

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.

[Click here if you wish to access our Financial Regulatory Developments website.](#)

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Bank Prudential Regulation & Regulatory Capital

Prudential Regulator Reports on Climate-Related Financial Risks for the UK Banking Sector

On September 26, 2018, the U.K. Prudential Regulation Authority published a report entitled “Transition in thinking: The impact of climate change on the U.K. banking sector.” The purpose of the report is to: (i) examine the financial risks from climate change that impact PRA regulated banks, building societies and designated investment firms; (ii) assess how those entities are responding to and managing the financial risks from climate change; and (iii) assist those entities in understanding the PRA’s supervisory approach to the financial risks from climate change. The report will also be used to inform the Bank of England’s wider work to assess the system-wide financial risks from climate change.

The report outlines the two key climate-related risk factors that give rise to financial risks for the banking sector. These are: (a) “physical risks” from climate and weather-related events, such as heatwaves, droughts, floods, storms and rises in sea level; and (b) “transition risks” arising from the process of adjustment towards a low-carbon economy. For the banking sector, climate-related risk factors manifest as increasing credit, market and operational risks. The report presents four case studies that demonstrate how the financial risks from climate change are already relevant to the banking sector.

The report sets out the PRA’s assessment of how firms in the sector have been enhancing their approach to climate-related risks. The PRA believes the issue needs board-level attention and it will shortly be launching a consultation on its supervisory expectations. It also plans to launch a climate financial risk forum with the Financial Conduct Authority, which will invite participation from the private sector, technical experts and other relevant stakeholders.

The report is available at: <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/report/transition-in-thinking-the-impact-of-climate-change-on-the-uk-banking-sector.pdf?la=en&hash=A0C99529978C94AC8E1C6B4CE1EECD8C05CBF40D>.

International Task Force Report Shows Momentum Building for Climate-Related Financial Disclosures

On September 26, 2018, the Task Force on Climate-related Financial Disclosures issued a status report outlining progress on adoption of the TCFD disclosure recommendations issued in June 2017. The TCFD was established by the Financial Stability Board in 2015 and its 2017 recommendations provide a voluntary framework for companies to develop more effective climate-related financial disclosures through their existing reporting processes. The recommendations are structured around four areas: (i) governance; (ii) strategy; (iii) risk management; and (iv) metrics and targets.

The TCFD surveyed the disclosures made in the 2017 annual reports of over 1,700 firms from diverse sectors and geographical locations. Despite the limited time since publication of its recommendations, the TCFD found that the majority of firms’ disclosures were already aligned with one or more of the TCFD’s recommendations. While TCFD’s supporters numbered 100 companies on the launch of the recommendations in June 2017, over 500 companies are now supporters of the TCFD, including the world’s largest banks, asset managers and pension funds, responsible for assets of nearly \$100 trillion. Commenting on the publication of the status report, FSB Chairman Mark Carney stated that “climate-disclosure is becoming mainstream.”

A key finding of the report is that, while many companies report on environmental issues, the majority have yet to specifically provide consistent information on the financial implications of climate change for their businesses. A further progress report will be published in 2019 and will analyze firms' 2018 disclosures.

The status report is available at: <http://www.fsb.org/2018/09/task-force-on-climate-related-financial-disclosures-status-report/> and TCFD recommendations are available at: <https://www.fsb-tcfd.org/publications/final-recommendations-report/>.

Derivatives

EU Final Report to Extend Exemption From the Clearing Obligation for Certain Intragroup Derivatives Transactions

On September 27, 2018, the European Securities and Markets Authority published a final report on the exemption from the clearing obligation for intragroup transactions with a third-country group entity. There are currently three sets of Regulatory Technical Standards made under the European Market Infrastructure Regulation that impose the clearing obligation of certain interest rate derivatives and credit derivatives. Each of these three RTS exempts from the clearing obligation certain intragroup derivatives transactions where one of the counterparties is a third-country group entity and there is no relevant equivalence decision in respect of the third country in which it is situated. An equivalence decision would enable parties that are subject to both the EU and a third country's clearing obligation to comply only with one jurisdiction's requirements, but no equivalence decisions have been made to date. Each of the three RTS sets a different expiry date for the intra-group exemption. These dates fall between December 21, 2018 and July 9, 2019.

Following a consultation launched in July 2018, ESMA's final report contains final draft amending RTS setting out ESMA's proposal to extend the exemption period by amending each of the RTS to have one unified expiry date of December 21, 2020. The final draft amending RTS have been submitted to the European Commission for endorsement.

The Final Report is available at: https://www.esma.europa.eu/sites/default/files/library/esma70-151-1768_final_report_no.6_on_the_clearing_obligation_intragroup.pdf.

Enforcement

UK Brokerage Firm Fined for Inadequate Controls Against Potential Market Abuse

On September, 27, 2018, the U.K. FCA published a Decision Notice (dated June 7, 2018) imposing a fine of £409,300 on a U.K. brokerage firm for failure to take reasonable care to organize and control its affairs responsibly and effectively with adequate risk management systems in relation to the detection and reporting of potential instances of market abuse.

During the period from January 2013 to August 2015, the firm was authorized by the FCA and provided its customers with a range of services, including placing trades on behalf of clients with wholesale Direct Market Access providers. The firm would enter into DMA agreements with the wholesale brokers and separately enter into individual contracts with clients wishing to trade, thereby providing a "back to back" market access service. This arrangement meant that trading activity was primarily monitored by compliance-based surveillance. The firm was unaware until November 2014 that it needed to conduct its own post-trade surveillance and had relied instead on post-trade surveillance checks being undertaken by underlying brokers. The firm did not have an adequate post-trade surveillance capability until August 2015.

The FCA found that the firm failed to take care to ensure that it could conduct post-trade surveillance adequately, which increased the risk that potentially suspicious trading would go undetected. This breached Principle 3 of the FCA's Principles for Businesses. This is the first case to be completed under a new process introduced for partly contested cases. The firm has agreed with the FCA's findings and accepted liability. However, it has disputed the amount of the penalty and the matter has been referred to the Upper Tribunal for reconsideration of that issue.

The Decision Notice is available at: <https://www.fca.org.uk/publication/decision-notice/linear-investments-limited.pdf>.

FinTech

US Federal Judge Affirms Commodity Futures Trading Commission's Authority to Police Virtual Currency Fraud

On September 26, 2018, the U.S. District Court for the District of Massachusetts issued an order confirming that the Commodity Futures Trading Commission maintains the authority to police virtual currency fraud. The order was issued in response to a motion to dismiss charges against My Big Coin Pay, Inc. and several individuals for operating a fraudulent virtual currency scheme through which they solicited customers to purchase a virtual currency known as My Big Coin (MBC).

The CFTC's initial enforcement order, filed in January 2018, accused the defendants of operating a fraudulent virtual currency scheme through which they solicited more than \$6 million from customers throughout the U.S. by making false and misleading claims that MBC was actively being traded, was backed by gold and could be used anywhere MasterCard credit cards were accepted. The defendants also were alleged to have misrepresented MBC's daily trading price in reports on its website, when no daily trading price existed because MBC was not actively being traded.

The defendants' attorneys sought to have the case thrown out on the basis that the CFTC has no authority to police virtual currency fraud since virtual currencies do not meet the definition of a "commodity" under the Commodity Exchange Act, and that in any case, the CFTC's anti-fraud authority extended only to fraudulent market manipulation.

However, Judge Rya Zobel claimed that MBC is in fact a commodity under the CEA, as the term "commodity" includes a "host of specifically enumerated agricultural products as well as 'all other goods and articles... and all services rights and interests... in which contracts for future delivery are presently or in the future dealt in.'" Judge Zobel determined that the law applies to broad categories of such products, and since bitcoin futures currently trade on exchange, by extension, bitcoin and other virtual currencies, including MBC, fit the definition of "commodities." Judge Zobel also rejected the defendants' argument regarding the limits of the CFTC's anti-fraud authority with respect to commodities, maintaining that the CEA "explicitly prohibit[s] fraud even in the absence of market manipulation."

This court order, along with a similar order issued by the U.S. District Court for the Eastern District of New York in March 2018, should solidify the CFTC's standing to police virtual currency fraud going forward.

The court order is available at: <https://www.cftc.gov/sites/default/files/2018-10/enfmybigcoinpayincmemorandum092618.pdf>.

Funds

Proposed Revisions to EU Guidelines on Stress Testing of Money Market Funds

On September 28, 2018, ESMA opened a consultation on proposed updates to the Guidelines on stress test scenarios for Money Market Funds under the Money Market Fund Regulation. The MMF Regulation has applied directly across the EU since July 21, 2018. MMFs are fund vehicles that invest in highly liquid short-term debt instruments, such as government bonds and often regarded as a short-term cash management function alternative to bank deposits.

The MMF Regulation tasks ESMA with developing Guidelines on common reference parameters of the stress test scenarios to be included in the stress tests that managers of MMFs are required to conduct. ESMA's original Guidelines, published in March 2018, include specifications for the stress tests, including common parameters and scenarios which take into account certain hypothetical risk factors. The Guidelines must be reviewed at least annually and updated for any market developments.

The consultation paper proposes updating the section in the Guidelines on the establishment of common reference stress test scenarios, the results of which should be included in the reporting template that managers of MMFs are required to use. ESMA is seeking feedback on the methodology, risk factors, data and the calculation of the impact. The calibration of stress test scenarios is not within scope of the consultation. However, feedback on how to calibrate the scenarios would be welcomed by ESMA.

Responses to the consultation should be submitted by December 1, 2018. ESMA intends to finalize the revised Guidelines in Q1 2019.

The consultation paper is available at: <https://www.esma.europa.eu/press-news/esma-news/esma-consults-stress-testing-rules-money-market-funds>.

MiFID II

EU Contracts for Difference Product Intervention Measures to be Extended

On September 28, 2018, ESMA announced that its various restrictions on the sale, distribution and marketing of Contracts for Difference to retail investors will be extended from November 1, 2018 for a further three months.

ESMA adopted two temporary product intervention Decisions under the Markets in Financial Instruments Regulation in June this year, one relating to binary options and another to CFDs. ESMA has powers under MiFIR to impose prohibitions or restrictions on certain financial instruments, financial activities or practices to address a significant investor protection concern in the Union. Product intervention measures imposed by ESMA under MiFIR must be reviewed at appropriate intervals and at least every three months. If a measure is not renewed after three months, it will expire and it would then fall to member states to impose similar restrictions at a national level, if they so wish. The U.K. FCA is expected to consult before the end of the year on whether to make permanent the EU's temporary prohibition on marketing, distribution and sale of binary options to retail investors. The International Organization of Securities Commissions recently published a report on retail OTC leveraged products, alongside a statement warning retail investors of the risks of investing in illegal or fraudulent binary options.

The first Decision prohibited the marketing, distribution and sale of binary options to retail investors from July 2, 2018 until October 2, 2018. ESMA adopted a Decision on September 21, 2018 to extend the ban relating to binary options for a further three months, although certain types of binary options were excluded from the

scope of the prohibition because ESMA considers that those binary options are less likely to present a significant investor protection concern.

The second Decision adopted in June imposed a number of restrictions on the marketing, distribution and sale of CFDs to retail investors between August 1, 2018 and November 1, 2018. ESMA's announcement confirms that the restrictions will be extended for a further three months. The extending Decision will also include an additional reduced character risk warning because CFD providers have experienced technical difficulties in using the risk warnings due to the character limitations imposed by third-party marketing providers.

Alongside the announcement, ESMA has issued updated Q&A to promote common, uniform and consistent supervisory approaches and practices in the day-to-day application of the measures. The updated Q&A clarifies that the CFD temporary product intervention measure applies in relation to rolling spot forex that do not qualify as an option, future, swap or forward rate agreement.

The ESMA's announcement is available at: https://www.esma.europa.eu/sites/default/files/library/esma71-99-1041_-_esma_to_renew_restriction_on_cfds_for_a_further_three_months.pdf, details of the extension of the ban relating to binary options are available at: <https://finreg.shearman.com/european-securities-and-markets-authority-intends>, details of the original Decisions adopted in March 2018 are available at: <https://finreg.shearman.com/european-securities-and-markets-authority-confirm>, details of IOSCO's report and warning are available at: <https://finreg.shearman.com/international-standards-body-encourages-regulator> and the FCA's information page about binary options is available at: <https://www.fca.org.uk/consumers/binary-options>.

New Data Completeness Indicators to be Published for EU Trading Venues

On September 27, 2018, ESMA announced that it will publish two new data completeness indicators for trading venues, detailing how venues are performing on the delivery of Double Volume Cap and bond liquidity data in compliance with their obligations under MiFIR. ESMA has been working with national regulators to improve the timeliness and completeness of the data underpinning the monthly DVC and quarterly bond liquidity assessment publications. ESMA believes that the new indicators will incentivize trading venues to provide timely and complete data. For both DVC and bond liquidity data, ESMA will introduce the following completeness indicators:

- I. The Completeness Ratio, to provide information on the completeness of each particular venue, irrespective of the performance of other venues.
- II. The Completeness Shortfall, which will give an indication of a venue's performance in terms of completeness compared to other trading venues and reflect the percentage of missing data for which a particular venue is responsible.

ESMA will publish the DVC completeness indicators on October 8, 2018 with the next DVC update and then on a monthly basis. It will publish bond liquidity completeness indicators from the next bond liquidity quarterly assessment publication by November 1, 2018 and then on a quarterly basis.

The ESMA press release is available at: https://www.esma.europa.eu/sites/default/files/library/esma71-99-1038_esma_to_publish_new_data_completeness_indicators_for_trading_venues.pdf.

Upcoming Events

October 15, 2018: SRB Conference 2018 – 10 years after the crisis: are banks now resolvable?

October 10, 2018: Public hearing on the EBA's consultation on revised ITS on supervisory reporting in line with the Liquidity Coverage Requirement under the CRR

November 28, 2018: EBA 7th Annual Research Workshop – Reaping the benefits of an integrated EU banking market

Upcoming Consultation Deadlines

October 10, 2018: HMT consultation on transposition of the Bank Creditor Hierarchy Directive

October 10, 2018: Comment deadline for FDIC proposal to retire certain Financial Institution Letters

October 12, 2018: ISDA consultation on fall backs based on overnight risk-free rates for certain derivatives

October 12, 2018: FCA consultation on approach to implementing technical standards under PSD2

October 14, 2018: Regulators (globally) consultation on a Global Financial Innovation Network

October 17, 2018: Comment deadline for Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (proposed changes to the Volcker Rule)

October 25, 2018: ECB consultation on draft Part 2 of the Guide to Assessments of Licence Applications by credit institutions

October 26, 2018: EBA consultation on revised ITS on supervisory reporting in line with the Liquidity Coverage Requirement under the CRR

October 26, 2018 Comment deadline for FDIC proposal to except a capped amount of reciprocal deposits from treatment as brokered deposits

October 27, 2018: FCA consultation on proposed changes to the rules governing P2P platforms

October 29, 2018: Comment deadline for interim final rule regarding expanded 18-month examination cycle for certain small insured depository institutions and U.S. branches and agencies of foreign banks

October 29, 2018: CFTC consultation on proposed clearing obligation exemptions for certain financial end users

November 2, 2018: FCA discussion paper on the potential introduction of a new duty of care for financial services firms

November 19, 2018: Comment deadline for OCC proposal to permit certain federal savings associations to operate with national bank powers

November 27, 2018: EBA consultation on revised ITS for supervisory reporting under the CRR

December 12, 2018: PRA consultation on revisions to supervisory reporting requirements

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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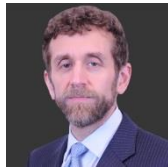
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