SHEARMAN & STERLING

FINANCIAL REGULATORY DEVELOPMENTS FOCUS

DEC. 17, 2018
ISSUE 48/2018

In this week's newsletter, we provide a snapshot of the principal U.S., European and global financial regulatory developments of interest to banks, investment firms, broker-dealers, market infrastructure providers, asset managers and corporates.

Click here if you wish to access our Financial Regulatory Developments website.

IN THIS ISSUE

Bank Prudential Regulation & Regulatory Capital

Basel Committee on Banking Supervision Agrees Next Steps for Basel Standards

On November 29, 2018, Central bankers and banking supervisors from over eighty jurisdictions met in Abu Dhabi, United Arab Emirates to discuss a range of policy and supervisory topics.

On November 26-27, 2018, there was a meeting of the Basel Committee on Banking Supervision at which it was agreed that a consultation would take place next year to discuss a framework to consolidate the Committee's standards into a single integrated structure. Moreover, a number of items were agreed:

I. A set of targeted revisions to the market risk framework which is due to be implemented by January 1, 2022.

II. A consultation on potential enhanced disclosures to reduce bank window-dressing behavior related to leverage ratio will be pursued. The Basel Committee issued a statement in October declaring unacceptable the alleged tendency in banks to engage in so-called window-dressing by temporarily reducing transaction volumes around key reference dates, which has supposedly the effect of allowing banks to report and publicly disclose better leverage ratios.

III. A set of revisions to the Pillar 3 disclosure framework will be published in December.

IV. A report will be published in December setting out the range of bank, regulatory and supervisory cyber-resilience practices across jurisdictions.

The press release is available at: https://www.bis.org/press/p181129.htm and details of the Basel Committee's consultation on the revised market risk framework are available at: https://finreg.shearman.com/basel-committee-on-banking-supervision-highlights.

Bank Structural Reform

UK Ring-Fencing Order Brings Full Regime Into Force From January 2019

On December 5, 2018, the U.K. Financial Services (Banking Reform) Act 2013 (Commencement No. 12) Order 2018 was made. The Order brings into force, from January 1, 2019, those provisions of the Financial Services (Banking Reform) Act 2013 on ring-fencing that are not already in force, including the prohibition on ring-fenced bodies to carry on excluded activities and provisions on group restructuring. The U.K. ring-fencing laws require U.K. banks which hold more than £25 billion in core deposits and banking groups whose members hold an average core deposit of more than £25 billion to separate their core retail banking business from their investment banking business. Restrictions will limit the products that a ring-fenced bank can offer and where it can conduct business. In particular, a ring-fenced bank will not be able to own a banking subsidiary or branch which is established outside of the EEA.

The Order is available at: http://www.legislation.gov.uk/uksi/2018/1306/pdfs/uksi_20181306_en.pdf.

Brexit for Financial Services

EU Court Rules That the UK Can Unilaterally Revoke Its Brexit Notice

On December 10, 2018, the Court of Justice of the European Union ruled that the U.K. is able to unilaterally revoke its notice of intention to withdraw from the EU. Any such revocation could only be made before the draft Withdrawal Agreement entered into force or, if there is no agreement, expiration of the two-year period since the withdrawal notification was made or any extension of that two-year period in accordance with Article 50 of the Treaty on the European Union. The revocation could also only be made after a revocation decision was made by the U.K. according to its constitutional requirements.

The CJEU decision means that the U.K. Parliament has three options to consider on Brexit: remain in the EU, accept the draft withdrawal agreement negotiated by the U.K. Government or leave the EU on March 29, 2019, without an agreement (known as a "hard Brexit").

The Court of Session referred the question of whether the U.K. can unilaterally revoke its notice of withdrawal from the EU on September 21, 2018. It remains for the Scottish Court to issue a declaratory judgment on this topic, based on the CJEU's ruling, on the legal position—*Wightman v Secretary of State for Exiting the European Union* [2018] CSIH 62.

To effect revocation, the U.K. would need to provide an unequivocal and unconditional written notice to the European Council. Revocation of the Brexit notice would mean that the U.K. would remain in the EU as a member state and the withdrawal process would end.

The CJEU ruling is available at: http://curia.europa.eu/juris/document/document.jsf?text=&docid=208636&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=1186545, the CJEU press release is available at: https://curia.europa.eu/jcms/upload/docs/application/pdf/2018-12/cp180191en.pdf and details of the Scottish Court's reference is available at: https://finreg.shearman.com/scottish-court-says-court-of-justice-of-the-europ.

Proposed Exemption From EU Margin Obligations for OTC Derivatives Novated to EU Counterparties in Preparation for a 'No Deal' Brexit

On November 29, 2018, the Joint Committee of the European Supervisory Authorities published a final report and final draft Regulatory Technical Standards to amend the existing RTS on margin requirements for uncleared OTC derivative contracts. The ESAs are proposing the introduction of a 12-month exemption from the margin exchange obligations to facilitate the novation of uncleared OTC derivative contracts to EU counterparties in the event of a "no deal" Brexit. The European Market Infrastructure Regulation requires counterparties to uncleared OTC derivative transactions to implement risk mitigation techniques to reduce counterparty credit risk. The RTS prescribe required margin amounts to be posted and collected and the methodologies by which the minimum amount of initial margin and variation margin should be calculated, as well as listing securities eligible as collateral, such as sovereign bonds, covered bonds, some securitization instruments, corporate bonds, gold and some equities. The variation margin requirements have applied to all counterparties since March 1, 2017.

On Brexit, U.K. firms will lose the passports that enable them to provide certain services across the EU. If the EU and the U.K. fail to reach an agreement on the U.K.'s exit from the EU and to the extent they are unable to avail themselves of equivalence, national perimeter regimes or reverse solicitation, U.K. firms may be unable to perform some of the operations for their derivatives contracts with EU clients. In preparation for this eventuality, firms may want to novate certain contracts to entities that are established and authorized in an EU27 member state. However, novation of an OTC derivatives contract may trigger the margin obligation and result in unexpected taxes or costs to the firms (arising from an event over which they have no control). To address this, the ESAs are proposing to amend the RTS on the margin obligation to introduce a time-limited exemption.

This would apply for bilateral OTC derivatives contracts that have either been entered into or novated before the margin obligation became applicable. The exemption would only apply to a novation from a U.K. counterparty to an EU counterparty and would be available for a period of 12 months following the U.K.'s exit from the EU to provide firms with time to negotiate any novation and complete any necessary repapering.

The exemption will not come into effect if the EU and U.K. agree the terms of the U.K.'s exit and the withdrawal agreement has entered into force. Similarly, it will not apply if the EU and the U.K. agree to extend the two-year negotiation period under the terms of the Treaty on European Union.

The final draft RTS have been submitted to the European Commission for endorsement.

The final report and final draft RTS is available at: https://eiopa.europa.eu/Publications/Reports/ESAs%202018%2025%20-%20Final%20Report%20-%20Bilateral%20margining%20%28novation%29.pdf and details of the proposed exemption from the clearing obligation are available at: https://finreg.shearman.com/proposed-exemption-from-the-eu-clearing-obligatioUK.

Further UK Legislation in Preparation for Brexit Comes Into Force

On December 6, 2018, three pieces of U.K. legislation to onshore EU laws in preparation for Brexit were made. These are:

I. The Trade Repositories (Amendment and Transitional Provision) (EU Exit) Regulations 2018 (SI 2018/1318).

A number of technical changes have been made as a result of the consultation process, but these do not affect the fundamental intention and scope of the legislation. The Regulations come into force on December 7, 2018, except for the provisions amending EMIR, which will come in force on exit day. Advance applications for registration of a trade repository must be submitted to the Financial Conduct Authority between December 7, 2018 and immediately before exit day, instead of on exit day.

These Regulations establish: (i) a temporary registration regime to enable U.K. and EU trade repositories to benefit—on complying with certain requirements - from temporary registration while the FCA considers their application; and (ii) a conversion regime that will allow U.K. trade repositories that are currently registered with the European Securities and Markets Authority to be registered as authorized U.K. trade repositories by the FCA from exit day.

II. The Short Selling (Amendment) (EU Exit) Regulations 2018 (SI 2018/1321).

A number of technical changes have been made as a result of the consultation process, but these do not affect the fundamental intention and scope of the U.K. SSR. The U.K. SSR covers only instruments admitted to trading on U.K. trading venues and U.K. sovereign debt. They do not cover instruments admitted to trading or traded on an EEA trading venue or the sovereign debt of EEA governments. The SSR will come into force on exit day and provide for:

a. the FCA to assume ESMA's responsibility for collating and publishing the list of shares principally traded in a third country, including shares which have their principal trading venue outside of the U.K. This relates to the EU SSR exemptions from the reporting requirements, the buy-in regime and restrictions on uncovered short selling for shares which are principally traded in a third country. To ensure continuity, the FCA may recognize ESMA's existing list for up to two years following exit day;

b. notifications by market makers of their intention to use the exemption available under the EU SSR must be made to the FCA before exit day to remain valid. European market makers will be required to join a U.K. trading venue and submit a notification to the FCA at least 30 days ahead of exit day to benefit from the exemption;

c. the continuation of the FCA's powers to restrict short selling in in-scope instruments in the event of a significant fall in the price of a share or in response to a threat to U.K. financial stability or market confidence; and

d. U.K. firms to be able to use U.K. sovereign credit default swaps to hedge correlated assets or liabilities issued by issuers located outside of the U.K. anywhere in the world, rather than in the EU.

III. The Central Securities Depositories (Amendment) (EU Exit) Regulations 2018 (SI 2018/1320).

The U.K. CSDR will come into force on exit day, except for the provisions on third-country CDS notification requirements, which come into force on December 7, 2018. A number of technical changes have been made as a result of the consultation process, but these do not affect the fundamental intention and scope of the U.K. CSDR 2018. The U.K. CSDR are primarily relevant for CSDs operating in the U.K. at the point of exit and CSDs that are currently providing services relating to the U.K. as defined in the CSDR. They are also relevant for end-users of CSD services, market infrastructures with links to U.K. CSDs and firms that undertake settlement internalization.

The U.K. CSDR amend the CSDR transitional regime so that third-country CSDs can continue to provide services relating to the U.K. after Brexit. Third-country CSDs must notify the Bank of England before exit day of their intention to provide services in the U.K. following Brexit. Any third-country CSDs benefitting from CSDR transitional arrangements at the point of exit, and any U.K. CSDs that have applied for authorization prior to exit, will be subject to existing U.K. law rather than the CSDR.

The U.K. CSDR do not onshore the forthcoming EU CSDR settlement discipline provisions. These cannot be transferred into U.K. law under the EU Withdrawal Act 2018 because they are not yet operative. The draft Financial Services (Implementation of Legislation) Bill is due to bring these provisions into effect in the U.K. in due course.

The Trade Repositories (Amendment and Transitional Provision) (EU Exit) Regulations 2018 and Explanatory Memorandum are available at: http://www.legislation.gov.uk/uksi/2018/1318/contents/made, the Short Selling (Amendment) (EU Exit) Regulations 2018 and Explanatory Memorandum are available at: http://www.legislation.gov.uk/uksi/2018/1321/contents/made and the Central Securities Depositories (Amendment) (EU Exit) Regulations 2018 and Explanatory Memorandum are available at: http://www.legislation.gov.uk/uksi/2018/1320/made.

UK Draft Regulations Governing Financial Market Infrastructure in Preparation for Brexit

On November 30, 2018, HM Treasury published a new draft statutory instrument, the draft Investment Exchanges, Clearing Houses and Central Securities Depositories (Amendment) (EU Exit) Regulations 2018. The draft instrument is part of its work to ensure that the U.K.'s financial services laws are operative on exit day. The related explanatory information was published on November 22, 2018. The draft Regulations amend relevant parts of the Financial Services and Markets Act 2000 and the Recognition Requirements for Investment Exchanges, Clearing Houses and Central Securities Depositories Regulations 2001/995. This U.K. legislation set out the regulatory regime for recognized investment exchanges, EEA market operators, clearing houses, CCPs and CSDs operating or offering services in the U.K., including:

I. the exemption allowing RIEs, clearing houses, CCPs and CSDs to carry out a regulated activity in the U.K. without authorization;

II. the recognition and supervisory powers of the FCA, over RIEs, and BoE over clearing houses, CCPs and CSDs;

III. rules governing the acquisition of control of RIEs;

IV. the passporting rights of EEA market operators and of U.K. RIEs operating in the EEA;

V. the FCA's powers and responsibilities on the suspension and removal of financial instruments from trading in the U.K. and the EEA; and

VI. provisions on the winding up, administration or insolvency of recognized clearing houses and CSDs.

The draft Regulations function to:

I. Make changes to the relevant U.K. legislation to replicate amendments made to retained EU law through the Markets in Financial Instruments (Amendments) (EU Exit) Regulations 2018, the Central Counterparties (Amendment, etc., and Transitional Provision) (EU

Exit) Regulations 2018 (referred to as the CCRs), the Central Securities Depositories (Amendment, etc., and Transition Provision) (EU Exit) Regulations 2018 and the Over the Counter Derivatives, Central Counterparties and Trade Repositories (Amendment, etc., and Transitional Provision) (EU Exit) Regulations 2018.

II. Enshrining the temporary permissions regime for EU27 CCPs and CSDs and the way in which these entities would become fully U.K.-authorized in due course.

III. Remove from FSMA the provisions on passport rights of EEA market operators in the U.K. and RIEs operating in the EEA. A temporary recognition regime for EEA market operators is not being put in place at this time. Instead, EEA market operators that currently passport into the U.K. and that do not fall within the overseas persons exclusion must apply to the FCA for recognition as a recognized overseas investment exchange (ROIE) and will need to attain that status prior to Brexit. Similarly, there is no U.K. legal provision providing for non-OTC treatment for EEA exchanges for purposes of the U.K.'s EMIR.

IV. Transfer the responsibility for recognizing and supervising third-country CSDs to the BoE and amending the definition of third-country CDS to refer to any CSD located outside the U.K.

HM Treasury intends to lay the draft Regulations before Parliament in the autumn. The BoE and the FCA will be updating their rules and relevant Binding Technical Standards to address any related deficiencies that may arise as a result of Brexit.

The draft regulations and explanatory information are available at: https://www.gov.uk/eu-withdrawal-act-2018-statutory-instruments/the-investment-exchanges-clearing-houses-and-central-securities-depositories-amendment-eu-exit-regulations-2018 and details of other draft onshoring legislation are available at: https://finreg.shearman.com/focus?categoryID=1013&yearmonth=0.

Draft UK Legislation to Onshore the EU Reorganization and Winding Up Directives Published in Preparation for Brexit

On November 30, 2018, HM Treasury published a draft statutory instrument to onshore further EU financial services legislation in preparation for Brexit—the draft Credit Institutions and Insurance Undertakings Reorganization and Winding Up (Amendment) (EU Exit) Regulations 2018. An explanatory memorandum has also been published. HM Treasury has prepared the draft SI using powers granted to it under the EU Withdrawal Act 2018 to address failures of retained EU law to operate effectively or other deficiencies arising from the U.K. leaving the EU.

The draft SI will onshore the EU Credit Institutions (Reorganisation and Winding Up) Directive and certain aspects of Solvency II. These Directives establish EEA frameworks for the reorganization and winding up of EEA banks, building societies, credit unions and insurers. They were transposed into U.K. law in the Insurers (Reorganization and Winding Up) Regulations 2004 (S.I. 2004/353), the Credit Institutions (Reorganization and Winding Up) Regulations 2004 (S.I. 2004/1045), and the Insurers (Reorganization and Winding Up) (Lloyd's) Regulations 2005 (S.I. 2005/1998).

The draft SI amends the U.K. implementing legislation so that the EEA will be treated in the same way as other third countries under U.K. laws. Among others things, the draft SI will:

I. Remove the prohibitions on U.K. courts from making winding-up or administration orders against EEA banks, building societies, credit unions, insurers, investment firms and group companies. After exit day, U.K. courts will be able to make orders in respect of an insolvent EEA firm, subject to the U.K. jurisdictional and insolvency tests being met.

II. Remove the automatic recognition of EEA insolvency measures by the U.K.

III. Remove the provisions giving preferential treatment for EEA countries by providing that certain contracts or rights within a reorganization or winding-up fall under the law of an EEA Member State. No change is being made to the provisions that allow for any applicable law to apply, whether it is English law or the law of an EEA member state or that of a third country. Examples of the applicable law provisions are the creditors' right to set off, regulated market transactions, repurchase and netting agreements.

In addition, HM Treasury has included transitional and savings provisions to provide certainty for market participants. Firstly, for insolvency proceedings that commence before March 29, 2019, the current law will apply to that insolvency. This means that U.K. insolvency proceedings could not be commenced and that the U.K. would have to automatically recognize the EEA insolvency proceedings. The provision would be subject to a U.K. court determining that one of three conditions has not been met: (i) an ongoing EEA measure or proceeding will have an adverse effect on the U.K.'s financial stability; (ii) U.K. creditors could be materially prejudiced in comparison to EEA creditors; or (iii) continuation of the proceedings would be unlawful under the Human Rights Act 1998. Furthermore, the draft SI provides that an EU insolvency officer cannot, in an ongoing EEA-led bank, building society or credit union insolvency, take action in the U.K. that is inconsistent with the U.K. settlement finality and financial collateral framework. These safeguarding provisions will not apply to resolution actions, under the EU Bank Recovery and Resolution Directive and related onshored U.K. legislation, which are ongoing at the time of the U.K.'s exit from the EU.

The draft Credit Institutions and Insurance Undertakings Reorganization and Winding Up (Amendment) (EU Exit) Regulations 2018 and explanatory information are available at: https://www.gov.uk/eu-withdrawal-act-2018-statutory-instruments/the-credit-institutions-and-insurance-undertakings-reorganisation-and-winding-up-amendment-eu-exit-regulations-2018.

Draft UK Regulations on Credit Ratings in Preparation for Brexit

On November 30, 2018, HM Treasury laid before Parliament the draft Credit Rating Agencies (Amendment, etc.) (EU Exit) Regulations 2019 to onshore the EU Credit Rating Agencies Regulation for Brexit. This follows the publication of related explanatory information on October 8, 2018.

The EU CRA Regulation regulates CRAs established in the EU. ESMA directly supervises EU CRAs registered with it under the CRA Regulation. The CRA Regulation provides that banks, investment firms, insurers, reinsurers, management companies, investment companies, alternative investment fund managers and CCPs may only use credit ratings for certain regulatory purposes if a rating is issued by: (i) an EU CRA registered with ESMA; (ii) a third-country CRA under the endorsement regime; or (iii) a third-country CRA under the equivalence/certification regime. Endorsement allows credit ratings issued by a third-country CRA to be used for regulatory purposes in the EU, provided that the rating has been endorsed by an EU CRA. The equivalence/certification regime allows credit ratings issued by a third-country CRA in relation to a third-country entity or financial instrument to be used in the EU for regulatory purposes. It does not cover ratings issued by a third-country CRA for an EU entity or a financial instrument issued in the EU.

The CRA Regulation will be brought into U.K. law under the European Union (Withdrawal) Act. HM Treasury is proposing to amend the CRA Regulation and existing U.K. legislation to ensure that U.K. CRAs can continue to operate and U.K. firms can continue to use credit ratings for regulatory purposes without interruption. The draft SI will transfer ESMA's powers and functions in relation to U.K. CRAs to the FCA from March 30, 2019. It will also grant additional powers and functions to the FCA so that it is able to effectively register and supervise CRAs.

The draft SI will establish a "conversion regime" under which CRAs that are already established in the U.K. will be able to convert their registration with ESMA to an FCA registration. Third-country CRAs that are currently certified by ESMA will be able to extend their certification to the U.K. Each of these steps will require a written notification to be given to the FCA before exit day.

A temporary registration regime will also be available for legal entities established in the U.K. before exit day that are part of a group of CRAs with an existing ESMA registration on exit day. Firms that have submitted an application for registration to the FCA prior to exit day, and whose application is still to be determined, will

enter the TRR. Such temporary registration will be for a period of three years from exit day. Other firms that wish to apply for registration as a U.K. CRA will need to submit an application to the FCA and will not be able to use the TRR.

Ratings issued by a U.K. CRA that is registered with the FCA, or by a third-country CRA under the endorsement or certification regime, will be permitted for regulated usages in the U.K. Where a rating has been issued before exit day in the EU by firms that register or apply for registration with the FCA, a transitional period of one year will allow firms to use credit ratings for regulatory purposes.

The draft Credit Rating Agencies (Amendment, etc.) (EU Exit) Regulations 2019 is available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/760647/Draft_Credit_Rating_Agency_SI_Text.pdf, the explanatory guidance is available at: https://www.gov.uk/government/publications/draft-credit-rating-agencies-amendments-etc-eu-exit-regulations-2018/draft-credit-rating-agencies-amendments-etc-eu-exit-regulations-2018-explanatory-information, the FCA's webpage on registering as a CRA can be viewed at: https://www.fca.org.uk/news/statements/registering-credit-rating-agency and details of the FCA's consultation are available at: https://finreg.shearman.com/uk-conduct-regulator-consults-on-brexit-related-c.

UK Treasury Policy on 'In Flight' EU Legislation in Preparation for a "No Deal" Brexit

On November 28, 2018, following the introduction to Parliament on November 22, 2018 of the Financial Services (Implementation of Legislation) Bill, HM Treasury published a Policy Note on the Bill. The Bill gives HM Treasury, in a Brexit no deal scenario, powers to implement and make amendments to a specified list of "in flight" financial services legislation. The Bill covers EU financial services legislation which is proposed or published but that is out of scope of the European Union (Withdrawal) Act 2018 because it will not be operative on or before exit day. Only legislation with an implementation date falling in the two years after exit is covered. The Bill sets out a list of the legislation that is covered, namely:

I. The settlement discipline regime under the CSDR (Articles 6 and 7);

II. The Delegated Cash Penalties Regulation;

III. Those provisions of the Prospectus Regulation that will come into force on July 21, 2019 and any secondary EU legislation adopted by the European Commission before that date;

IV. The reporting obligation under the Securities Financing Transactions Regulation;

V. The proposed revisions to the EU Capital Requirements Directive, Capital Requirements Regulation and BRRD, published by the European Commission on November 23, 2016 (known as the risk reduction package);

VI. The proposed CCP Recovery and Resolution Regulation published by the Commission on November 28, 2016;

VII. The proposed revisions to EMIR and the related changes to the regulations establishing the ESAs on third-country CCP authorization and supervision—EMIR Refit and EMIR 2.2—published by the Commission on June 13, 2017;

VIII. The proposed prudential regime for EU investment firms and related changes to CRR, CRD and the Markets in Financial Instruments Directive;

IX. The proposed Directive on cross-border distribution of collective investment funds;

X. The proposed Directive on the issue of covered bonds and covered bond supervision and related changes to the CRR;

XI. The proposed Regulation on the promotion of the use of SME growth markets; and

XII. The proposed revisions to various EU pieces of legislation aimed at strengthening the EU's framework for preventing money laundering and terrorist financing, published by the Commission on September 12, 2018.

The two-year restriction means that the proposed EU requirements for third-country banking groups to establish an intermediate parent undertaking (or intermediate holding company) would not be transferred

into U.K. law because those provisions are only set to come into force four years after the revised EU CRD enters into force. The proposed EU IPU requirements are not generally considered to reflect the U.K.'s financial services policy, in any event.

The Policy Note explains that the Bill will ensure that, even if the U.K. leaves the EU without a deal, that the U.K.'s financial services law is kept in step with these EU developments in a timely way. Significantly, the Bill provides HM Treasury with powers to amend this EU legislation as it deems fit for the U.K.'s financial markets. This goes beyond HM Treasury's more limited powers in respect of exit day legislation under the EU Withdrawal Act 2018.

HM Treasury's Policy Note further confirms that the EU's proposed CCP location policy would not be transferred into the U.K.'s framework because it would not improve it and it would result in global liquidity pools being cut off and increase costs for businesses.

The scope of the Bill is limited to legislation considered relevant to U.K. financial services. For example, the Bill does not include the proposed EU Regulation establishing a framework for a market-led development of Sovereign Bond-Backed Securities, which is intended to enhance the Eurozone's Banking Union.

The draft regulations prepared by HM Treasury using these powers will be subject to Parliament's affirmative resolution procedure.

The Policy Note is available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/759855/1_Financial_Services__Implementation_of_Legislation__Bill_Policy_doc_pdf.pdf, the Bill is available at: https://services.parliament.uk/Bills/2017-19/financialservicesimplementationoflegislation.html and details of the EU Withdrawal Act 2018 are available at: https://finreg.shearman.com/uk-brexit-legislation-receives-royal-assent.

Conduct & Culture

UK Financial Conduct Authority Publishes Its Final Approach to Authorization

On November 28, 2018, the FCA published its final document, entitled "FCA Mission: Approach to Authorisation," explaining the purpose of authorization and the FCA's approach to it. The paper sets out details of the FCA's approach to: (i) evaluating whether firms meet the requisite Threshold Conditions and assessing whether individuals are "fit and proper;" (ii) how the FCA uses authorization to promote competition; and (iii) revoking authorization.

The final Approach to Authorisation includes a feedback statement to the consultation which ran from December 11, 2017 to March 12, 2018. The FCA notes that it has made clarifications on the following:

I. the assessment of authorization applications for individuals with key roles in solo-regulated and dual-regulated firms;

II. the assessment of drivers of behavior that can create culture likely to cause harm;

III. situations where the FCA may revoke authorization, registration and approval;

IV. the role of the Regulatory Decisions Committee;

V. the provision of support to firms to promote competition; and

VI. measurement of the FCA's operational performance and the effectiveness of its approach.

The FCA has also included an improved set of its public commitments to firms.

The "FCA Mission: Approach to Authorisation" is available at: https://www.fca.org.uk/publication/corporate/our-approach-authorisation-final-report-feedback-statement.pdf and the FCA's Mission is available at: https://www.fca.org.uk/publications/corporate-documents/our-mission.

Cyber Security

UK Financial Conduct Authority Reports on Cyber Security Resilience in Financial Services

On November 27, 2018, the FCA published a report entitled "Cyber and Technology Resilience: Themes from cross-sector survey 2017-2018." The FCA compiled the report by requesting 296 firms during 2017 and 2018 to provide a self-assessment of their cyber and technological capabilities, focusing on governance, delivery of change management, managing third-party risks and the effectiveness of cyber defenses. The FCA analyzed the responses and considered data from firm's responses to recent operational incidents to produce the report.

In the report, the FCA identifies areas of strength as well as areas where improvement is needed. Areas for improvement include people, third-party management and protection of a firm's key assets. The FCA will be considering these areas in the 2019 supervisory plans.

This area is gaining increasing focus, both in the U.K. and globally. The BoE, the U.K. Prudential Regulation Authority and the FCA published a joint discussion paper in July 2018, entitled "Building the U.K. financial sector's operational resilience," indicating that a step change is needed by firms and financial market infrastructure in their approach to operational resilience. A U.K. Parliamentary Committee inquiry into IT failures in the financial services sector was also recently launched.

The report is available at: https://www.fca.org.uk/publication/research/technology-cyber-resilience-questionnaire-cross-sector-report.pdf, details of the joint discussion paper are available at: https://finreg.shearman.com/uk-regulators-seek-views-on-improving-operational and details of the Parliamentary inquiry are available at: https://finreg.shearman.com/uk-parliamentary-committee-launches-inquiry-into-.

MiFID II

UK Conduct Authority Consults on Permanent Product Intervention Measures

On December 7, 2018, the U.K. FCA launched two consultations proposing to prohibit the sale, marketing and distribution of binary options to retail consumers and to restrict the sale, marketing and distribution of contracts for difference and similar products to retail customers. Both CFDs and binary options are considered to have given rise to significant investor protection concerns, due to their complexity, the lack of transparent information at the point of sale, the risk of significant loss for investors and the deployment of aggressive marketing techniques by providers and distributors of the products. The FCA's product intervention powers under the Markets in Financial Instrument Regulation and, where the FCA has gone beyond those powers, FSMA 2000, allow it to impose prohibitions or restrictions on certain financial instruments, financial activities or practices to address a significant investor protection concern. The proposed rules would be permanent and would replace the temporary measures introduced, and subsequently renewed, by ESMA earlier this year.

The proposed rules would apply to the following firms that carry out in-scope activities in the U.K. or provide services from the U.K. into another jurisdiction: (i) U.K. MiFID investment firms (except for collective portfolio

management investment firms) and banks authorized under the CRD that carry out MiFID business; (ii) EEA MiFID investment firms (except for collective portfolio management investment firms) and CRD banks doing MiFID business using their passporting rights; and (iii) third-country investment firms with a branch in the U.K.

The Binary Option Ban

The U.K. ban on the sale, marketing and distribution of binary options to retail consumers will apply to all binary options. It will include so-called "securitized binary options," which ESMA defined as binary options listed on a formal trading venue, are subject to a prospectus and have minimum contract periods from the point of entry to the expiry of the binary option. ESMA excluded securitized binary options when it renewed the EU binary options ban from November 1, 2018 for a further three-month period. The FCA does not believe the characteristics of these types of binary options sufficiently address the investor protection concern. In addition, the FCA's view is that the ban should ensure that securitized binary options do not become widely offered in the U.K.

The CFD Restrictions

The FCA's proposals to impose restrictions on the sale, marketing and distribution of CFDs and directly substitutable products are based on ESMA's temporary restriction (currently due to expire on February 2, 2019) and feedback to the FCA's 2016 discussion paper on possible restrictions. The FCA is proposing to require firms to:

I. limit leverage to between 30:1 and 2:1 depending on the volatility of the underlying asset;

II. close out a customer's position when their funds fall to 50% of the margin needed to maintain their open positions on their CFD account;

III. provide protections that guarantee that a client cannot lose more than the total funds in their trading account;

IV. desist offering current and potential customers cash or other inducements to encourage retail customers to trade; and

V. provide standardized risk warnings that inform customers of the percentage of their retail client accounts that make losses.

The FCA's proposals differ from ESMA's measures in two ways. First, they set leverage limits for CFDs referencing certain government bonds to 30:1, compared to ESMA's 5:1 limit. Second, they apply to a wider range of products, covering both CFDs (spread bets, rolling spot FX products) and CFD-like options (such as turbo certificates, knock out options and delta one options).

The FCA is also seeking input on whether exchange-traded futures and OTC forwards should be brought within scope of the rules or also be subject to similar rules. The FCA is requesting information on the activities that firms currently undertake in these markets and whether other products might present similar risks. The FCA also discusses possible policy options, including leverage limits, margin close out rules and negative balance protections, transparency requirements and a commercial hedging exemption.

Responses to both consultations should be submitted by February 7, 2019, except for responses to the discussion on futures and forwards, which should be submitted by March 7, 2019. The FCA intends to publish responses to the consultation feedback and final rules in March 2019.

Firms subject to ESMA's measures should continue to comply with them for as long as they are in force in the U.K. The FCA states that in the event of a "hard Brexit" in which the U.K. will exit the EU on March 29, 2019, if its permanent rules are not in place, it will likely adopt temporary measures replicating ESMA's temporary measures to ensure that there is no loss of protection in any intervening period.

The FCA also confirmed that it will consult in early 2019 on a potential ban on the sale of derivative products referencing cryptocurrencies, including CFDs, to retail consumers.

The binary options ban consultation paper is available at: https://www.fca.org.uk/publication/consultation/cp18-37.pdf, the CFD restriction consultation paper is available at: https://www.fca.org.uk/publication/consultation/cp18-38.pdf, the technical annex to the CFD restriction consultation paper is available at: https://www.fca.org.uk/publication/consultation/cp18-38-annex.pdf and details of the FCA's 2016 discussion paper on CFD's are available at: https://finreg.shearman.com/uk-regulator-proposals-to-amend-the-conduct-of-bu.

Payment Services

European Commission Publishes Commission Delegated Regulation on the Electronic Central Register Under Payment Services Directive

On November 29, 2018, the European Commission adopted RTS on the development, operation and maintenance of the electronic central register and access to the information it contains under the Payment Services Directive 2015, known as PSD2. The register will contain details of authorized payment institutions, certain exempt persons and their agents and it will identify the payment services for which each payment institution is authorized or exempt person is registered. PSD2 took effect on January 13, 2018. The electronic central register established by these RTS will be the responsibility of the European Banking Authority. It is intended that these RTS, once published in the Official Journal of the European Union, will be binding and directly applicable in all Member States from 20 days after publication.

The Commission Delegated Regulation is available at: http://ec.europa.eu/transparency/regdoc/rep/3/2018/EN/C-2018-7666-F1-EN-MAIN-PART-1.PDF.

Securities

European Supervisory Authorities Advocate Proportional Approach to Compliance With Certain Aspects of the Securitization Regulation

On November 30, 2018, the ESAs issued a joint statement addressing two issues arising from the EU Securitization Regulation. The Securitization Regulation will apply directly across the EU from January 1, 2019 to securities issued under securitizations on or after January 1, 2019. Securitizations issued before that date may be referred to as STS securitizations, provided that they meet certain conditions.

The first issue addressed in the joint statement relates to disclosure requirements for EU securitizations. The Securitization Regulation requires originators and sponsors to notify ESMA of any securitization that meets the "Simple, Transparent and Standardized" criteria. ESMA will maintain a list of all such securitizations on its website. Securitization special purpose entities, originators and sponsors of a securitization will be required to make certain information available via a securitization repository to holders of a securitization position, to the national regulators and, upon request, to potential investors. ESMA and the European Commission still have to address a number of market concerns on the proposed ESMA disclosure templates (that will be introduced as Technical Standards under the Regulation) as part of these transparency requirements. This is a process that will not be concluded by January 1, 2019.

As a result, the transitional provisions of the Regulation apply and those provisions require that the templates used for disclosure of structured finance instruments under the CRA Regulation (known as the CRA3 templates) must be used until the ESMA disclosure template is adopted. The ESAs recognize that this will

create substantial and costly adjustments for reporting entities that have never provided information using the CRA3 templates. Therefore, the ESAs stress that national regulators, despite having no legal power to disapply the Securitization Regulation, ought to exercise their supervisory powers for the transparency requirements in a proportionate and risk-based manner, by taking into account the type and extent of information already being disclosed by the reporting entities and considering each action taken to comply with the requirements on a case-by-case basis.

The second issue addressed in the ESA's statement concerns the consolidated application of securitization rules for EU banks under the CRR. The ESAs acknowledge that EU banking subsidiaries engaging in local securitization activities in non-EU countries may have difficulties complying with the expanded scope of requirements relating to due-diligence, risk retention, transparency, re-securitization and criteria for credit-granting. These problems are expected to be resolved with the adoption of the revised CRR (which is currently subject to negotiations between the EU legislative bodies) because the scope, on the current version, will limit the new requirements to due diligence obligations. In the meantime, the ESAs emphasize that national regulators must, again, apply their supervisory powers in a proportional manner and make an assessment on a case-by-case basis in instances of non-compliance.

The Joint Statement is available at: https://eba.europa.eu/documents/10180/2427712/JC_Statement_Securitisation_CRA3_templates_plus_CRR2_final.pdf.

UK Regulations Implementing the EU Securitization Regulation Made

On December 4, 2018, the U.K. Securitization Regulations 2018 were laid before Parliament and will come into force on January 1, 2019. The Regulations implement the EU Securitization Regulation (also known as the STS Regulation) into U.K. law.

The EU Securitization Regulation provides the criteria for identifying which securitizations will be designated as simple, transparent and standardized securitizations, a system to monitor the application of those criteria and common requirements on risk retention, due diligence and disclosure. It also allows (but does not require) originators, sponsors and securitization special purpose entities to use third-party firms to assess whether a securitization meets the STS criteria, provided that those firms are authorized by the relevant national regulator. Originators, sponsors or original lenders of a securitization will be required to retain on an ongoing basis a material net economic interest in the securitization of at least 5 %. Related amendments to the CRR set out preferential regulatory treatment for investors, in particular, for bank investors, of their exposures to securitizations that are deemed to be STS securitizations.

The Securitization Regulation is directly applicable across the EU to securities issued under securitizations on or after January 1, 2019. Securitizations issued before that date may be referred to as STS securitizations provided that they meet certain conditions. The amendments to the CRR will apply from January 1, 2019 as well but, for securitizations issued before January 1, 2019, the existing CRR provisions will apply until December 31, 2019.

Certain U.K. legislative amendments are required to align provisions of U.K. law with the EU Regulation and ensure that it is effective and enforceable in the U.K. In particular, the U.K. Securitization Regulations 2018 designate the FCA and Prudential Regulation Authority as the competent authorities responsible for supervising compliance with the EU Securitization Regulation and confer the requisite powers on the two regulators to fulfil that function.

The U.K. Securitization Regulations 2018 are available at: http://www.legislation.gov.uk/uksi/2018/1288/pdfs/uksi_20181288_en.pdf and the related Explanatory Memorandum is available at: http://www.legislation.gov.uk/uksi/2018/1288/pdfs/uksiem_20181288_en.pdf.

People

Financial Stability Board Appoints New Chair and Vice Chair

On November 26, 2018, the Financial Stability Board announced the appointment of Randal K. Quarles (Governor and Vice Chairman for Supervision at the U.S. Federal Reserve System) as its new Chair and Klaas Knot (President of De Nederlandsche Bank) as its Vice Chair for a three-year term starting on December 2, 2018. Klass Knot will succeed Randal K. Quarles as Chair on December 2, 2021 for the next three-year term.

The current FSB Chair, Mark Carney, will step down on December 1, 2018 after seven years of leadership.

The press release is available at: http://www.fsb.org/2018/11/appointment-of-new-fsb-chair-and-vice-chair/.

Upcoming Events

December 18, 2018: ESAs public hearing on draft joint guidelines on the cooperation and information exchange between national regulators supervising banks and other financial institutions for AML/CFT compliance

Upcoming Consultation Deadlines

December 21, 2018: FCA second consultation on Brexit-related changes to its Handbook and Binding Technical Standards

January 2, 2019: BoE/PRA joint consultation on approach to amending financial services legislation under the European Union (Withdrawal) Act 2018

January 2, 2019: PRA consultation on changes to PRA Rulebook and onshored Binding Technical Standards for Brexit

January 2, 2019: BoE consultation on changes to FMI rules and onshored Binding Technical Standards for Brexit

January 2, 2019: BoE consultation on approach to resolution statements of policy and onshored Binding Technical Standards for Brexit

January 11, 2019: ESMA call for evidence on periodic auctions for equity instruments

January 15, 2019: FCA consultation on climate change and green finance

January 16, 2019: Basel Committee consultation on leverage ratio treatment of client-cleared derivatives

January 25, 2019: FCA consultation on open-ended funds and illiquid assets

January 31, 2019: PRA consultation on managing financial risks from climate change

February 1, 2019: IOSCO consultation on proposed framework for assessing leverage used by investment funds

February 1, 2019: FSB discussion paper on financial resources to support CCP resolution and the treatment of CCP equity in resolution

February 7, 2019: FCA consultation on a proposed ban of the sale, marketing and distribution of binary options to retail consumers

February 7, 2019: FCA consultation on the proposed restrictions on the sale, marketing and distribution of CFDs and CFD-like options to retail customers

February 8, 2019: ESA consultation on draft joint guidelines on the cooperation and information exchange between national regulators supervising banks and other financial institutions for AML/CFT compliance

March 7, 2019: FCA discussion on possible product intervention measures for other retail derivative products

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. IF YOU WISH TO RECEIVE MORE INFORMATION ON THE TOPICS COVERED IN THIS PUBLICATION, YOU MAY CONTACT YOUR USUAL SHEARMAN & STERLING REPRESENTATIVE OR ANY OF THE FOLLOWING:

CONTACTS

BARNEY REYNOLDS
Partner
London
barney.reynolds
@shearman.com

REENA AGRAWAL SAHNI
Partner
New York
reena.sahni
@shearman.com

RUSSELL SACKS
Partner
New York
rsacks
@shearman.com

THOMAS DONEGAN
Partner
London
thomas.donegan
@shearman.com

SUSANNA CHARLWOOD
Partner
London
susanna.charlwood
@shearman.com

DONNA PARISI
Partner
New York
dparisi
@shearman.com

NATHAN GREENE
Partner
New York
ngreene
@shearman.com

GEOFFREY GOLDMAN
Partner
New York
geoffrey.goldman
@shearman.com

JOHN ADAMS
Partner
London
john.adams
@shearman.com

PHILIP UROFSKY
Partner
Washington D.C.
philip.urofsky
@shearman.com

TOBIA CROFF
Partner
Milan
tobia.croff
@shearman.com

HERVÉ LETRÉGUILLY
Partner
Paris
hletreguilly
@shearman.com

MATTHEW READINGS
Partner
London
matthew.readings
@shearman.com

SIMON DODDS
Of Counsel
London
simon.dodds
@shearman.com

BRADLEY K. SABEL
Of Counsel
New York
bsabel
@shearman.com

TIMOTHY J. BYRNE
Counsel
New York
tim.byrne
@shearman.com

JENNIFER D. MORTON
Counsel
New York
jennifer.morton
@shearman.com

KOLJA STEHL
Counsel
Frankfurt/London
kolja.stehl
@shearman.com

ELIAS ALLAHYARI
Associate
London
elias.allahyari
@shearman.com

MATTHEW HUMPHREYS
Associate
London
matthew.humphreys
@shearman.com

THOMAS JONES
Associate
London
thomas.jones
@shearman.com

JENNY DING JORDAN
Associate
New York
jenny.jordan
@shearman.com

P. SEAN KELLY
Associate
New York
sean.kelly
@shearman.com

OLIVER LINCH
Associate
London
oliver.linch
@shearman.com

JENNIFER OOSTERBAAN
Associate
New York
jennifer.oosterbaan
@shearman.com

WILF ODGERS
Associate
London
wilf.odgers
@shearman.com

INYOUNG SONG
Associate
London
inyoung.song
@shearman.com

ELLERINA TEO
Associate
London
ellie.teo
@shearman.com

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069