11, 2014, the Bank of England (“BoE”) published a document setting out proposed changes to increase the BoE’s transparency, accountability and governance. The proposals are grouped under four headings: (i) improvements to Monetary Policy Committee transparency; (ii) transparency of records and documents; (iii) governance of the BoE and; (iv) governance of the BoE’s policy responsibilities. The BoE proposes, amongst other things, to simplify its committee structure, align the status of the Financial Policy Committee and Prudential Regulation Authority (“PRA”) with that of the Monetary Policy Committee and make the PRA a full part of the BoE, rather than it being a subsidiary. The proposals will be considered fully in the next Parliament.

The report is available at:

<http://www.bankofengland.co.uk/publications/Documents/news/2014/warshrespone.pdf>.

Credit Ratings

US Office of the Comptroller of the Currency Releases Community Reinvestment Act Evaluations

On December 10, 2014, the US Office of the Comptroller of the Currency (“OCC”) released a list of Community Reinvestment Act performance evaluations for the time period of November 1, 2014 through to November 30, 2014. The list of evaluations contains only national banks, federal saving associations and insured federal branches of foreign banks that have received ratings. The rating categories include outstanding, satisfactory, needs to improve and substantial noncompliance. In total, 23 evaluations were made, two were rated outstanding, 20 rated satisfactory and one was rated as needs to improve. Satisfactory ratings are generally required in order for banks to undertake expansionary transactions.

The list of performance evaluations is available at:

<http://www.occ.gov/static/cra/nov14.html>.

European Securities and Markets Authority Certifies US Credit Rating Agency

On December 12, 2014, the European Securities and Markets Authority (“ESMA”) published an updated list of registered and certified credit rating agencies (“CRAs”), and approved the certification in the European Union of Egan-Jones Ratings Co. (EJR), a US CRA. The certification regime is only available to third country registered and supervised CRAs not established in the EU and which are not of systemic importance to the financial stability or integrity of the financial markets of one or more member states. The registration regime, however, applies to CRAs established in the EU. Credit ratings issued by EJR can now be used for regulatory purposes under EU legislation, and the new CRA is required to comply with the regulatory requirements set out under the CRA Regulation as well as ESMA’s regulatory technical standards.

The updated list of registered and certified CRAs is available at

<http://www.esma.europa.eu/page/List-registered-and-certified-CRAs>.

Derivatives

Regulation Extending Transitional Periods for Capital Requirements for Exposures to Central Counterparties Published in Official Journal of the European Union

On December 12, 2014, the Implementing Regulation extending the transitional periods relating to own funds requirements for exposures to central counterparties (“CCPs”) under CRD IV and the Regulation on OTC derivative transactions, CCPs and trade repositories was published in the Official Journal of the European Union. The Implementing Regulation extends the transitional periods by an additional six months, to June 15, 2015. The Implementing Regulation enters into force on December 15, 2014.

The Implementing Regulation is available at:

http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_2014_355_R_0002&from=EN.

European Banking Authority Final Technical Advice on Structured Deposits

On December 11, 2014, the EBA published its finalized technical advice on possible delegated acts on criteria and factors for intervention powers concerning structured deposits under the Markets in Financial Instruments Regulation (“MiFIR”). Under MiFIR, the EBA must monitor the market for structured deposits which are sold, distributed or marketed in the EU. The EBA may also under certain circumstances impose temporary prohibitions or restrictions on the marketing, distribution or sale of those structured deposits. The finalized technical advice sets out 12 factors and related criteria that the EBA and national competent authorities should take into account when assessing whether there are investor protection concerns related to structured deposits, including the degree of complexity of the structured deposit, the type of client to which a structured deposit is marketed or sold, and the degree of transparency of the structured deposit.

The finalized technical advice is available at

<http://www.eba.europa.eu/documents/10180/657547/EBA-OP-2014-13+-+Technical+Advice+on+Structured+Deposits.pdf>.

Enforcement

SEC Penalizes Morgan Stanley for Violating Market Access Rule

On December 10, 2014, the US Securities and Exchange Commission (“SEC”) penalized Morgan Stanley & Co. LLC for violating the market access rule in failing to uphold credit limits when a rogue trader engaged in fraudulent trading of Apple shares. The SEC’s market access rule requires broker-dealers to have adequate risk controls in place before providing customers with access to the markets. A SEC investigation found that Morgan Stanley did not uphold necessary risk management controls in 2012 when it provided market access to its brokerage customer, Rochdale Securities. Rochdale was given a \$200 million daily trading limit with the bank. However Rochdale nearly quadrupled the trading limit in order to allow their trader, Mr. Miller, to take on a risky position in Apple shares, without any action by Morgan Stanley to implement its \$200 million limit.

The SEC enforcement action is available at:

<http://www.occ.gov/static/cra/nov14.html>.

Financial Conduct Authority Penalizes Former Managing Director of Blackrock

On December 15, 2014, the Financial Conduct Authority (“FCA”) published a final notice prohibiting Jonathan Burrows from performing any function related to any regulated activity carried on by any authorized or exempt persons or by any exempt professional firm. The FCA found that Mr Burrows showed a lack of

honesty and integrity and failed to meet the FCA's fit and proper test for approved persons, as Mr Burrows was found in November 2013 to have failed to purchase a valid train ticket whilst travelling, and later admitted to evading rail fares on several occasions, knowing that he was breaking the law.

The final notice is available at: <http://www.fca.org.uk/static/documents/final-notices/jonathan-paul-burrows.pdf>.

Financial Market Infrastructure

US Office of the Comptroller of the Currency Official Testifies on Cybersecurity

On December 10, 2014, the OCC's Senior Critical Infrastructure Officer, Valerie Abend, discussed regulatory initiatives aimed at mitigating cybersecurity issues in a testimony before the US Senate Committee on Banking, Housing and Urban Affairs. Ms. Abend discussed the construction of the OCC supervisory framework relating to cybersecurity matters and also described the role of the Federal Financial Institutions Examination Council ("FFIEC"), an interagency body comprised of the principals of the five federal banking regulatory agencies – the OCC, the Federal Reserve Board, the Federal Deposit Insurance Corporation ("FDIC"), the National Credit Union Administration and the Consumer Financial Protection Bureau – and the FFIEC's State Liaison Committee. The FFIEC has stated that one of its top priorities is to enhance an institution's ability to curb cyber-attacks.

The written and oral testimonies are available at:

<http://www.occ.gov/news-issuances/congressional-testimony/2014/pub-test-2014-165-written.pdf> and

<http://www.occ.gov/news-issuances/congressional-testimony/2014/pub-test-2014-165-oral.pdf>.

Funds

Approval of New EU Long Term Investment Fund by Council of the European Union

On December 10, 2014, the Council of the European Union announced that it approved an agreement reached with the European Parliament on a new regulation that would increase the capital available for long-term investments into the EU economy, by creating a new form of fund vehicle, the EU Long Term Investment Fund ("ELTIF"). ELTIFs are expected to provide investors with stable long term returns, due to the asset classes that would be invested into, and will be subject to distinctive additional rules, requiring them for example to invest at least 70% of their capital in clearly defined categories of assets. Only alternative investment funds managed by alternative investment fund managers would be able to market themselves as ELTIFs. The regulation will be adopted by the Council at an upcoming meeting without any further discussion, and once the text of the regulation is finalized in all EU languages.

The press release and final text of the regulation are available at:

http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/146140.pdf and
<http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%2016386%202014%20NIT>.

Recovery & Resolution

Bank of England Publishes 2014 Stress Testing Results

On December 16, 2014, the BoE published the results of the first stress testing exercise of the UK banking system. The eight banks and building societies subject to this exercise were Barclays Bank, Co-operative Bank, HSBC Bank, Lloyds Banking Group, Nationwide Building Society, Royal Bank of Scotland, Santander UK and Standard Chartered. The PRA Board found no capital inadequacies for Barclays, HSBC, Nationwide, Santander UK and Standard Chartered according to their balance sheets as at the end of 2013 and does not require these banks to put forward any revised capital plans. The PRA Board found that the Co-operative Bank, Lloyds Banking Group and Royal Bank of Scotland need to improve their capital position but only required the Co-operative Bank to submit a revised capital plan.

The press release and stress test are available at:

<http://www.bankofengland.co.uk/publications/Pages/news/2014/169.aspx> and
<http://www.bankofengland.co.uk/financialstability/Documents/fpc/results161214.pdf>.

Prudential Regulation Authority Revises Supervisory Statement on Credit Risk Mitigation

On December 12, 2014, the PRA issued an updated version of its supervisory statement on credit risk mitigation, which sets out the PRA's expectations for the recognition of credit risk mitigation in the calculation of certain risk-weighted exposure amounts. The updated statement clarifies that the PRA does not expect a netting agreement to be an eligible form of credit risk mitigation under CRD IV, where a resolution authority is able to bail-in the liabilities in question on a gross basis. The PRA also does not expect that the legal effectiveness and enforceability of a netting agreement is negatively affected by a resolution authority having the power to bail-in those liabilities on a net basis only.

The updated supervisory statement is available at:

<http://www.bankofengland.co.uk/prd/Documents/publications/ss/2013/ss1713.pdf>.

Events

December 10, 2014: Meeting of the FDIC Systemic Resolution Advisory Committee.

December 17, 2014: Meeting of the SEC Advisory Committee on Small and Emerging Companies.

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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