

FINANCIAL REGULATORY DEVELOPMENTS FOCUS

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.

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AML/CTF, Sanctions and Insider Trading

US Financial Crimes Enforcement Network Releases Customer Due Diligence FAQs

On April 3, 2018, the U.S. Financial Crimes Enforcement Network released answers to 37 frequently asked questions regarding its final rule on Customer Due Diligence Requirements for Financial Institutions, which was published in the Federal Register on May 11, 2016 and amended on September 29, 2017. This is the second series of FAQs FinCEN has released. The FAQs cover various topics in connection with the requirement that financial institutions obtain beneficial ownership information for legal entity customers, including the beneficial ownership threshold and its interaction with other AML program obligations, collection and verification of identifying information, particularly for legal entity customers with complex ownership structures and the definition of “legal entity customer,” including the treatment of foreign financial institutions. The FAQs also provide guidance regarding the beneficial ownership certification requirement, including when a single customer opens multiple accounts and in respect of product or service renewals, obligations to update beneficial ownership information and requirements to understand the nature and purpose of the customer relationship.

The FinCEN FAQs are available at: https://www.fincen.gov/sites/default/files/2018-04/FinCEN_Guidance_CDD_FAQ_FINAL_508_2.pdf.

Bank Prudential Regulation & Regulatory Capital

US Department of the Treasury Releases Report Outlining Community Reinvestment Act Recommendations

On April 3, 2018, the U.S. Department of the Treasury issued recommendations to the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation regarding the modernization of the Community Reinvestment Act. The report is a follow-up to Treasury’s 2017 report to the President entitled *A Financial System That Creates Economic Opportunities: Banks and Credit Unions*. The recommendations are intended to allow financial institutions to better serve the communities where they operate, while maintaining safe and sound operations. The report notes that since the enactment of the CRA 40 years ago, the banking industry has undergone significant organizational, operational and technological changes, and that regulatory expectations have failed to keep pace.

The Treasury report focuses on four key areas. First, Treasury recommends modernizing the definitions of geographic assessment areas to correspond to changes, including changes in technology and customer behavior. Second, the report identifies a number of perceived weaknesses in the CRA performance evaluation process, including inconsistent examination staffing, practices and procedures, and lack of clear guidance for examination criteria. In response to these perceived weaknesses, the report recommends improving the flexibility and transparency of the CRA performance evaluation process, including providing more clarity with respect to examination guidance. Third, the Treasury report recommends improvements to the CRA examination process, including standardization of CRA examination schedules and changes to promote more timely evaluations and ratings. Finally, the Treasury report recommends changes to better incentivize CRA performance, given that the CRA itself does not have explicit penalties for non-performance (although other statutes do penalize unsatisfactory performance under the CRA).

The Treasury report is available at: <https://home.treasury.gov/sites/default/files/2018-04/4-3-18%20CRA%20memo.pdf>.

US Federal Financial Regulators Issue Final Rule Exempting Commercial Real Estate Transactions of \$500,000 or Less from Appraisal Requirements

On April 2, 2018, the OCC, Board of Governors of the Federal Reserve System and the FDIC issued a final rule that exempts commercial real estate transactions of \$500,000 or less from the appraisal requirements promulgated under Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. The final rule raises the threshold from \$250,000 to \$500,000, for which appraisals are not required in connection with commercial real estate transactions. The agencies originally proposed to increase the threshold to \$400,000, but they determined that an increase to \$500,000 would not pose a threat to the safety and soundness of financial institutions, and would result in a material reduction in the compliance-related regulatory burden for financial institutions. For purposes of the final rule, “commercial real estate transaction” is defined as “a real estate-related financial transaction that is not secured by a single 1-to-4 family residential property.” The final rule clarifies that construction loans of \$500,000 or less secured by a single 1-to-4 family residential property are not exempted from the appraisal requirement. In lieu of an appraisal, financial institutions are required to obtain an evaluation of the collateral that is sufficient to support the institution’s decision to engage in the transaction and consistent with safe and sound business practices. The final rule took effect on April 9, 2018.

The full text of the final rule is available at: <https://www.gpo.gov/fdsys/pkg/FR-2018-04-09/pdf/2018-06960.pdf>.

Consumer Protection

US Consumer Financial Protection Bureau Releases Semi-Annual Report

On April 2, 2018, the U.S. Consumer Financial Protection Bureau published its semi-annual report. The report, which is mandated by the Dodd-Frank Act, highlights and summarizes various topics the CFPB is working on, including a list of rules, orders and initiatives to be undertaken in the upcoming period. The report notes upcoming proposed and final rules, including reconsideration of certain aspects of Regulation C (Home Mortgage Disclosure), finalization of amendments to Regulation P (Annual Privacy Notice Requirements Under the Gramm-Leach-Bliley Act), and finalizing an amendment to Regulation Z (Federal Mortgage Disclosure Requirements under the Truth in Lending Act). In his introductory letter to the report, CFPB Acting Director Mick Mulvaney was critical of past actions by the CFPB, contending that the CFPB was too powerful and subject to very little oversight. Acting Director Mulvaney noted that the CFPB “will continue to execute the law, but will no longer go beyond its statutory mandate.” In addition, Acting Director Mulvaney requested Congress enact four changes in order to promote and establish CFPB accountability: funding the CFPB through the congressional appropriations process, requiring congressional approval of major CFPB rules, ensuring that the CFPB Director is accountable to the President in the exercise of executive authority and creating an independent Inspector General for the CFPB.

The CFPB report is available at: https://files.consumerfinance.gov/f/documents/cfpb_semi-annual-report_spring-2018.pdf.

Funds

UK Financial Conduct Authority Finalizes Rules Enhancing Governance of Authorized Fund Managers

On April 5, 2018, the Financial Conduct Authority published a Policy Statement and final rules relating to strengthening the governance arrangements of U.K. authorized fund managers. The need to enhance these

arrangements was identified by the FCA in the Asset Management Market Study launched in 2015. The final AMMS report was published in June 2017 and set out remedies the FCA intended to implement to address identified issues. At the same time, the FCA published a consultation paper on the first set of proposals.

The Policy Statement sets out the FCA's response to the feedback on its proposals and the final rules and guidance. The new rules and guidance applies to U.K. AFMs in relation to their management of authorized funds (that is, authorized open-ended collective investment schemes). The rules will apply either on April 1, 2019 or on September 30, 2019, depending on the lead time that the FCA considers the industry needs to implement the required changes. Below is a summary of the FCA's decision on the various consultation points:

- **Strengthening the duty of AFMs to act in the best interests of investors:** There is an existing duty on AFMs to act in the best interests of fund investors. The FCA is going ahead with its proposal to enhance an AFM's duty to act in the best interests of fund investors. An AFM will be required to assess, and justify to its fund investors, the charges taken from the funds it manages in the context of the overall service and value provided. This includes both charges that are usually paid directly to third parties and the management fees that AFMs set for themselves. The FCA believes that this is important as AFMs are agents of their investors—they act on their behalf and owe them duties—they are not solely product providers. The rules have been re-drafted to clarify that fund charges should be assessed in the context of the overall value delivered, instead of focusing on “value for money”. In particular, the re-drafting clarifies that AFMs can assess performance over a time period appropriate to the fund's investment objective, policy and strategy. Also, AFMs will be required to publish a statement setting out a description of the assessment of value, either in the fund's annual report or in a separate composite report. The new rules will apply from September 30, 2019, instead of April 1, 2019, as was initially proposed.
- **Independent Directors:** The FCA has largely not changed its proposed rule requiring AFMs to appoint a minimum of two independent directors to their board and for them to comprise at least 25% of the total board membership. The new rules will apply from September 30, 2019, instead of April 1, 2019, as was initially proposed.
- **Senior Manager & Certification Regimes:** The FCA will introduce a new specific Prescribed Responsibility for AFMs when it extends the SM&CR to almost all financial services firms. This would make clear that a Senior Manager, usually the chair of the board of an AFM, must take reasonable steps to ensure that the firm complies with its obligation to carry out the assessment of value, the duty to recruit independent directors, and the duty to act in the best interests of fund investors. These rules extending the SM&CR are expected to be published later in 2018 and to apply from mid-to-end 2019.
- **Box Profits:** The FCA is proceeding with the requirement for fund managers to return any risk-free box profits to the fund. It found that the managers of some dual-priced authorized funds, by matching the units of incoming and outgoing investors, were making a risk-free profit on the difference between the dealing prices for those matched transactions. Following consultation, the rules have been re-drafted to reflect technical feedback received from respondents and now allow some flexibility in how risk-free profits should be allocated. These rules will apply from April 1, 2019.
- **Share Classes:** The FCA's final revised guidance removes the need for an AFM to get individual consent from each investor before moving them to cheaper but identical classes of the same fund. In addition, the open-ended notification requirements that the FCA had consulted on have been replaced with a recommendation that AFMs make a one-off notification to investors, which does not require a response, a minimum of 60 days before a mandatory conversion.
- **Trail Commissions:** The FCA consulted on whether it should continue to allow the payment of trail commission. It has no immediate plans to propose any policy changes at this stage.

- Extending the scope to other governance products: The FCA also consulted on extending the governance proposals for AFMs to unit-linked and with-profits insurance products and investment trusts (also referred to as investment companies). The FCA is undertaking further work on these products and expects to make a decision in the first half of 2019. Further changes to investment trust governance arrangements are being kept under review, but the FCA has no immediate plans to implement changes. The FCA confirms that, as initially proposed, it does not intend to extend the governance arrangements to pensions.

The final rules and revised Guidance should be read in conjunction with the FCA's second consultation paper, published alongside the Policy Statement, on improving disclosures by AFMs to their investors.

The Policy Statement and final rules are available at: <https://www.fca.org.uk/publication/policy/ps18-08.pdf> and the AMMS final report and the first consultation paper are available at: <http://finreg.shearman.com/uk-financial-conduct-authority-publishes-final-as>.

UK Financial Conduct Authority Consults Improving Disclosure to Fund Investors by Authorized Fund Managers

On April 5, 2018, the FCA published a second consultation paper on remedies arising out of the AMMS. This consultation concerns improving disclosure by AFMs to their investors and should be read with the Policy Statement, final rules and revised guidance on enhanced governance arrangements for U.K. AFMs, which were published alongside the consultation paper.

The FCA is proposing:

- new guidance on how AFMs should make fund objectives and investment policies clear and more useful for investors;
- new rules requiring managers to be clear about why (or why not) a benchmark has been used and how investors should assess the performance of the fund;
- new rules requiring AFMs that use benchmarks to use and reference them consistently across marketing materials;
- new rules requiring that where managers present past performance they must do so in an appropriate and consistent manner; and
- amending the performance fee rules to require that performance fees be calculated on performance net of other fees.

The proposed rules would apply to AFMs in respect of their management of authorized funds. Responses to the consultation should be submitted by July 5, 2018.

The second consultation on remedies arising from the AMMS is available at: <https://www.fca.org.uk/publication/consultation/cp18-09.pdf>.

MIFID II

UK Financial Conduct Authority Confirms Regulatory Status of Cryptocurrency Derivatives

On April 6, 2018, the FCA published a statement confirming the regulatory requirements applicable to firms engaged in cryptocurrency derivatives. The FCA does not regulate cryptocurrencies, provided that they do not form part of other regulated services or products. However, the FCA states that cryptocurrency derivatives may be categorized as financial instruments under the revised Markets in Financial Instruments Directive II and that firms carrying out regulated activities in cryptocurrency derivatives should comply with the FCA's Handbook rules as well as the directly applicable EU provisions. The FCA points out that dealing

in, arranging transactions in, advising on or providing other services that are regulated activities in relation to derivatives that reference cryptocurrencies or tokens issued through an Initial Coin Offering will require FCA authorization.

The FCA's statement is available at: <https://www.fca.org.uk/news/statements/cryptocurrency-derivatives>.

Securities

US Federal Reserve Bank of New York Introduces Three New Reference Rates

On April 3, 2018, the U.S. Federal Reserve Bank of New York, in conjunction with the Office of Financial Research, introduced three new reference rates. These three rates, the Secured Overnight Financing Rate, the Broad General Collateral Rate and the Tri-Party General Collateral Rate, are based upon overnight repurchase agreement transactions collateralized by Treasury Securities. The Federal Reserve Bank of New York has previously published indicative historical data for these three new rates. In connection with the production of these new rates, the Federal Reserve Bank of New York indicated that it plans to update its International Organization of Securities Commissions statement of compliance during the second quarter of 2018 to include these rates.

The Federal Reserve Bank of New York's announcement is available at: https://www.newyorkfed.org/markets/opolicy/operating_policy_180403.

European Securities and Markets Authority Publishes Final Technical Advice Under the Prospectus Regulation

On April 3, 2018, the European Securities and Markets Authority published its final report on its technical advice to the European Commission to supplement the provisions of the Prospectus Regulation with delegated legislation. The Prospectus Regulation entered into force on July 20, 2017 and certain provisions took effect directly across the EU on July 20, 2017. It will further take effect partly on July 21, 2018 with the remainder of its provisions taking effect on July 21, 2019. The Prospectus Regulation is a major part of the European Commission's drive towards EU Capital Markets Union. It will repeal and replace the existing Prospectus Directive as well as its supplemental Regulation on the form and content of a prospectus.

ESMA was mandated by the European Commission to provide technical advice on possible delegated acts on the format and content of the prospectus, the content, format and sequence of the EU Growth Prospectus (a new type of prospectus for small and medium-sized enterprises and in certain cases non-SMEs for small issuances) and scrutiny and approval of the prospectus. ESMA consulted on its draft technical advice in three consultations launched in July 2017. ESMA has made a number of amendments to its technical advice, based on feedback received on the consultations.

ESMA has amended its technical advice on the format of the prospectus, the base prospectus and final terms by removing the requirements for a mandatory cover note and a stand-alone use of proceeds section in the prospectus. It will also not impose a mandatory "How to use this prospectus" section in the base prospectus. It has also made changes to the location of risk factors disclosures and to the positioning of risk factors in the Universal Registration Document. ESMA has also made changes to its proposals in relation to the share registration document, the share securities note, the building block for pro-forma financial information, the schedule on depositary receipts issued over shares and the content of the secondary issuance regime.

Following responses to its consultation on the content and format of the EU Growth Prospectus, ESMA is proceeding with its format proposals largely as consulted on, but has made a number of changes to the content requirements for the EU Growth Prospectus.

Following feedback to its consultation on scrutiny and approval of the prospectus, ESMA has made adjustments to the criteria for completeness, comprehensibility and consistency and may provide further guidance at a later date. It has also made changes to its technical advice on approval of the prospectus and approval and filing of the universal registration document.

ESMA's technical advice will now be considered by the European Commission and, if endorsed, will form the basis of delegated acts to be adopted by July 21, 2019.

The Final Report is available at: <https://www.esma.europa.eu/regulation/corporate-disclosure/prospectus> and details of the July 2017 consultations are available at: <http://finreg.shearman.com/european-securities-and-marke>.

International Standards Body Recommendations for Secondary Corporate Bond Market Transparency and Regulatory Reporting

On April 5, 2018, IOSCO published a final report on regulatory reporting and public transparency in the secondary corporate bond markets. The report discusses the importance to robust capital markets of making information accessible to regulators and the public via regulatory reporting requirements and pre- and post-trade transparency requirements respectively. The report discusses the approach taken in various jurisdictions to impose these requirements before setting out seven recommendations for national regulators.

The recommendations update IOSCO's 2004 report, "Transparency of Corporate Bond Markets," which discussed the then-existing transparency arrangements for corporate bond markets, as well as the regulatory regimes that were in place in member jurisdictions and set out Core Measures for national regulators to consider to ensure adequate transparency and regulatory reporting arrangements. The recommendations also take into account IOSCO's 2017 report, "Examination of the Liquidity of the Secondary Corporate Bond Markets," which set out the findings of an evidence-based examination of the state of secondary corporate bond markets from 2004 until approximately 2015 and provided a detailed overview and discussion of the markets and how they had evolved since 2004.

The recommendations are:

- Regulatory authorities should be able to obtain the information necessary to develop a comprehensive understanding of the corporate bond market in their jurisdiction. This understanding should include the characteristics of the market and the types of bonds traded.
- To facilitate cross-border understanding amongst regulators of corporate bond markets, regulatory authorities should make a clear framework and underlying methodology of regulatory reporting and transparency available.
- Regulatory authorities should have access, either directly or upon request, to pre-trade information where it is available, relating to corporate bonds. This might include information other than firm bids and offers, such as indications of interest.
- Regulatory authorities should implement post-trade (transaction) regulatory reporting requirements for secondary market trading in corporate bonds. Taking into consideration the specifics of the market, these requirements should be calibrated in a way that a high level of reporting is achieved. These requirements should include the reporting of information about the identification of the bond, the price, the volume, the buy/sell indicator and the timing of execution.
- Regulatory authorities should consider steps to enhance the public availability of appropriate pre-trade information relating to corporate bonds, taking into account the potential impact that pre-trade transparency may have on market liquidity.

- Regulatory authorities should implement post-trade transparency requirements for secondary market trading in corporate bonds. Taking into consideration the specifics of the market, these requirements should be calibrated in a way that a high level of post-trade transparency is achieved. They should also take into account the potential impact that post-trade transparency may have on market liquidity. Post-trade transparency requirements should include, at a minimum, the disclosure of information about the identification of the bond, the price, the volume, the buy/sell indicator and the timing of execution.
- Where there is transparency of post-trade data relating to corporate bonds, regulatory authorities should take steps to facilitate the consolidation of that data.

The report explains that, in the EU, these recommendations are met by the provisions of the revised Markets in Financial Instruments Directive and the Markets in Financial Instruments Regulation, which have applied since January 3, 2018. The report also notes the approach taken by regulators in member jurisdictions generally and touches on the treatment by regulators in the United States, Canada, Japan and Korea of specific aspects of the recommendations.

The Final Report is available at: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD597.pdf>.

Upcoming Events

April 12, 2018: U.S. Senate Committee on Banking, Housing, and Urban Affairs hearing on the 2018 CFPB Semi-Annual Report, presented by Acting CFPB Director Mick Mulvaney

April 12, 2018: U.S. Financial Stability Oversight Council executive session. Agenda will include discussion of potential amendments to the Council's bylaws, potential amendments to FSOC interpretive guidance regarding non-bank financial company designations, potential application to the FSOC from a bank holding company or its successor under Section 117 of the Dodd-Frank Act, and an update on the annual re-evaluation of the designation of a non-bank financial company

April 17, 2018: FDIC Board of Directors meeting

April 18, 2018: ECB public hearing by telephone conference on proposed guide to internal models

April 24, 2018: ECB public hearing via telephone conference on its consultation on draft guides to ICAAP and ILAAP

April 25, 2018: EBA public hearing on draft EBA Guidelines on Management of Non-Performing and Forborne Exposures

May 31, 2018: Bank of England and Centre for Economic Policy Research conference on competition and regulation in financial markets

Upcoming Consultation Deadlines

April 12, 2018: CMA working paper on the supply of fiduciary management services by investment consultancy firms

April 12, 2018: European Commission consultation on implementing the final aspects of Basel III into EU law

April 13, 2018: ESMA open hearing on proposed EU technical standards for securitization repositories

April 16, 2018: FATF survey on the 2016 Guidance on correspondent banking

April 25, 2018: FSB survey on legal barriers to OTC derivatives trade reporting

- May 4, 2018: IOSCO consultation on conflicts of interest and associated conduct risks during the equity capital raising process
- May 4, 2018: ECB consultation on draft guides to ICAAP and ILAAP
- May 4, 2018: Basel Committee technical consultation on Pillar 3 disclosure requirements and the regulatory treatment of accounting provisions
- May 6, 2018: IOSCO consultation on proposed recommendations for trading venues and their regulators when implementing, operating and monitoring volatility control mechanisms to preserve orderly trading
- May 7, 2018: PRA consultation on governance and risk management for algorithmic trading
- May 11, 2018: FCA survey of European Economic Area firms currently operating in the U.K. under a passport
- May 16, 2018: PRA consultation on guidance on the eligibility of guarantees as unfunded credit protection for capital requirement purposes
- May 23, 2018: European Commission's legislative proposals to address NPL build-up in the EU
- May 23, 2018: European Commission's proposed Regulation on the law applicable to the third-party effects of assignments of claims
- May 23, 2018: ESMA consultations on draft technical standards on the application for registration of a securitization repository and on draft advice to the European Commission on supervisory fees for securitization repositories
- May 25, 2018: ESMA consultation on supplementary guidance on the CRA endorsement regime
- May 25, 2018: Basel Committee consultation on revisions to Pillar 3 Framework
- May 27, 2018: EBA consultation on extending the Joint Committee Guidelines on complaints-handling for the securities and banking sectors
- May 28, 2018: ECB consultation on proposed guide to internal models
- June 4, 2018: European Commission proposed amending Regulation on cross-border payments in the EU
- June 4, 2018: European Commission proposed EU covered bonds legislative package
- June 5, 2018: HM Treasury consultation on cash and digital payments in the new economy
- June 8, 2018: PSR consultation on its review of PSR Directions made in 2015
- June 8, 2018: EBA consultation on draft EBA Guidelines on Management of Non-Performing and Forborne Exposures
- June 20, 2018: FCA consultation on Model Driven Machine Executable Regulatory Reporting
- June 20, 2018: Basel Committee consultation on revisions to minimum capital requirements for market risk
- June 21, 2018: FCA consultation on its approach to supervision
- June 21, 2018: FCA consultation on its approach to enforcement
- June 28, 2018: FCA consultation on revising the Financial Crime Guide to include insider dealing and market manipulation
- July 5, 2018: FCA consultation on improving disclosure by AFMs to their investors (part of the Asset Management Market Study)

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:

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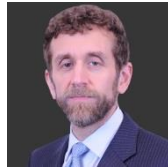
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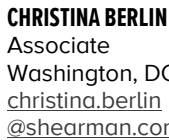
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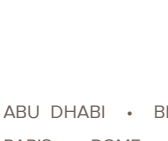
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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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