

## 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

#### First EU Asset Classes for Central Clearing Obligation Proposed

On 11 July 2014, the European Securities and Markets Authority (“ESMA”) launched its first consultation on asset classes of derivatives to be subject to mandatory clearing under the European Markets Infrastructure Regulation (“EMIR”). ESMA’s consultation papers included draft regulatory technical standards (“RTS”) for clearing of interest rate swaps and credit default swaps through central clearing houses authorized or recognized under EMIR. ESMA proposes four classes of IRS to be cleared: basis swaps, fixed-to-float IRS, forward rate agreements and overnight index swaps. For CDS, ESMA proposed European untranchet Index CDS to be cleared. ESMA has decided that the clearing obligation for equity and interest rate futures and options is not currently appropriate. The IRS consultation is open until 18 August 2014, the CDS consultation is open until 18 September 2014.

The consultation papers are available at: <http://www.esma.europa.eu/news/Press-release-ESMA-defines-central-clearing-interest-rate-and-credit-default-swaps?t=326&o=home>.

#### CFTC Issues Time-Limited No-Action Relief to Futures Commission Merchants from CFTC Regulations Requiring Acknowledgement Letter from Certain Depositories

On 11 July 2014, the US Commodity Futures Trading Commission’s (“CFTC”) Division of Swap Dealer and Intermediary Oversight (“DSIO”) issued a no-action letter announcing relief for futures commission merchants (“FCMs”) from compliance with certain CFTC regulations.

Specifically, CFTC Regulations 1.20(d)(3)(i) and (ii), 1.26, 22.5, and 30.7(d)(3)(i) and (ii) require that FCMs deposit customer funds only with depositories that have provided the FCM with an acknowledgement letter in which such depositories agree to provide the DSIO Director (or such director's designees) with direct, read-only electronic access to transaction and account balance information for FCM customer accounts. Under the no-action letter, FCMs would not have to comply with these requirements until 17 October 2014.

The full text of the CFTC no-action letter is available at:

<http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/14-91.pdf>.

## Regulatory Capital

### European Commission Seeks Views on Sensitive Information Disclosure Under CRD IV

On 11 July 2014, the European Commission published a consultation paper seeking views on the potential economic consequences of country-by-country reporting under the Capital Requirements Directive ("CRD") which requires banks and investment firms to disclose key information on their business, on a country-by-country basis. From 1 July 2014, firms were required to publish information on their name(s), nature of activities, geographical location, turnover and number of employees on a full time equivalent basis. From 1 January 2015 firms will be required to publish information on their profit or loss before tax, tax on profit or loss and public subsidies received ("sensitive information"). The Commission must report, before 31 December 2014, to the European Parliament and the Council of the EU on any potential negative consequences of the sensitive information disclosures, including any effects on competitiveness, investment and credit availability and the stability of the financial system. If any potential negative consequences are identified, the Commission may prepare a legislative proposal to amend CRD, including deferring the disclosure obligation. The consultation closes on 12 September 2014.

The consultation paper is available at:

[http://ec.europa.eu/internal\\_market/consultations/2014/country-by-country-crd4/docs/consultation-document\\_en.pdf](http://ec.europa.eu/internal_market/consultations/2014/country-by-country-crd4/docs/consultation-document_en.pdf).

### EBA Considers Macro-prudential Rules under CRD IV

On 8 July 2014, the European Banking Authority ("EBA") published its opinion for the European Commission on the macro-prudential rules under the Capital Requirements Regulation ("CRR") and the CRD. The opinion analyses whether the rules are effective, efficient, transparent and consistent with global standards. The opinion considers the capital conservation buffer, the countercyclical buffer, the global systemically important institutions buffer, systemic risk buffer, higher risk weights, Pillar 2 measures (additional own funds, specific treatment of assets, limitation of operations, tightening of liquidity requirements, additional disclosure), liquidity coverage requirement and the net stable funding

requirement. The European Commission must report, before 31 December 2014, to the European Parliament and the Council of the EU on the macro-prudential rules under CRD IV, including submitting a legislative proposal if amendments to the current rules are considered appropriate.

The opinion is available at:

<http://www.eba.europa.eu/documents/10180/657547/EBA-Op-2014-06+-EBA+opinion+on+macroprudential+rules+in+CRR-CRD.pdf>.

### **EBA Final Guidelines on Significant Transfer Risk for Securitizations**

On 7 July 2014, the EBA published final Guidelines on significant credit risk transfer for securitizations. Under the CRR, national regulators can decide, on a case-by-case basis, that a securitization does not result in a significant transfer of credit risk to third parties. National regulators can also decide that significant risk has transferred for an originator institution if it can demonstrate that the reduction of own funds requirements achieves such a transfer. The EBA is required to monitor the use of these provisions, prepare guidelines and advise the European Commission by 31 December 2017 on whether technical standards are required in this area. The Guidelines, which apply to originator institutions and national regulators, provide direction on the assessment of significant transfer of credit risk and will apply six months after adoption of the Guidelines.

The EBA Guidelines are available at:

<http://www.eba.europa.eu/documents/10180/749215/EBA-GL-2014-05+Guidelines+on+Significant+Risk+Transfer.pdf>.

### **EBA Consults on Draft Guidelines Relating to SREP**

On 7 July 2014, the EBA published a consultation paper on draft Guidelines for common procedures and methodologies for the supervisory review process (“SREP”), the assessment of a firm and treatment of risks. The draft Guidelines are addressed to national regulators who must ensure that the Guidelines are applied by firms when assessing capital and liquidity adequacy and risks. The Guidelines link the ongoing supervision and assessment of a firm’s viability under the SREP with the determination of whether a firm is failing or likely to fail under the Banking Recovery and Resolution Directive (“BRRD”). The consultation is open until 9 October 2014. The EBA expects the final Guidelines to apply from 1 January 2016.

The consultation paper is available at:

<http://www.eba.europa.eu/documents/10180/748829/EBA-CP-2014-14+%28CP+on+draft+SREP+Guidelines%29.pdf>.

### **UK FPC Consults on Leverage Ratio**

On 11 July 2014, the Bank of England’s Financial Policy Committee (“FPC”) published a consultation paper on a review of the leverage ratio, an indicator of a firm’s solvency. The FPC was requested by HM Treasury to conduct a review of the leverage ratio, including the FPC’s ‘toolkit’ for implementing the framework.

The FPC is seeking views on policy choices determining the role of the leverage ratio in the capital framework for UK firms, including the design of the framework. The main issues considered are: (i) whether certain characteristics in the existing risk-weighted framework should be echoed in the leverage framework - the FPC is considering whether a leverage conservation buffer on top of the minimum leverage ratio should be introduced; (ii) whether an additional leverage ratio should be introduced, which would apply to a different category of firm such as ring-fenced banks or systemically important institutions (or both) whose failure would be most destabilising for the financial system; (iii) whether a time-varying leverage component should be introduced; and (iv) possible alternatives to the leverage ratio. The FPC also considers that it should be granted powers of Direction over the entire leverage ratio framework as soon as possible. A Direction from the FPC would require the Prudential Regulation Authority (“PRA”) or Financial Conduct Authority (“FCA”) to implement a specific macroprudential measure. The consultation closes on 14 August 2014. The FPC intends to publish a final review on the leverage ratio by November 2014.

The paper available at:

[http://www.bankofengland.co.uk/financialstability/Documents/fpc/fs\\_cp.pdf](http://www.bankofengland.co.uk/financialstability/Documents/fpc/fs_cp.pdf).

### OCC Increases Assessments for Certain National Banks and Federal Savings Associations

On 9 July 2014, the Office of the Comptroller of the Currency (“OCC”) published a final rule that increases assessments on national banks and federal savings associations (“FSAs”) with total assets over \$40 billion. The final rule, which becomes effective on 8 August 2014, would raise the marginal assessment rate for national banks and FSAs with more than \$40 billion in assets by 14.5 percent beginning 30 September 2014. The final rule will not affect assessment rates for banks and FSAs with \$40 billion or less in total assets.

The full text of the OCC final rule is available at: <http://www.occ.gov/news-issuances/federal-register/79fr38768.pdf>.

## Recovery & Resolution

### EBA Begins Work on BRRD Level 2 and 3 Measures

The EBA has begun consulting on Level 2 (technical standards) and Level 3 (guidelines) measures under the BRRD. The BRRD, which establishes the framework for the recovery and resolution of banks and investment firms, will apply from 1 January 2015, except for the bail-in provisions which must apply from 1 January 2016 at the latest. The EBA has published consultation papers on: (i) RTS on the content of resolution plans and the assessment of resolvability; (ii) RTS on the criteria to be applied in assessing whether a valuer is independent when undertaking valuation work for bank resolution; (iii) guidelines on measures to reduce or remove impediments to resolvability and the circumstances under which measures can be applied; and (iv) the types of tests, reviews or exercises

that may lead to public support measures under the BRRD. Responses to the consultations are due in early October 2014.

The consultation papers are available at:

<http://www.eba.europa.eu/documents/10180/751636/EBA-CP-2014-15+%28CP+on+draft+GL+on+measures+to+reduce+or+remove+impediments+to+resolvability%29.pdf>;

<http://www.eba.europa.eu/documents/10180/751477/EBA-CP-2014-16++%28CP+on+draft+RTS+on+Content+Res++Plans+and+Assessment+of+Resolvability%29.docx.pdf>;

<http://www.eba.europa.eu/documents/10180/753427/EBA-CP-2014-18+CP+draft+RTS+on+independent+valuers.pdf>; and

<http://www.eba.europa.eu/documents/10180/751885/EBA-CP-2014-17+CP+draft+GL+support+measures.pdf>.

### **Council of the EU Adopts Single Resolution Mechanism Regulation**

On 14 July 2014, the Council of the EU announced that it had adopted the Single Resolution Mechanism (“SRM”) Regulation. The SRM, which is part of the Single Supervisory Mechanism, provides for the orderly resolution of Eurozone banks under the BRRD. The SRM Regulation must still be finalized and will only come into force when it has been published in the Official Journal of the European Union.

The press release is available at:

[http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ecofin/143925.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/143925.pdf).

### **Secondary Legislation Enacted to Extend UK Special Resolution Regime**

On 11 July 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 recognised under EMIR), systemically important investment firms and group companies. The secondary legislation comes into force on 1 August 2014.

The legislation is available at: <http://www.legislation.gov.uk/new/uksi/2014-07-11>.

### **FCA and PRA Publish Final Terms of Reference for HBOS Review**

On 11 July 2014, the FCA and PRA published the final Terms of Reference for the review into the failure of HBOS plc (“HBOS”). The review, which was commissioned by the Financial Services Authority (“FSA”), started in September 2012 following the conclusion of related enforcement proceedings. A report is to be published jointly by the FCA and PRA by the end of this year. The report will assess the FSA’s supervision of HBOS, the FSA enforcement investigations following HBOS’s failure, explain why HBOS failed, assess the management, governance and culture at HBOS at the relevant time. The review will assess HBOS’s systemic vulnerabilities over the relevant period, as well as its

capital, asset quality, liquidity positions, management, governance and culture, and will make recommendations that have not already been covered in previous reports such as Northern Rock and RBS.

The final Terms of Reference are available at:

<http://www.bankofengland.co.uk/publications/Documents/news/2014/tor110714.pdf>.

## Financial Services

### Order Published which Paves the Way for Rules on Regulation of Senior Management

On 9 July 2014, an Order was made and published which will bring into effect, on 25 July 2014, certain provisions of the Financial Services (Banking Reform) Act 2013 relating to the conduct of persons working in the financial services sector. The Order paves the way for the PRA and FCA to consult on rules and statements of policy on the regulation of senior management, the certification of certain employees of financial institutions, the applicability of rules of conduct to all employees of financial institutions and the extension of the limitation period for imposing sanctions. The regulators are expected to consult on these issues before the end of 2014.

The Order is available at:

[http://www.legislation.gov.uk/ukxi/2014/1819/pdfs/ukxi\\_20141819\\_en.pdf](http://www.legislation.gov.uk/ukxi/2014/1819/pdfs/ukxi_20141819_en.pdf).

### FCA Proposes Unbundling Research from Dealing Commission

On 10 July 2014, the FCA published a discussion paper on how firms use dealing commission, the charges paid by consumers for executing trades and conducting external research. The FCA recently conducted a review of the use of dealing commission relating to the controls and oversight of an investment manager when acquiring research from brokers in return for client dealing commissions, resulting in changes to its rules which came into effect on 2 June 2014. The FCA considers that further work on the use of dealing commissions is needed to improve price transparency in the market for research as well as improve the controls investment managers have over the use of dealing commissions and the potential conflicts of interest for investment managers acting as agents for their customers. The FCA is proposing that unbundling research from dealing commissions is required to address these issues and that, to be most effective, it should be on an EU-wide basis. The FCA notes that the ESMA consultation paper on their advice under the Markets in Financial Instruments Directive II (known as “MiFID II”) indicates that the same unbundling approach is advocated by the European authority.

The FCA discussion paper is available at:

<http://www.fca.org.uk/static/documents/discussion-papers/dp14-03.pdf>.

### FCA Launches Wholesale Sector Competition Review

On 9 July 2014, the FCA launched a review of competition in the wholesale sector, publishing a call for input from market participants and stakeholders which

aims to identify any areas that warrant further study. The review focuses on the wholesale securities and investment markets, including markets and market infrastructure, investment banking activities, asset management and corporate banking. It does not include payment systems, credit rating agencies, benchmarking activities and wholesale insurance. The review aims to establish areas in the wholesale sector where competition is not working effectively covering issues such as exploitation of market power, barriers to entry, expansion or switching, flow of information between market participants, best execution, cross-selling and conflicts of interest.

The FCA call for input is available at:

<http://www.fca.org.uk/static/documents/market-studies/wholesale-sector-competition-review-call-for-inputs.pdf>.

### **Review of Authorization Requirements for New UK Banks**

On 7 July 2014, the PRA and the FCA published a joint report update on the review of requirements for firms entering the UK banking sector. The report is an update of steps that the regulators have taken following the review of the authorization process and the prudential and conduct requirements for new bank applicants published by the FSA and the Bank of England in March 2013. The PRA and FCA joint report set out how the PRA and FCA have implemented the changes proposed in 2013 and states that: (i) capital and liquidity requirements for new applicants that are deemed resolvable with no systemic risk are now lower; (ii) a new mobilization option has been developed which assists new entrants obtain restricted authorization whilst putting infrastructure and controls in place; (iii) increased pre-application support from both regulators; and (iv) a streamlined application pack. The report announces that there has been a substantial increase in the number of firms considering establishing a new bank.

The joint report is available at:

<http://www.bankofengland.co.uk/prd/Documents/publications/reports/2014/barriers2014.pdf>.

### **FCA Launches Project Innovate**

On 11 July 2014, the FCA published a call for input into a new initiative, called Project Innovate, which the regulator is proposing. The FCA is proposing to establish an Incubator Hub and an Innovation Hub. The Incubator Hub will assist innovative financial businesses through the UK regulatory authorization process and the Innovation Hub will be a dedicated contact service for firms authorized using the Incubator Hub. Responses to the FCA are due by 5 September 2014.

The call for input is available at: <http://www.fca.org.uk/static/documents/project-innovate-call-for-input.pdf>.

### **FCA on Considerations for Firms Using Off-the-Shelf Banking Solutions**

On July 2014, the FCA published a document setting out considerations (including guideline questions) for firms thinking about using third-party

technology (off-the-shelf) banking solutions. Where the services offered are critical to a regulated firm's business operations, the service providers are regarded by the FCA as outsource service providers and the regulated firm is then subject to regulatory obligations designed to manage operational risk.

The document is available at:

<http://www.fca.org.uk/your-fca/documents/considerations-for-firms-thinking-of-using-third-party-technology-banking-solutions>.

### High Court Case Provides Clarification on Application of CASS Rules

In *MF Global UK Limited* [2014] EWHC 2222 (Ch) the High Court found in favour of an application to enable a settlement agreement which would release all tracing and other claims to a client money trust, referred to as the client money pool ("CMP"). The judgment provides further clarification following the analysis of an earlier version of client money rules in the Lehman Brothers case.

The settlement related to a shortfall in the CMP resulting from the firm's breach of its obligations to segregate client money under CASS 7 and CASS 7A of the Client Assets Sourcebook of the Financial Services Authority's Handbook. Nothing in the rules expressly excludes compromise and the court concluded that in order to administer the client money trust effectively and economically, it is essential for a trustee to have the power to compromise claims.

*MF Global UK Limited* [2014] EWHC 2222 (Ch) is available at:

<http://www.bailii.org/ew/cases/EWHC/Ch/2014/2222.html>.

## Consumer Protection

### CFPB Issues Guidance for Mortgage Brokers Transitioning to a "Mini-Correspondent" Lender Model

On 11 July 2014, the Consumer Financial Protection Bureau ("CFPB") issued guidance for mortgage brokers transitioning to a "mini-correspondent" lender model. The guidance addresses the CFPB concern that some mortgage brokers may be shifting to the mini-correspondent model under the belief that such model would automatically exempt them from consumer protection rules affecting broker compensation. Under the guidance, the CFTC sets out some of the questions the CFPB uses to evaluate mortgage transactions involving mini-correspondent lenders including examination into how the mini-correspondent lender is structured and operating. However, the guidance makes clear that no single question is determinative of how the CFPB may characterize a particular mortgage transaction.

The full text of the CFPB guidance is available at:

[http://www.consumerfinance.gov/f/201407\\_cfpb\\_guidance\\_mini-correspondent-lenders.pdf](http://www.consumerfinance.gov/f/201407_cfpb_guidance_mini-correspondent-lenders.pdf).



## Enforcement

### SEC Charges Ernst & Young With Violating Auditor Independence Rules in Lobbying Activities

On 14 July 2014, the Securities and Exchange Commission (“SEC”) charged Ernst & Young LLP with violations of auditor independence rules that require firms to maintain their objectivity and impartiality with clients. Under the SEC enforcement order, Ernst & Young provided prohibited legislative advisory services on behalf of two audit clients while representing that it was an “independent” auditor in audit reports issued on the clients’ financial statements. The enforcement order further provides that Ernst & Young will pay more than \$4 million to settle the charges.

The full text of the SEC enforcement order is available at:

<http://www.sec.gov/litigation/admin/2014/34-72602.pdf>.

## People

**Catherine Bradley** has been appointed as a non-executive director to the FCA board. She will begin her three year term from 2 August 2014.

On 8 July 2014, the CFTC Commissioner J. Christopher Giancarlo announced the appointment of **Jason Goggins** (Chief of Staff) and **Marcia Blase** (Senior Counsel) to his senior staff.

## Events

16 July: “What Makes a Bank Systemically Important?” (US Senate Committee on Banking, Housing & Urban Affairs)

16 July: “Monetary Policy and the State of the Economy” (US House Committee on Financial Services)

17 July: “A Legislative Proposal Entitled the ‘Bank Account Seizure of Terrorist Assets (BASTA) Act’” (US House Committee on Financial Services)

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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