

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.

Derivatives

US CFTC Staff Issues Interpretative Guidance Regarding Auditor Independence

On 28 March 2014, the US Commodity Futures Trading Commission's ("CFTC") Division of Swap Dealer and Intermediary Oversight ("DSIO") issued an interpretation regarding the auditor independence requirements under Regulation 1.16 for certified public accountants conducting examinations of futures commission merchants ("FCMs"). The CFTC had previously issued a series of new and amended regulations requiring FCMs holding customer funds to implement enhanced customer protections to include risk management programs; internal monitoring and controls; capital and liquidity standards; customer disclosures; and auditing and examination programs (the "Customer Protection Rule"). In the Customer Protection Rule, the CFTC revised Regulation 1.16 to require, among other things, a certified public accountant's audit report of an FCM to state whether the audit was conducted in accordance with the auditing standards adopted by the Public Company Accounting Oversight Board ("PCAOB"). The CFTC also stated that the amendments to Regulation 1.16 would harmonize FCM audit requirements with the audit requirements for broker-dealers ("BDs") registered with the Securities Exchange Commission ("SEC"). In the interpretive guidance, the DSIO announced their view that a public accountant of an FCM will comply with the CFTC's Regulation 1.16 auditor independence requirements if such public accountant complies with the SEC and PCAOB audit independence requirements applicable to BDs.

The full text of the interpretive guidance is available at:

<http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-40.pdf>.

US CFTC and Canadian Authorities Sign Memorandum of Understanding to Enhance Supervision of Cross-Border Regulated Entities

On 27 March 2014, the CFTC announced that CFTC Acting Chairman Mark Wetjen and leaders of the Alberta Securities Commission, the British Columbia Securities Commission, the Ontario Securities Commission, and the Autorité des marchés financiers (collectively “Canadian Authorities”) have entered into a Memorandum of Understanding (“MoU”) regarding cooperation and the exchange of information in the supervision and oversight of regulated entities that operate on a cross-border basis in the United States and in Alberta, British Columbia, Ontario, or Québec.

Through the MoU, the CFTC and the Canadian Authorities express their willingness to cooperate in the interest of fulfilling their respective regulatory mandates regarding derivatives markets. The scope of the MoU includes markets and organized trading platforms, central counterparties, trade repositories, and intermediaries, dealers, and other market participants.

The full text of the MoU is available at:

<http://www.cftc.gov/ucm/groups/public/@internationalaffairs/documents/file/asc-bcsc-osc-amfmou032514.pdf>.

IOSCO Continues Dialogue with European Commission on Equivalence

The International Organization of Securities Commissions published a letter on behalf of its Asia Pacific members to the European Commission dated 21 March 2014 regarding the recognition of Asia Pacific central counterparties (“CCPs”) under the European Market Infrastructure Regulation. The letter contains three requests which are:

1. That the effect of any equivalence decision on the domestic Asian-Pacific markets is taken into account;
2. For provision of information on and a copy of the Memorandum of Understanding with the European Securities and Markets Authority (“ESMA”); and
3. That the European Commission exercises its discretion to extend the deadline of 15 June 2014 under the Capital Requirements Regulation (“CRR”) for non-EU CCPs to qualify as “qualifying CCPs” for the purpose of the calculation by banks and investment firms of the risk weightings attached to their exposure to CCPs.

The letter is available at:

http://www.iosco.org/committees/aprc/pdf/20140321_APRC_letter_to_EU.pdf.

OTC Derivatives Regulators Issue Report to the G20

On 31 March 2014, the Over-the-Counter (“OTC”) Derivatives Regulators Group (“ODRG”), which is made up of authorities with responsibility for the regulation of OTC derivatives markets in Australia, Brazil, the European Union, Hong Kong, Japan, Ontario, Quebec, Singapore, Switzerland, and the United States, issued a report that identifies the current list of remaining cross-border implementation

issues related to global reform of OTC derivatives markets. The report also includes a summary of the status of such issues and a timetable for addressing them through a series of reports to the G20 Finance Ministers and Central Bank Governors over the course of 2014.

The initial report to the G20 addresses cross-border issues the ODRG is working on to develop approaches to address, namely, the treatment of branches and affiliates and the implementation of the trading commitment through organized trading platforms. The report also addresses how ODRG members are working to implement understandings reached in the areas of equivalence and substituted compliance, clearing determinations, margin requirements for non-centrally cleared derivatives transactions, and access to trade repository data.

The full text of the ODRG report is available at:

<http://www.cftc.gov/ucm/groups/public/@internationalaffairs/documents/file/odrg-report033114.pdf>.

Bank Structure

Volcker Rule Becomes Effective

On 1 April 2014, the final regulations known as the Volcker Rule, issued jointly on 10 December 2014 by the Office of the Comptroller of the Currency (“OCC”), the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission (“SEC”), and the CFTC to implement section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, became effective.

The final regulations were published in the Federal Register on 31 January 2014 and are available at: <http://www.occ.gov/news-issuances/federal-register/79fr5536.pdf>.

See our previous client note on the Volcker Rule at:

<http://www.shearman.com/en/newsinsights/publications/2014/01/volcker-unbound>.

Compensation

EBA Guidelines on Notional Discount Rate for Variable Remuneration

On 27 March 2014, the European Banking Authority (the “EBA”) published guidelines on the applicable notional discount rate for variable remuneration. Under the Capital Requirements Directive, firms are required to set appropriate ratios between the fixed and variable component of total remuneration for staff whose professional activities have a material impact on the risk profile of the firm. The maximum ratio between the variable and the fixed part of the total remuneration is 100%. However, member states may allow the ratio to be increased to a maximum of 200%. The guidelines apply in member states which have implemented the option of applying the discount rate and to firms which make use of such rate. National regulators in the relevant member states are

required to comply with the guidelines. The guidelines apply from 1 June 2014 for calculations of the ratio for remuneration awarded from the year 2014 onwards.

The guidelines are available at: <http://www.eba.europa.eu/-/eba-publishes-guidelines-on-the-applicable-notional-discount-rate-for-variable-remuneration>.

Regulatory Capital

EBA Publishes Further Final Draft Technical Standards

The EBA published, on 27 and 28 March 2014, final draft technical standards required under the CRR. The technical standards have been passed to the European Commission for adoption. Once published in the Official Journal of the European Union, the standards will apply across the EU. The final draft technical standards published are:

- (i) Final draft implementing technical standards (“ITS”) on currencies for which the justified demand for liquid assets exceeds their availability;
- (ii) Final draft regulatory technical standards (“RTS”) on derogations for eligible currencies;
- (iii) Final draft ITS listing the currencies with an extremely narrow definition of central bank eligibility;
- (iv) Final draft RTS on additional collateral outflows; and
- (v) Final draft RTS on own funds (part IV).

The related press releases and materials are available at:

<http://www.eba.europa.eu/-/eba-publishes-final-draft-technical-standards-on-liquidity-requirements>;

<http://www.eba.europa.eu/-/eba-publishes-final-draft-technical-standards-on-additional-collateral-outflows>; and

<http://www.eba.europa.eu/-/eba-publishes-final-draft-technical-standards-on-own-funds-part-iv>.

FPC Confirms Terms of Reference for Review of Leverage Ratio

On 27 March 2014, the Financial Policy Committee (“FPC”) of the Bank of England announced the terms of reference of its review of the leverage ratio. The review was requested by the Chancellor in November 2013. The FPC review will consider what leverage standard is required to ensure that the UK banking system is resilient, in particular, the merits of varying the leverage ratio in proportion to risk-weighted standards. The FPC intends to publish the review in November 2014, together with any necessary recommendation.

The press release is available at:

<http://www.bankofengland.co.uk/publications/Pages/news/2014/062.aspx>.

Federal Reserve Board releases results of Comprehensive Capital Analysis and Review

On 26 March 2014, the Board of Governors of the Federal Reserve System (“Federal Reserve Board”) announced it has approved the capital plans of 25 bank holding companies participating in the Comprehensive Capital Analysis and Review (“CCAR”). The Federal Reserve Board objected to the plans of the other five participating firms - four based on qualitative concerns and one because it did not meet a minimum post-stress capital requirement.

Strong capital levels help ensure that banking organizations have the ability to lend to households and businesses and to continue to meet their financial obligations, even in times of economic difficulty. Now in its fourth year, the Federal Reserve Board in CCAR evaluates the capital planning processes and capital adequacy of the largest bank holding companies, including the firms’ proposed capital actions such as dividend payments and share buybacks and issuances.

US firms have substantially increased their capital since the first set of government stress tests in 2009. The aggregate tier 1 common equity ratio, which compares high-quality capital to risk-weighted assets, of the 30 bank holding companies in the 2014 CCAR has more than doubled from 5.5% in the first quarter of 2009 to 11.6% in the fourth quarter of 2013, reflecting an increase in tier 1 common equity of more than \$511 billion to \$971 billion during the same period. That trend is expected to continue. All but two of the 30 participants in this year’s CCAR are expected to build capital from the second quarter of 2014 through the first quarter of 2015. In the aggregate, the firms are expected to distribute 40% less than their projected net income during the same period. The 30 institutions in CCAR this year have a combined \$13.5 trillion in assets, or approximately 80% of all US bank holding company assets.

The Federal Reserve Board’s 2014 Comprehensive Capital Analysis and review is available at:

http://www.federalreserve.gov/newsevents/press/bcreg/ccar_20140326.pdf.

Basel Committee Publishes Final Standardised Approach for Measuring Counterparty Credit Risk Exposures

On 31 March 2014, the Basel Committee on Banking Supervision published a final standard on the treatment of derivatives-related transactions in its capital adequacy framework which will be used for measuring exposure at default for counterparty credit risk. The new standard will replace, from 1 January 2017, the Current Exposure Method and the Standardised Method.

The press release and final Standardised Approach are available at:

<http://www.bis.org/press/p140331.htm>.

Financial Services

ESMA Strengthens Cooperation in the EU

On 26 March 2014, ESMA published guidelines which provide for national regulators to enter into and comply with the provisions of a multilateral memorandum of understanding (“MMoU”) which is a framework for cooperation and the exchange of information between regulators and between regulators and ESMA. The MMoU comes into effect on 29 May 2014.

ESMA’s press release is available at:

<http://www.esma.europa.eu/content/Guidelines-cooperation-arrangements-and-information-exchange-between-competent-authorities-a>.

ESMA Opinion on Good Practices for Product Governance Arrangements

On 27 March 2014, ESMA published an opinion on good practices for product governance arrangements which includes a non-exhaustive set of examples of good practice which illustrate arrangements that firms could put in place to enhance investor protection.

The opinion is available at: <http://www.esma.europa.eu/content/Structured-Retail-Products-Good-practices-product-governance-arrangements>.

First Statutory Audit Report of FCA and PRA Published

On 25 March 2014, the UK’s National Audit Office (“NAO”) published its first statutory audit report of the Financial Conduct Authority (“FCA”) and the Prudential Regulation Authority (“PRA”). The report examines the progress made by the regulators in developing and implementing their regulatory approaches. The report concludes that the two regulators cost more than the Financial Services Authority (the “FSA”). The 24% increase in cost is attributed to the difference in regulatory approach adopted by the new regulators and the cost of running two regulators instead of one. The NAO recommends that the regulators should (i) develop more structured approaches to evaluation of their work; (ii) establish a body of evidence from experience of managing conflicts between conduct and prudential regulation; (iii) review the effect of staff turnover rates in practice; (iv) evaluate the impact of the new regular data requests on firms; and (v) clearly define the outcomes sought and measures of performance. Clarification is also needed over how the PRA would access the information necessary to assess its economy and effectiveness.

The NAO report is available at: <http://www.nao.org.uk/wp-content/uploads/2015/03/Regulating-financial-services.pdf>.

Funds

ESMA Publishes Final Technical Advice Relating to Provision of Information to ESMA by National Regulators on the Operation of the Passport Regime and National Placement Regimes

On 27 March 2014, ESMA published its final technical advice to the European Commission setting out the information that ESMA considers national regulators should be mandated to provide to ESMA under delegated regulations to be adopted by the Commission. Under the Alternative Investment Fund Managers Directive (“AIFMD”), EU alternative investment fund managers (“AIFMs”) use the EU passport for managing and marketing of EU alternative investment funds (“AIFs”) in the EU. Non-EU AIFs and non-EU AIFMs are subject to the national private placement regime of each member state where they manage or market AIFs. The AIFMD makes provision for the EU passport to potentially be extended in the future. Before consideration of such an extension, ESMA must provide the European Parliament, Council and Commission by 22 July 2015 with an opinion on the functioning of the EU passport and the national placement regimes under the AIFMD and advice on the application of the passport to non-EU AIFMs and AIFs. The opinion and advice is to be based on information provided to ESMA by national regulators about the EU and non-EU AIFMs under their supervision. The technical advice to the European Commission sets out the information that ESMA considers it should receive from the national regulators to inform its opinion and advice. The information is likely to be required on a quarterly basis according to ESMA’s proposed schedule.

ESMA’s final report is available at:

<http://www.esma.europa.eu/content/Technical-advice-European-Commission-information-competent-authorities-should-provide-ESMA-p>.

Consumer Protection

EBA Alert Over Fraudulent Scams

On 26 March 2014, the EBA published an alert that its name and logo are being used to validate email scams in an attempt to obtain money or personal details. The EBA warns that it cannot accept any responsibility for losses suffered as a result of such scams. The alert also confirms that the EBA does not have any ability to contact people regarding wire transfer applications and cannot require any payments or guarantees for allowing financial transfers to enter the EU.

The EBA press release is available at: <http://www.eba.europa.eu/-/eba-issues-an-alert-over-fraudulent-scams-on-its-behalf>.

Complaints Commissioner Decides Against the FSA

On 27 March 2014, the Complaints Commissioner published a decision on a complaint that the FSA, the predecessor of the FCA and the PRA, failed to act fairly, as required under the Financial Services and Markets Act, in publishing the Final Notice relating to the Complainant. The Complaints Commissioner found

that the FSA did not exercise fairness in its decision and recommends that the FSA apologise to the Complainant for the delay in the investigation of his complaint, pay certain sums to the Complainant, reviews its procedures to ensure that there is an assessment of fairness of the publication of Final Notices going forwards and considers withdrawing the publication of the Complainant's Final Notice. The Complaints Commissioner is investigating a related complaint from the same Complainant regarding the FSA's conduct of the enforcement investigation, in particular the exercise of a search and seizure warrant.

The decision is available at:

<http://www.fsc.gov.uk/documents/final/FSA01600.pdf>.

Enforcement

More Brokers Charged Over Alleged Manipulation of LIBOR

On 28 March 2014, the UK's Serious Fraud Office (the "SFO") announced that criminal proceedings had been brought against three former employees of ICAP plc for alleged manipulation of LIBOR. The SFO has brought charges against nine people relating to the manipulation of LIBOR during the course of its investigation.

The press release is available at: <http://www.sfo.gov.uk/press-room/latest-press-releases/press-releases-2014/libor-three-former-icap-brokers-to-be-charged-.aspx>.

Santander UK Fined by FCA for Investment Advice Failings

On 26 March 2014, the FCA published a final notice against Santander UK under which the bank was fined £12,377,800 for investment advice failings. The FCA found that Santander UK had failed to (i) ensure that it was giving suitable advice to customers; (ii) monitor the quality of investment advice given; and (iii) ensure that new advisers were properly trained before being allowed to give investment advice. In addition to the fine, Santander UK is expected to pay compensation to affected customers.

The FCA press release and final notice are available at:

<http://www.fca.org.uk/news/press-releases/santander-uk-investment-fine>.

SEC Halts Pyramid Scheme Targeting Asian and Latino Communities

On 28 March 2014, the SEC announced charges and asset freezes against the operators of a worldwide pyramid scheme targeting Asian and Latino communities in the US and abroad. The SEC alleges that three entities collectively operating under the business names WCM and WCM777 have raised more than \$65 million since March 2013 by falsely promising tens of thousands of investors that the return on investment in the cloud services venture would be 100% or more in 100 days.

The full text of the SEC complaint is available at:

<http://www.sec.gov/litigation/complaints/2014/comp-pr2014-60.pdf>.

Events

4 April 2014: EBA public hearing on consultation paper on draft technical standards on the mapping of ECAIs credit assessments.

EUROPE

BARNEY REYNOLDS

T: +44 20 7655 5528
barney.reynolds@shearman.com
London

AZAD ALI

T: +44 20 7655 5659
azad.ali@shearman.com
London

ANNA DOYLE

T: +44 20 7655 5978
anna.doyle@shearman.com
London

ELLERINA TEO

T: +44 20 7655 5070
ellerina.teo@shearman.com
London

JAMES CAMPBELL

T: +44 20 7655 5570
james.campbell@shearman.com
London

THOMAS DONEGAN

T: +44 20 7655 5566
thomas.donegan@shearman.com
London

JOHN ADAMS

T: +44 20 7655 5740
john.adams@shearman.com
London

MARIA CHAN

T: +44 20 7655 5835
maria.chan@shearman.com
London

NATALIE CALDWELL

T: +44 20 7655 5722
natalie.caldwell@shearman.com
London

BILL MURDIE

T: +44 20 7655 5149
bill.murdie@shearman.com
London

KOLJA STEHL

T: +49 69 9711 1623
kolja.stehl@shearman.com
Frankfurt

MAK JUDGE

T: +44 20 7655 5182
mak.judge@shearman.com
London

OLIVER LINCH

T: +44 20 7655 5715
oliver.linch@shearman.com
London

AMERICAS

DONALD N. LAMSON

T: +1 202 508 8130
donald.lamson@shearman.com
Washington, DC

JENNIFER D. MORTON

T: +1 212 848 5187
jennifer.morton@shearman.com
New York

JARED R. GIANATASIO

T: +1 212 848 4384
jared.gianatasio@shearman.com
New York

RUSSELL D. SACKS

T: +1 212 848 7585
rsacks@shearman.com
New York

SYLVIA FAVRETTO

T: +1 202 508 8176
sylvia.favretto@shearman.com
Washington, DC

BRADLEY K. SABEL

T: +1 212 848 8410
bsabel@shearman.com
New York

CHRISTINA BROCH

T: +1 202 508 8028
christina.broch@shearman.com
Washington, DC

ABU DHABI | BEIJING | BRUSSELS | FRANKFURT | HONG KONG | LONDON | MILAN | NEW YORK | PALO ALTO
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This memorandum 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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