CADWALADER

CABINET NEWS

Research and commentary on regulatory and other financial services topics

It's Coming at You From All Sides

May 2, 2024

Table of Contents:

In This Issue ...

May 2, 2024

As always, your comments and questions are valued. Feel free to reach out to us anytime by dropping a note **here**.

Mercedes Tunstall and Alix Prentice
Partners and Co-Editors, *Cabinet News and Views*

CFPB Uses Laboratory Experiments to Attack Junk Fees

May 2, 2024

By Mercedes Kelley Tunstall
Partner | Financial Regulation

On April 30, 2024, the Consumer Financial Protection Bureau ("CFPB") published a **report called "Price Complexity in Laboratory Markets"** that concluded that the financial services industry should keep pricing for financial services and products simple. Using actual people in a laboratory setting at the Gettysburg Lab for Experimental Economics, the CFPB conducted a series of experiments that had the participants interact with various market models through private, networked computer terminals. "Participants earned 'tokens,' and at the end of each session, tokens were exchanged for dollars."

"While not expected to exactly mirror real-world transactions, the CFPB found in these experiments that more complex pricing generally led to more detrimental outcomes for consumers." The **CFPB's accompanying press release** highlighted outcomes from the experiment that appeared to advocate for sellers not having any choice in being able to offer more than one price because when the participants were presented with granular pricing they were "15 times more likely to select a higher-priced option in markets with 16 sub-prices than in those with one price."

Although such an observation is non-sensical as one considers how a participant could have chosen a higher-priced option if there was only ONE price option, and despite the report's conclusion that "to be confident that laboratory results will generalize, more work must be done," the CFPB's press release concluded that price complexity poses challenges to consumers. In describing price complexity that exists in the marketplace today, the CFPB focused primarily on fees the CFPB has deemed to be "junk fees" that are charged to consumers if they pay late, transfer balances, or overdraft their deposit accounts.

But, just for good measure, the CFPB detailed other aspects of financial products and services pricing that are complex such as differing down-payment amounts consumers have available for mortgages and auto loans, different car models available to purchase, and interest rates that vary based upon the consumer's credit score. The purpose of identifying these aspects of price complexity makes one wonder if the same agency that has taken action to severely limit credit card late fees is beginning to advocate for doing away with credit scores altogether, and taken to its logical conclusion, wants all Americans that must finance the purchase of a motor vehicle to drive the exact same car?

These Are Junk Fees

May 2, 2024

By Mercedes Kelley Tunstall
Partner | Financial Regulation

In the Consumer Financial Protection Bureau's ("CFPB's") **most recent Supervisory Highlights, published on April 24th**, the agency identified a wide variety of fees that were improperly charged to mortgage borrowers. As compared to other "junk fee" efforts by the CFPB, almost all of the fees identified in this report were charged to the borrower either in violation of their agreement or for reasons that had nothing to do with the borrower's actions, but instead could be ascribed to mistakes made by their servicers. Nevertheless, the CFPB used the publication of this document as a means to publish a **press release** that beats the drum regarding **their final rule** that severely restricts credit card late fees because they are "junk fees." That rule has been **severely challenged** by the credit card industry.

For example, the fees and fee practices that were highlighted by the Supervisory Highlights include:

- Borrowers who obtained a loan modification as a result of COVID were still charged late fees, in violation of laws that required servicers to exclude such fees from the loan modification;
- Certain borrowers that had conforming loans with Fannie Mae, but who were in a certain state of delinquency, were charged property inspection fees by their servicers, in violation of Fannie Mae standards; and
- Some servicers used generic "service fee" descriptors for up to eighteen different kinds of fees, junk or legitimate, such that borrowers were unable to discern whether the fee was accurately assessed.

DOL Issues Final Rule Regarding Fiduciary Investment Advice

May 2, 2024

By James Frazier
Partner | Executive Compensation, Benefits & ERISA

On Tuesday, April 23, 2024, the U.S. Department of Labor (the "DOL") released its new final rule (the "Final Rule") regarding when a person becomes a "fiduciary" by virtue of providing investment advice for purposes of the Employee Retirement Income Security Act of 1974 ("ERISA") and Section 4975 of the **Internal Revenue Code of 1986** (the "Code"). Upon becoming effective, the Final Rule will meaningfully expand the definition of fiduciary as it pertains to the provision of investment advice. The Final Rule is the latest in the DOL's efforts to change this definition. In 2018, the Fifth Circuit Court of Appeals vacated the DOL's 2016 fiduciary regulation, its last formal rulemaking effort in this regard.

Under the **current DOL regulation**, issued in 1975, a person is an investment advice fiduciary if he or she meets all elements of a five-part test set forth therein. Under this test, a person is an investment advice fiduciary only if: (1) he or she renders investment advice as to the value of securities or other property, or makes recommendations regarding the advisability of investing in, acquiring or selling securities or other property, (2) on a regular basis, (3) pursuant to a mutual agreement, arrangement or understanding, (4) that the advice will serve as a primary basis for investment decisions with respect to plan assets and (5) such advice is individualized based on the particular needs of the plan.

The DOL believes a change is necessary to modernize the definition of an investment advice fiduciary under ERISA and Section 4975 of the Code given certain market changes since 1975, including the rise of participant-directed plans and IRAs. The DOL also noted in the related preamble that the Final Rule closes what the DOL believes are loopholes in the five-part test that serve to "defeat retirement investors' legitimate investor expectations when they received investment advice from trusted advice providers in the modern market place . . ."

Under the Final Rule, a person renders fiduciary "investment advice" for purposes of ERISA and Section 4975 of the Code if he or she makes a recommendation regarding any securities transaction or other investment transaction or any investment strategy involving securities or other investment property to a retirement investor (including any plan, plan participant or beneficiary, IRA, IRA owner, IRA beneficiary, and any fiduciary with authority or control) for a fee or other compensation (direct or indirect), and either of the following is satisfied:

- (i) the person either directly or indirectly (*e.g.,* through or together with any affiliate) makes professional investment recommendations to investors on a regular basis as part of their business and the recommendation is made under circumstances that would indicate to a reasonable investor in like circumstances that the recommendation is based on review of the retirement investor's particular needs or individual circumstances, reflects the application of professional or expert judgment to the retirement investor's particular needs or individual circumstances, and may be relied upon by the retirement investor as intended to advance the retirement investor's best interest; or

- (ii) the person represents or acknowledges that they are acting as a fiduciary under Title I of ERISA, Section 4975 of the Code, or both, with respect to the recommendation.

The Final Rule represents a significant departure from the existing rule. Among other changes, the Final Rule scraps the "regular basis," "mutual agreement" and "primary basis" prongs of the existing regulation's five-part test (including to address the DOL's loophole concerns) in favor of the new standard in (i), above. As noted previously, the Final Rule represents a meaningful expansion of the investment advice fiduciary definition.

For purposes of the final rule, recommendations addressing the following are picked up:

- the advisability of acquiring, holding, disposing of, or exchanging, securities or other investment property, investment strategy, or how securities or other investment property should be invested following a rollover, transfer, or distribution;
- the management of securities or other investment property, including, among other things, recommendations on policies or strategies, portfolio composition, selection of others to provide investment advice or management services, selection of account arrangements or voting of proxies; and
- rolling over, transferring, or distributing assets from a plan or IRA, including recommendations as to whether to engage in the transaction, the amount, the form, and the destination of a rollover, transfer, or distribution.

The DOL confirmed that it intends that whether a recommendation has been made will be construed consistent with the Securities and Exchange Commission's Regulation Best Interest, with a focus on whether there has been a "call to action."

The Final Rule also provides that:

- salesperson recommendations will not trigger fiduciary status if such person does not provide such recommendations in either context outlined above for providing fiduciary advice;
- the mere provision of investment information or education without an investment recommendation is not covered advice; and
- written statements disclaiming fiduciary status under ERISA or Section 4975 of the Code, the Fiduciary Rule or the conditions to providing advice set forth above, will not control to the extent such statements are inconsistent with other oral and written communications, applicable Federal and State law or other interactions with the retirement investor.

In connection with the Final Rule, the DOL also amended the following prohibited transaction class exemptions ("PTCE") – PTCE 2020-02, PTCE 86-128, PTCE 84-24, PTCE 83-1, PTCE 80-83, PTCE 77-4 and PTCE 75-1. As a general matter, **PTCE 2020-02** (which generally provides relief for covered persons providing fiduciary advice to receive compensation that would otherwise be prohibited) will now be the primary class exemption available to provide exemptive relief for the receipt of compensation by investment advice fiduciaries that would otherwise be prohibited by ERISA and Section 4975 of the Code, although **PTCE 84-24** (which has been available to provide relief for certain transactions involving insurance agents and brokers, pension consultants, insurance and investment companies and investment company underwriters) will now provide relief for independent insurance agents receiving compensation that would otherwise be prohibited in connection with the provision of certain investment advice. The DOL removed the other existing relief in PTCE 84-24 for investment advice transactions and also removed relief for investment advice transactions from the transactions covered by each of **PTCE 86-128, PTCE 83-1, PTCE 80-83, PTCE 77-4 and PTCE 75-1**, Parts III and IV.

The effective date for the Final Rule and the changes to the relevant PTCEs is September 23, 2024. There is a one-year transition period after the effective date for certain conditions in PTCE 2020-02 and PTCE 84-24.

A Decade-Long Death of Footnote 195

May 2, 2024

By Peter Y. Malyshev
Partner | Financial Regulation

Sometimes a small footnote (which technically is not even a part of the official Federal rule) may have an outsize impact on the rule itself. In 2013, subsequent to the enactment of the Dodd Frank Act of 2010, the Commodity Futures Trading Commission ("CFTC") had implemented its rules and guiding principles for swap execution facilities ("SEFs") – i.e., the platforms where swaps must be traded if they are available for execution between multiple trading participants. If a platform qualifies as a SEF, it must register with the CFTC and must meet a number of requirements, such as (i) limiting participation on SEFs to only eligible contract participants ("ECPs"), as defined in the Commodity Exchange Act, (ii) ensuring competitive execution of transaction either through a request for quote ("RFQ") or central limit order book ("CLOB") functionality, (iii) preventing fraud and manipulation on the SEFs, and (iv) facilitating clearing and reporting of transactions executed on the SEFs to swap data repositories ("SDRs").

If a SEF-executed transaction is subsequently cleared through a derivatives clearing organization ("DCO"), the DCO would typically generate a record and that record would supersede previous agreements and confirmations because the transactions would be settled with the DCO. However, if a SEF-executed transaction is not cleared through a DCO, it would have to settle between the counterparties, and some form of a bilateral swap agreement (such as an ISDA master agreement) would be essential in addition to a confirmation generated by a SEF.

Understanding the importance of properly documenting swap transactions, the CFTC required in its § 37.6(b) rule (and further explained in its Footnote 195 to SEF rule's adoption release) that all uncleared swap transactions be properly documented and in the event there are ISDAs or any other swap agreements between the parties, the terms of such previously negotiated agreements could be incorporated in the SEF confirmations if these agreements were provided to the SEFs. In other words, the SEFs will have to collect and maintain the libraries of thousands upon thousands of bilaterally negotiated agreements when these agreements are provided to a SEF by its trading participants. From the moment the SEF rule was adopted in 2013, it became clear that the requirements in Footnote 195 were a burden that neither the SEFs nor the trading participants were able to comply with; as a result, the CFTC issued a series of no-action letters (such as CFTC Letter 17-17) where the staff of the CFTC agreed not to enforce the requirements of Footnote 195.

Eventually, acknowledging the impracticality of obtaining and storing previously negotiated master agreements, the CFTC **amended** its Part 37 rules, which now provide that:

- SEFs are permitted to incorporate in an uncleared swap confirmation by reference terms of previously negotiated master agreements between counterparties without being required to obtain a copy of such agreements;

- confirmation of all terms of a swap transaction executed on a SEF must be done “as soon as technologically practicable” after the execution of the swap transaction;
- the confirmation provided by the SEF after the execution of a swap transaction legally supersedes only the conflicting terms of the previous agreement (rather than the entire agreement), such as the ISDA master agreement, while both the SEF and the CFTC can obtain a copy of such agreement; and
- additional technical amendments of the SEF rules and swap dealer rules in Part 23.

Rule amendments will become effective on May 31, 2024 and CFTC Letter 17-17 will expire.

The UK Moves Closer to a T+1 Settlement Cycle

May 2, 2024

By Alix Prentice
Partner | Financial Regulation

The UK's Accelerated Settlement Taskforce published its **report** on reforms to the settlement cycle on 28 March 2024. Mirroring the move by all North American markets to a T+1 cycle in May 2024 as well as ongoing EU consultations on a move to the same timing, the report points to consensus that the UK will need to adopt T+1 sooner rather than later. As the report points out, China has operated at T+0 for a number of years, and India has already moved to T+1.

Given that activities currently taking place on T+1 will consequently need to be completed by the end of Trade Date, a potential reduction in time (depending on location) of up to 83% compared with T+2 settlement could be a result of this shift. This means that operational considerations and changes will be paramount, and the report consequently recommends that:

- market standards for onboarding new accounts should be established;
- allocations, confirmations and trade level matching processes should be mandated for Trade Date;
- operational changes for electronic processes for sharing standing settlement instructions will be required;
- market standards should be established for settlement instructions on Trade Date;
- market standards should also be established for securities lending recalls; and
- timings, including CREST opening hours and the deemed end of Trade Date will also need to be revised.

The report also recommends close collaboration and alignment of the moves to T+1 between the UK and Europe, but also says that if timelines cannot be aligned, the UK should proceed in any event.

UK Financial Regulator Publishes Guidance on New Anti-Greenwashing Rule

May 2, 2024

Greenwashing remains at the top of enforcement agendas in 2024. There is growing awareness that many corporate claims regarding positive environmental impacts, sustainability and carbon-neutrality do not tell the whole story or are simply inaccurate. In light of that growing awareness, regulatory authorities are taking action to minimise greenwashing and enhance consumer protection. Among these is the UK's Financial Conduct Authority ("FCA"). In our recent Client & Friends Memo, we take a detailed look at the FCA's recently published guidance for companies outlining how they can ensure they comply with the authority's new anti-greenwashing rule.

Read the memo from Jason Halper, Duncan Grieve, Alix Prentice and Sharon Takhar **here**.

What 3rd Circ. Trust Ruling Means for Securitization Market

May 2, 2024

By Mercedes Kelley Tunstall
Partner | Financial Regulation

By Michael S. Gambro
Partner | Capital Markets

Cadwalader partners **Mercedes Kelley Tunstall** and **Michael Gambro** co-authored an article, "What 3rd Circ. Trust Ruling Means for Securitization Market," which appeared in *Law360*.

On March 19, the U.S. Court of Appeals for the Third Circuit handed down the decision that statutory trusts that are used as issuing entities for securitizations are considered "covered persons" for purposes of the Consumer Financial Protection Act in the long-running case of *Consumer Financial Protection Bureau v. National Collegiate Master Student Loan Trusts*. This article provides background on the underlying litigation, describes the court's analysis and identifies possible next steps in the litigation.

Cadwalader partners **Cheryl Barnes**, **Sophie Cuthbertson**, **David Gingold**, **Stuart Goldstein** and **Andrew Karp** contributed to this article.

Read it **here**.

Statutory Trusts Subject to Consumer Financial Protection Bureau Jurisdiction

May 2, 2024

Today's General Counsel has published an article citing Cadwalader partners Mercedes Tunstall and Andrew Karp **where they discuss** how the Third Circuit handed down a **decision** in a case involving the Consumer Financial Protection Bureau and the National Collegiate Master Student Loan Trust that finds that statutory trusts used to handle securitizations are considered "covered persons" for purposes of the Consumer Financial Protection Act and thus, are subject to CFPB jurisdiction.

Read the article **here**.

Insights From the PRA's Thematic Review of the Treatment of Risk in Private Equity Financing

May 2, 2024

By Alix Prentice
Partner | Financial Regulation

On 23 April, the UK's banking regulator, the Prudential Regulation Authority ("PRA"), published a **letter** to Chief Risk Officers setting out the results of a thematic review of private equity related financing activities.

Given the grown of assets under management in the private equity sector from around £2 trillion to £8 trillion over the last decade, with a commensurate increase in related bank financing activities, the PRA has taken a look at banks' risk management practices. Of particular interest is the treatment of financing that the letter characterises as 'non-traditional', including NAV and subscription financing, as well as structural market changes that have resulted from the growth of private credit markets. Given these changes, alongside geopolitical uncertainties, the PRA has looked at risk management frameworks and control structures for aggregate PE exposures, and has made a number of findings. The letter asks banks to assess these against current practices and put in place any necessary improvements to risk management that were highlighted as a result of this benchmarking exercise.

Thematic Review Findings

The PRA's review focussed on independent credit and counterparty credit risk management or 'CCRM' processes, and it raises the following expectations for review:

- *Data aggregation and a holistic approach to risk management:* the PRA's expectation is that all transaction and exposure data, along with collateral pledges, relating to the PE sector should be captured thereby enabling risk functions to identify, measure and consolidate counterparty and credit risk exposure information on a sector and individual sponsor and fund level.
- *Credit and counterparty risk interlinkages:* here, the PRA's expectation is that overlapping credit exposures, collateral pledges and financial claims where performance and recovery values are interlinked should be subject to due diligence and management information processes that recognise and measure the risk that arises out of these linkages.
- *Stress testing:* the PRA wants to see routine stress testing of sector and individual financial sponsor exposures performed in a modular way and "*tailored to the idiosyncratic risk profile of different products and structures.*" In keeping with other pronouncements on stress testing, the PRA also wants to see a move away from using historical default rates and previous risk patterns, and the use of higher than previously observed default and loss correlations.
- *Board level reporting:* In keeping with their findings on data aggregation, the PRA wants to see Boards being informed of aggregate exposures linked to the PE sector in order that

Boards may satisfy themselves that the scale and composition of these exposures fit within the overall risk profile.

Next Steps

Banks should provide the PRA with confirmation that they have shared the output of the benchmarking exercise with their Board Risk Committee, and provide their analysis of their CCRM process benchmarked against the letter’s findings together with detailed plans to remediate any gaps identified with their PRA supervisors by 30 August.