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Cabinet **News and Views**

Informed analysis for the financial services industry

Swirling Winds

June 2, 2022

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We've all seen The Weather Channel's videos of drenched reporters holding onto the sides of buildings or light poles to escape Mother Nature's wrath, with swirling winds and driving rain adding drama to the images.

So when JPMorgan CEO Jamie Dimon warned investors to "brace yourself" for an economic hurricane, we all took notice. While it is too early to tell whether Mr. Dimon will be an accurate weather prognosticator, it does seem like a good idea to at least check the storm supply checklist and stay focused on the clouds above or on the horizon.

It was important to see President Biden give a very visible vote of confidence to Fed chairman Powell earlier this week (see our write-up below), and we shall see in the coming weeks and months how this all shakes out – inflation, oil prices, Ukraine, supply chain challenges and so on.

For now, economic life goes on, and it was another busy week in Washington, in particular, with several significant developments.

Thank you for your continued interest in *Cabinet News and Views*. And, once again, we welcome your comments.

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

President Biden Reiterates Independence of the Fed at Meeting with FRB Chair Powell

By **Daniel Meade**
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Federal Reserve Board Chair Jay Powell had a meeting at the White House earlier this week with President Biden and Secretary of the Treasury Yellen to discuss inflation.

Prior to the meeting, President Biden issued a statement noting that, while taming inflation is a top priority of the Administration, the main tool to use was monetary policy. President Biden reiterated that monetary policy is the purview of the Federal Reserve, that the Federal Reserve's independence is important, and that he would continue to respect the Federal Reserve's independence.

President Biden stated that, "It starts with a simple proposition: Respect the Fed and respect the Fed's independence, which I have done and will continue to do." He went on to state that his job as President is to not only nominate "highly qualified individuals for that institution, but to give them the space they need to do their job. I'm not going to interfere with their critically important work."

No, Fancy Technology Does Not Excuse Compliance Obligations

By **Mercedes Kelley Tunstall**
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The Consumer Financial Protection Bureau ("CFPB") released a regulatory Circular providing guidance regarding the use of "complex algorithms" to assess whether a consumer should be extended credit. Often referred to as "black box" solutions, which may include artificial intelligence protocols, the CFPB has stated that full compliance with obligations is required, regardless of the technology used.

One of the challenges that "black box" technologies present is that the reasons for the results received are not provided and cannot be easily ascertained by humans. The CFPB is not forbidding the use of "black boxes" but is effectively mandating the use of so-called "explainable AI" procedures in association with black box solutions. "Explainable AI" basically means that a subsequent black box (or series of black boxes) is added onto the solution, which is trained specifically to identify the reasons the first black box reached its results. Thus, when a creditor uses a black box to assess whether to extend credit to a consumer, secondary black box programs can be utilized to provide the specific reasons that the consumer was not approved, which is required by the Equal Credit Opportunity Act to be identified on adverse action notices that are then provided to the consumer.

OFAC Settles with Puerto Rico-Based Bank over Apparent Sanctions Compliance Lapse

By **James A. Treanor**
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On May 27, OFAC announced a civil settlement with a Puerto Rico-based bank in connection with apparent violations of the Venezuela Sanctions Regulations. While the settlement amount of $255,938 is a fraction of the blockbuster fines paid by some banks in recent years, the case nonetheless serves as an important reminder that sanctions requirements vary from program to program, and compliance procedures must be tailored accordingly.

As described in OFAC's Enforcement Release, over the course of approximately 14 months from August 2019 through October 2020, the Puerto Rican bank processed 377 transactions totaling $853,126 on behalf of two sanctioned bank customers who were "low level employees" of the Government of Venezuela. One individual "worked in a clerical level position" in a Government of Venezuela Diplomatic Representation Office, while the other individual "was a customer service representative of Compañía Anónima Nacional Teléfonos de Venezuela (CANTV), a Venezuelan state-owned entity."

Notably, the two customers – who held a total of four personal accounts at the bank – were not sanctioned by virtue of having been named on OFAC's Specially Designated Nationals and Blocked Persons List (the "SDN List"). Nor were the transactions prohibited due to the customers' residence in a sanctioned country such as Cuba or Iran (Venezuela is not subject to such comprehensive territorial sanctions). Instead, the individuals were sanctioned due to the identity of their employer. In particular, Executive Order 13884 of August 5, 2019, requires the blocking of all property and interests in property of the "Government of Venezuela" – a term defined very broadly in the Order to include, among other things, "any person who has acted or purported to act directly or indirectly on behalf of" a Venezuelan governmental agency or instrumentality.

Documentation in the bank's possession identified the customers as employees of the Venezuelan government, but the bank nonetheless neglected to block their accounts for over a year. While the precise reasons for this delay are unclear, it appears that the link was not made between the customers' status as "Government of Venezuela" employees and the application of Venezuela-related sanctions. Indeed, the bank represented as part of the settlement with OFAC that since identifying and voluntarily self-reporting the apparent violations, it had created "more robust sanctions-related procedures and developed additional resources and guidance . . . including guidance on the [Venezuela Sanctions Regulations]." In consideration of this and other mitigating factors, including additional compliance enhancements and cooperation with OFAC's investigation, the bank's settlement payment of $255,938 reflects a 40% reduction off the applicable base civil monetary penalty of $426,563 (one-half of the transaction value).

For its part, OFAC reminded financial institutions of the agency's expectation that they "conduct due diligence on their own direct customers . . . to confirm that those customers are not persons whose property and interests in property are blocked." This case serves as a reminder that such diligence requires a nuanced understanding of how different sanctions programs operate, and that it is often not enough to rely on basic screening processes that merely screen for hits against the SDN and other sanctions lists.

CFPB Makes the Case for Credit Card Issuers to Provide Actual Payment Histories

By **Mercedes Kelley Tunstall**
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In a blog post, the Consumer Financial Protection Bureau ("CFPB") revealed that it had sent letters requesting information from credit card issuers as to the reasons why actual payment histories are often not being reported to credit bureaus.

To date, a combination of systems, technology and operational issues has typically precluded the provision of such information by credit card issuers, who report monthly on the status of credit card accounts. Under the Fair Credit Reporting Act, companies who have information about consumer credit use have the option to "furnish" that information to the credit bureaus. However, the CFPB has interpreted a failure of a creditor to report information to the credit bureaus to be potentially misleading (see Examination Procedures, FCRA, page 53). Accordingly, this inquiry by the CFPB appears to be setting the stage for the CFPB to conclude that a failure to provide actual payment histories to the credit bureaus is similarly potentially misleading. Although the CFPB's research on this topic from 2020 suggests that the inclusion of actual payment histories could cause consumer credit scores to rise by as much as 20 points, this level of granular detail could also be potentially problematic for credit-seekers.

Eighth Circuit Follows Second Circuit and Affirms Broad Safe Harbor Protections for Bank Customers


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In *Kelley v. Safe Harbor Managed Account 101, Ltd.*,[1] the Eighth Circuit Court of Appeals endorsed a broad view of parties protected from avoidance claims related to certain derivative and financial contracts ("QFCs"), including a securities contract (*e.g.*, purchase and sale of securities).

In a case arising from the Thomas Petters Ponzi scheme, the St. Louis-based appellate court found that (a) a note purchase agreement "fit plainly" within the statutory definition of a securities contract (*e.g.*, purchase and sale of a security),[2] and (b) the customer of a financial institution is a safe harbor-protected entity if the financial institution acts as a custodian for the customer.[3]

In its ruling, the Eighth Circuit becomes the first Circuit Court to endorse the Second Circuit Court of Appeals' view, espoused in its *Tribune* decision,[4] that bank customers are within the protections afforded parties to a safe harbor-protected transaction if the bank acts as agent or custodian for the customer.

The Bankruptcy Code provides broad protections to specified parties under QFCs, including nonavoidance of related transfers, including margin and settlement payments. *See*, *e.g.*, 11 U.S.C. § 546(e) (transfers related to securities contracts). Financial institutions (*e.g.*, banks) and financial participants (*e.g.*, entities conducting certain high-value transactions) are among the protected parties. The safe harbor provisions are broadly worded with the goal of protecting financial and securities markets from turmoil. Issues include what parties are protected in complex, multiparty transactions.

Over four years ago, in *Merit Management v. FTI Consulting*,[5] the Supreme Court unanimously held that (a) avoidance action protections do not extend to transfers in which banks or other financial institutions serve as intermediaries or "mere conduits" in multi-step securities transactions that are ultimately between two non-financial institutions and (b) the relevant transfer in a multistep transaction is the overarching transfer and not any component.

But *Merit*'s impact, thought by some commentators to narrow safe harbor protections, has been constrained, in part, because the justices declined to address a substantial gap in the analysis – could non-financial institutions qualify for safe harbor protections if they were customers of financial institutions?

In its *Tribune* decision, the Second Circuit marched through that gap, finding that customers of an intermediary bank acting as an agent and as a depository in connection with a leveraged buyout transaction met the definition of a financial institution and were protected from constructive fraud claims.[6]

In *Kelley*, the Eighth Circuit affirmed a lower court determination that a bank acted as a custodian, receiving and disbursing funds in connection with a note purchase agreement; consequently, the recipients of the transfers were safe harbor-protected entities.[7]

Comment

Case law examining the scope of safe harbor protections is not extensive. The statutory language is broad and generally construed in accordance with its plain meaning. QFCs in the influential Second Circuit enjoy the wide and deep safe harbor afforded by *Tribune* and its progeny. The Eighth Circuit's endorsement of the Second Circuit's approach likely affirms the continued vitality of broad application of safe harbor protections. The Supreme Court may not soon revisit these issues, as it denied a certiorari petition for review of the *Tribune* decision.[8]

[1] No. 20-3330, 2022 WL 1177748, at *1 (8th Cir. Apr. 21, 2022).

[2] *Id.* at *5; see 11 U.S.C. § 741(7)(A)(i).

[3] *Kelley*, 2022 WL 1177748, at *4; *see* 11 U.S.C. § 101(22)(A).

[4] *In re Trib. Co. Fraudulent Conveyance Litig.*, 946 F.3d 66 (2d Cir. 2019).

[5] 138 S. Ct. 883, 892-93 (2018).

[6] *Id.* at 79-80.

[7] *Kelley*, 2022 WL 1177748, at *4. The Eighth Circuit remanded on the issue whether the payments were made in connection with a securities contract. The District Court erroneously construed the payments transfer trail. However, the appellate court noted that 546(e) sets a low bar for the required relationship between the securities contract and the transfer sought to be avoided. We will monitor the remand proceedings.

[8] *Deutsche Bank Tr. Co. v. Robert R. McCormick Found.*, 141 S. Ct. 728 (2020); *Deutsche Bank Tr. Co. Americas v. Robert R. McCormick Found.*, 141 S. Ct. 2552 (2021).

In Depth: Fifth Circuit Bombshell on SEC ALJs Raises Questions about DEA ALJs


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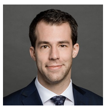
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In a decision that likely will reverberate throughout the administrative state, a three-judge panel of the United States Court of Appeals for the Fifth Circuit recently held in *Jarkesy v. Securities and Exchange Commission* that the Securities and Exchange Commission's use of its in-house administrative law judges ("ALJs") to adjudicate securities fraud actions seeking the imposition of monetary penalties was unconstitutional for three independent reasons. While the first two reasons the Fifth Circuit discussed are inapplicable to the Drug Enforcement Administration administrative hearing process, the third reason is directly relevant. Specifically, the court found that the statutory removal protections afforded to the SEC's ALJs, providing that ALJs cannot be removed from office without a Merit Systems Protection Board hearing, violated the Take Care Clause of Article II of the Constitution by insulating SEC tribunals from Presidential control. Because DEA administrative judges enjoy the same statutory removal protections as those the Fifth Circuit panel found unconstitutional, *Jarkesy* might serve to invalidate the DEA's judicial hearing processes.

Read our Clients & Friends Memo here.