CADWALADER

Cabinet **News and Views**

Informed analysis for the financial services industry

A Meaningful Impact

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In This Issue ...

The U.S. regulatory agencies were out in full force this week, with significant activity and pronouncements that will have a meaningful impact on the financial services industry.

It's hard to summarize these important developments in this short introduction to this week's issue, so we encourage readers to carefully review our authors' insightful contributions.

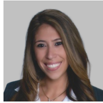
In addition, our firm was honored last week to be named at the *IFLR* Americas Awards as the "Team of the Year" in the "Financial Services Regulatory" category for our work in the crypto and LIBOR spaces. We are also so proud of our colleague Lary Stromfeld, who heads our LIBOR Preparedness Team, for receiving an "Outstanding Achievement Award" in recognition of his critical role in the drafting and ultimate passage of LIBOR legacy contract legislation at the New York State and federal levels. What a well-deserved honor!

As we prepare this weekend in the U.S. to honor our Armed Forces, especially those who made the Ultimate Sacrifice, we cannot help but also acknowledge the tragic events in Uvalde, Texas and, just a week earlier, in Buffalo, New York and Laguna Woods, California. The sadness is deep and overwhelming.

Daniel Meade and **Michael Sholem**
Co-Editors, *Cabinet News and Views*

SEC Proposes New ESG Rules for Funds, Clearly Signaling Its Intent to Scrutinize ESG Claims

By **Michael J. Ruder**
Special Counsel | Capital Markets


By **Melissa Farber**
Associate | Capital Markets

The Securities and Exchange Commission (the "SEC") yesterday proposed amendments to rules and forms relating to ESG disclosures for investment advisors and investment companies. Specifically, the proposed changes seek to expand U.S. funds' disclosure requirements to clients and shareholders and to prevent misleading and deceptive claims relating to ESG qualifications.

The SEC's proposed rule explains that the intent of the proposed rules is to "create a consistent, comparable, and decision-useful regulatory framework for ESG advisory services and investment companies to inform and protect investors while facilitating further innovation in this evolving area of the asset management industry." The proposal would require disclosure regarding ESG strategies in fund prospectuses, annual reports, and adviser brochures. It would also require, in some cases, tabular ESG disclosure. Finally, it would require certain environmentally focused funds to disclose the greenhouse gas (GHG) emissions associated with their portfolio investments. A fact sheet released by the SEC can be found here.

Interestingly, the proposal categorizes ESG-focused funds into three different categories, and provides different disclosure requirements for each category:

1. *Integration Funds*. Funds that integrate ESG factors alongside non-ESG factors in investment decisions would be required to describe how ESG factors are incorporated into their investment process.

2. *ESG-Focused Funds*. Funds for which ESG factors are a significant or main consideration would be required to provide detailed disclosure, including a standardized ESG strategy overview table.

3. *Impact Funds*. A subset of ESG-Focused Funds that seek to achieve a particular ESG impact would be required to disclose how it measures progress on its objective.

This vote follows the SEC's announcement earlier this week that a major financial institution agreed to pay a $1.5 million penalty for misleading statements and omissions regarding its quality review of ESG factors in investment decisions. This settlement, taken together with yesterday's rule proposal and March's proposed climate disclosure rule, makes it apparent that the SEC is serious in its efforts to tackle so-called "greenwashing" and "social washing" concerns about ESG-related disclosures. As a result of this increased focus by the SEC, funds and other issuers should consult with counsel to ensure that their public statements and disclosures regarding ESG matters are not potentially misleading.

Yesterday's proposal will be published in the Federal Register for public comment. The comment period will remain open for 60 days after publication. The SEC's decision to allow for only 60 days to comment is notable because in recent weeks the SEC has faced public criticism and comment letters regarding the short comment periods on numerous recent rule proposals.

Please contact Cadwalader if you have questions about the application of the proposed rules.

A Call to Arms: CFPB Encourages States to Use Federal Authorities to Bring Enforcement Actions

By **Rachel Rodman**
Partner | Global Litigation

By **Wesley Wintermyer**
Associate | White Collar Defense and Investigations

The Consumer Financial Protection Bureau ("CFPB") issued an interpretive rule on May 19, reiterating the authority that states have to pursue companies and individuals that violate federal consumer financial protection laws, including the Consumer Financial Protection Act of 2010 ("CFPA").

When Congress enacted the CFPA in 2010, it provided for concurrent enforcement by federal and state regulators. Congress viewed federal preemption of state enforcement efforts as one cause for the Great Recession, and it thus equipped states with express enforcement authority under the CFPA. The CFPB's new rule interpreting the CFPA is not subject to notice-and-comment rulemaking under the Administrative Procedures Act, and it will become effective upon publication in the Federal Register. The rule affirms that:

- **States are not limited by statutory limitations on the CFPB's enforcement authority.** The CFPA includes a long list of exemptions to the CFPB's authority, such as: merchants; retailers; accountants and tax preparers; attorneys engaged in the practice of law; persons regulated by the Securities and Exchange Commission; persons regulated by the Commodity Futures Trading Commission; and auto dealers. The rule interprets these exemptions as not applying to states or state regulatory entities because Congress applied these carve-outs only to the "Bureau" or "Director." Thus, according to the CFPB, states can use the CFPA to pursue enforcement actions "against a broader cross-section of companies and individuals" than even the CFPB itself.

- **States have authority to enforce the CFPA and other federal financial protection laws.** The CFPA authorizes states to bring civil actions against "covered persons" or "service providers" that violate: (1) the CFPA (*e.g.*, by engaging in unfair, deceptive, or abusive acts or practices); (2) any of the 18 enumerated consumer laws listed within the CFPA (*e.g.*, Equal Credit Opportunity Act, Fair Debt Collection Practices Act, Truth in Lending Act); or (3) any rule or order prescribed by the CFPB, such as consent orders. The interpretive rule notes that the CFPA requires that states consult with the CFPB before initiating any such action.

- **CFPB enforcement actions do not box out state enforcement actions.** Where the CFPB is pursuing enforcement, states can bring coordinated actions or separate actions to stop or remediate harm that is not addressed by the CFPB's action against the same entity. The CFPA allows such concurrent actions except in a few instances, such as for mortgage loan

> modification and foreclosure rescue services. The CFPB views concurrent state actions as “complementary enforcement activities” that serve to protect consumers at the state level.

The interpretive rule is meaningful more for its timing than its content. States have been empowered to bring civil actions under the CFPA since its passage. Thus, we view this rule as an express call to arms to states to bolster their enforcement efforts – particularly as to: (1) enforcement of Bureau consent orders; and (2) entities that are exempted from the CFPB’s authority.

CFTC Considers FTX's Democratized Clearing Proposal

By **Peter Y. Malyshev**
Partner | Financial Services

On May 25, 2022, the U.S. Commodity Futures Trading Commission ("CFTC") conducted a public hearing to consider a request from LedgerX, LLC, d.b.a. FTX US Derivatives ("FTX"), to amend its order of registration as a derivatives clearing organization ("DCO") to allow direct clearing of listed futures contracts on Bitcoin and Ethereum and other digital assets by retail participants. This is a dramatic departure from a traditional clearing model where retail participants can trade and clear futures only through professional intermediaries – registered and heavily-regulated futures commission merchants ("FCMs").

This proposal follows the trend of democratization and disintermediation in crypto and digital assets markets to allow broader participation of retail traders, in contrast to participation by the traditional professional traders and hedgers, such as farmers, refiners, and financial institutions.

FTX currently offers clearing of futures and options on cryptos and other digital assets for retail participants only on a fully collateralized basis, while the proposal, if approved by the CFTC, would also allow FTX to clear margined products on a non-intermediated basis. For margined contracts (in contrast to fully-collateralized ones), a DCO collects only a portion of collateral to cover the risks of possible losses, which increases the risk of default. Normally, these increased risks are absorbed by the intermediaries – the FCMs and DCO's clearing members, albeit at a certain cost for customers.

To cover for the increased risks in a disintermediated model, the proposal includes several innovative features, such as (1) instantaneous risk management (every 30 seconds) and marking-to-market of customer futures positions 24/7; (2) posting of margin to cover open positions (the pay-as-you-go feature); (3) partial auto-liquidation of positions if collateral on deposit falls below the maintenance margin level (the go-as-you-pay feature); (4) full-auto-liquidation of portfolios through backstop liquidity providers if the value of position drops further below a threshold; and (5) the funding of FTX guaranty fund as further security.

FTX's proposal raises fundamental questions of how U.S. derivatives market infrastructure should operate in the future, because, if approved, the disintermediated model of clearing will be used for futures on all other assets (such as energy, agriculture, interest rates, forex) and not only for cryptos. The CFTC has received numerous comments on the proposal. Regardless of how the CFTC will ultimately decide on the proposal, it is certain that the "retailification" and democratization of U.S. derivatives markets will continue.

Acting Comptroller Hsu Brings Crypto-Skepticism to Blockchain Summit

By **Daniel Meade**
Partner | Financial Regulation

By **Mercedes Kelley Tunstall**
Partner | Financial Regulation

This week, Acting Comptroller of the Currency Michael Hsu gave remarks to the DC Blockchain Summit titled "Crypto: A Call to Reset and Recalibrate."

By speaking at the Blockchain Summit, Mr. Hsu may have gone into the so-called belly of the beast to give his self-proclaimed crypto-skeptic message. Notwithstanding his skepticism, Mr. Hsu noted that he does see cryptocurrency's potential, but will continue along the OCC's "careful and cautious approach to crypto in order to ensure that the national banking system is safe, sound, and fair."

Mr. Hsu noted that the recent collapse of the TerraUSD stablecoin and the selloff seen in other crypto assets showed risks in the asset class, and he said it also showed that much of the growth in the crypto space is "indicative of the crypto economy's dependency on hype."

Mr. Hsu shared three "high-level observations from the perspective of a bank regulator."

First, he said that recent events "have revealed deep vulnerabilities in the crypto system." He noted three in particular:

- Cryptocurrency markets are highly fragmented and cryptocurrency exchanges are prone to hacks
- Contagion risks for cryptocurrency markets are just as real as other financial markets
- Custody and ownership rights are under-developed for the size, scope, and ambitions of the industry

Second, he pointed out that the OCC's "careful and cautious" approach has shown value in the recent market volatility, as "there has been no contagion from cryptocurrencies to traditional banking and finance."

Third, he observed that "hype is not harmless," and elaborated by saying that the hype of crypto and digital assets and the associated vulnerabilities "make the crypto space very dangerous for investors of modest means."

Mr. Hsu summarized his remarks by noting that the recent market volatility involving stablecoins (and cryptocurrencies more broadly) provides an opportunity "to reset and to recalibrate the problems the industry is trying to solve."

Meeting of G7 Finance Ministers and Central Bank Governors: Crypto-Asset Regulation

By **Michael Sholem**
Partner | Financial Regulation

The G7 Finance Ministers and Central Bank Governors recently met in Petersberg, Germany, from May 18 and 20. They were joined by the heads of the International Monetary Fund, World Bank Group, Organisation for Economic Cooperation and Development, and the Financial Stability Board ("FSB"). The Ukrainian Prime Minister and Finance Minister were also in attendance.

After the meeting on May 20, a joint communiqué was released on behalf of the G7 Finance Ministers and Central Bank Governors. A wide range of topics was discussed during the meeting, including: the continued economic support for Ukraine; macroeconomic stability; global health and the COVID-19 pandemic; digitalisation; climate and the environment; sustainability of the financial market; and international financial architecture.

The G7 reiterated their support for the FSB's role to oversee and address stability risks in the financial market arising from all forms of crypto-assets. Furthermore, they have welcomed the global cooperation to resolve current crypto-asset regulatory issues, particularly in the area of cross-border payments.

Given the recent developments and uncertainty in the crypto-asset market, the G7 are asking the FSB to coordinate with international standard-setters to rapidly develop and implement a consistent and comprehensive regulation of crypto-asset issuers and service providers. This is carried out with the goal of holding crypto-assets (including stablecoins) to the same standards as the rest of the financial system. Critically, the G7 have called for the implementation of the Financial Action Task Force "travel rule," with the implementation of stronger disclosure and regulatory reporting requirements.

In their joint communiqué, when discussing reserve assets backing stablecoins, the G7 "reaffirm that no global stablecoin project should begin operation until it adequately addresses relevant legal, regulatory and oversight requirements through appropriate design and by adhering to applicable standards."

Deposit Insurance Limits and Trusts and Mortgage Servicing

By **Mercedes Kelley Tunstall**
Partner | Financial Regulation

The FDIC released a "Small Entity Compliance Guide" that provides a summary of its final rule allowing for the "simplification of deposit insurance," which takes effect on April 1, 2024.

The Compliance Guide provides an overview of how the final rule, which will be published as 12 C.F.R. §330, affects the coverage rules for trusts (revocable and irrevocable), as well as for mortgage servicing accounts. In any case other than when an insured depository institution ("IDI") is the trustee, all trusts, regardless of their revocability status, will be subject to the same set of deposit insurance rules, and eligible beneficiaries will include natural persons, charitable organizations and non-profit entities. Going forward, all trusts are subject to the calculation that has applied to revocable trust accounts with five or fewer beneficiaries since 2008, which effectively allows for deposit insurance up to $1,250,000 for a single trust that has five or more beneficiaries, regardless of the allocation of funds to beneficiaries within the trust. If the trust has fewer than five beneficiaries, then the total amount of deposit insurance available is the standard maximum deposit insurance amount ("SMDIA"), which is currently $250,000, times the total number of beneficiaries, again, regardless of the allocation of funds to the beneficiaries within the trust. For mortgage servicing accounts, the amount of per-borrower coverage, up to the SMDIA, includes "any funds paid into the account to satisfy the principal and interest obligation of the mortgagors to the lender, regardless of the origin of the funds." This change provides consistent treatment for all mortgage servicing account balances held to satisfy the principal and interest obligations to a lender.

Depository institutions are not required to reach out to their depositors ahead of the changes in April 2024, but the Compliance Guide provides suggestions regarding how banks might consider identifying affected accounts nonetheless.

Cadwalader Receives 2022 IFLR Americas 'Team of the Year: Financial Services Regulatory' Award, and Lary Stromfeld Wins 'Outstanding Achievement Award' for 'Contribution to Regulatory Reform'

Cadwalader was named "Team of the Year" in the "Financial Services Regulatory" category, as part of the 2022 *IFLR* Americas Awards last week in New York. The *IFLR* noted the role Cadwalader's Financial Services Regulatory team played in helping to shape the use of crypto currencies in the wealth management industry, as well as its role in LIBOR transition.

In recognition of the team's market-leading LIBOR transition practice, Cadwalader Financial Services partner Lary Stromfeld was awarded with a prestigious "Outstanding Achievement Award" for his "Contribution to Regulatory Reform." Stromfeld leads Cadwalader's LIBOR Preparedness Team, whose work in recent years has included representing the U.S. Federal Reserve's Alternative Reference Rates Committee (ARRC) and a broad range of financial services clients on moving away from LIBOR.

IFLR says Stromfeld "has played a key role in one of the biggest issues facing the financial sector for most of the last decade: LIBOR transition," referencing his role in the passage of New York State legislation in 2021 that addressed legacy contracts. *IFLR* notes: "This marks a crucial step in streamlining and simplifying the transition process for the whole industry," while also assisting other states in governing their own transitions. *IFLR* also credits Stromfeld for his role in developing a similar legacy law at the federal level.

In December, Cadwalader won the 2021 *Financial Times* "North America Innovative Lawyers" award in the highly competitive category of "Creating new standards," in recognition of the firm's LIBOR transition practice.

Cadwalader's Financial Services group, which is co-chaired by James Frazier and Ivan Loncar, is a market-leading team whose attorneys are experienced in virtually all financial law-related statutory and regulatory requirements, including those governing broker-dealers, securities and futures exchanges, clearing corporations, banks, insurance, investment advisers, and funds and pension plans. The group is also focused on supporting clients in developing service areas, such as ESG, crypto and digital assets.