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Cabinet **News and Views**

Informed analysis for the financial services industry

Everybody's Talking

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Be sure to set a reminder on your device of choice: June 23 at 4:30 p.m., EDT. That's when the Federal Reserve will announce the findings of its annual stress tests of major U.S. banking institutions. With the uncertainty in markets today – as exemplified by $5 gasoline and rising consumer prices for groceries and other necessities in the U.S. – some of the Fed's stress hypotheticals might read more like reality. We shall see.

In the meantime, we have continued activity in the digital assets/crypto space to examine, in the U.S. as well as in the UK and Europe. We take a closer look in this week's issue.

What's on your mind? We'd love to hear from you.

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

United States Courts Possess Personal Jurisdiction over Foreign Banks in Ongoing LIBOR Case

By **Joel Mitnick**
Partner | Antitrust

The United States Supreme Court denied a petition for *certiorari* filed by six foreign banks that argued that U.S. courts lacked personal jurisdiction over them. (*Lloyd's Banking Group. PLC v. Schwab Short-Term Bond Market Fund*, *cert. denied* June 21, 2022.)

By way of background, the appeal to the Supreme Court arose out of the sprawling set of litigations brought against numerous banks to recover damages from alleged manipulation of the London Interbank Offered Rate ("LIBOR"). Specifically, the appeal here was brought by a group of plaintiffs affiliated with the Charles Schwab Corporation (the "Schwab" plaintiffs). The Schwab plaintiffs' complaint had alleged claims for violations of state law and federal securities law. Unlike some other LIBOR plaintiffs, the Schwab plaintiffs did not bring claims alleging violations of antitrust law. The United States Court of Appeal for the Second Circuit held in 2016 that the Schwab plaintiffs' allegations had been adequately pled to state a claim.

In a subsequent decision in 2018, the Second Circuit held that the District Court had possessed personal jurisdiction over the defendant banks, including six of the defendants that were not alleged to have sold financial instruments to Schwab at all (the "Non-Seller Defendants"). The Court adopted the "conspiracy" test of jurisdiction as articulated by the Fourth Circuit. Under that test, a complaint would establish the basis for personal jurisdiction if it alleged that: (1) a conspiracy existed; (2) the defendant participated in the conspiracy; and (3) a co-conspirator's overt acts in furtherance of the conspiracy had sufficient contacts with a state to subject that co-conspirator to the jurisdiction of that state. The Court further found that the Schwab plaintiffs' complaint was adequate to assert jurisdiction under that test. The Non-Seller Defendants filed an appeal to the Supreme Court to resolve a conflict among the circuits as well as among various state supreme courts as to the viability of the doctrine of "conspiracy jurisdiction." It was in that appeal that the Supreme Court denied *certiorari*.

Chief Justice Roberts and Justices Kagan and Gorsuch, without explanation, did not participate in the Court's consideration of the appeal.

Compliance in Commodity Derivatives Markets

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

On June 21 and 22, lawyers, compliance professionals and commodity traders convened in Houston to discuss current compliance matters and the state of commodity markets, with the focus on energy commodities as well as carbon and environmental products. The following themes emerged from the panels with speakers from private industry, consultancies and regulators, such as the Commodity Futures Trading Commission ("CFTC"), the Federal Energy Regulatory Commission ("FERC") and the National Futures Association ("NFA").

1. Enforcement

In 2021 and 2022, the industry experienced a record number of enforcement actions from the CFTC and the NFA, with record settlement amounts. Enforcement focused on fraud and manipulation, Foreign Corrupt Practices Act ("FCPA")-like enforcement and misappropriation of material non-public information in commodity markets, failure to register in appropriate capacity and substantive regulatory violations, such as reporting. Importantly, in addition to enforcement from traditional market regulators, the Department of Justice ("DOJ") has been much more actively involved in commodity derivatives market-related enforcement traditionally relegated to the CFTC, FERC, NFA and the Securities and Exchange Commission ("SEC").

2. Commodity Digital Assets

Application of financial engineering is rapidly spreading beyond cryptocurrencies to physical commodity markets. Blockchain is increasingly used to track commodity transactions and the non-fungible tokens ("NFTs"), and other smart contracts are helping end users to trade commodities and ensure a more efficient and accurate delivery. These applications are at the nexus of the SEC's, CFTC's and FERC's jurisdictional reach, with a significant regularity overlap. DOJ is likely to continue being actively involved in policing these markets under its wire fraud authorities, while market regulators clarify their regulatory reach.

3. ESG and Environmental Commodities

Environmental, social and governance ("ESG") initiatives in commodity markets are at the forefront of commodity trading strategies – with the emphasis on climate change mitigation and the trading of environmental commodities. Both compliance and voluntary markets in carbon mitigation are rapidly developing under local state authorities (such as CCA and RGGI) as well as commonly accepted voluntary industry standards and registries (such as ACR, CAR and Verra). The CFTC recently published a request for information ("RFI") to assess the scope of the markets and its likely jurisdictional reach.

4. Market Volatility

The war in Ukraine and the unprecedented global sanctions imposed on Russia, which together with Ukraine are the world's largest suppliers of many critical commodities, such as natural gas, crude oil, agricultural commodities and fertilizers, have severely strained commodity markets and are likely to even further disrupt commodity and commodity derivatives markets. Market volatility is causing drastically higher and more frequent margin calls, which increase the costs of trading; as a result, many commodity contracts have moved from the exchanges to the OTC markets. These trends call for enhanced compliance supervision on both the exchange and clearing side of the markets, and the end user and market intermediary side.

5. Enhanced Compliance

Discussions during the FIA conference demonstrated that the category of unregulated commodity trader no longer exists, and there are either registered or unregistered market participants – but all are regulated and all are subject to potential CFTC, SEC, FERC, NFA or DOJ enforcement. This calls for greater assessment of operational, regularity and compliance risks and a design of more comprehensive compliance policies and procedures as well as business continuity and disaster recovery procedures.

FDIC Amends Deposit Insurance Fund Restoration Plan and Proposes Increase in Assessment Rates

By **Daniel Meade**
Partner | Financial Regulation

On June 21, the Federal Deposit Insurance Corporation ("FDIC") Board voted to amend the Deposit Insurance Fund ("DIF") restoration plan originally adopted in September 2020. As part of that amended restoration plan, the FDIC issued a Notice of Proposed Rulemaking ("NPR") to propose a universal increase in initial base deposit insurance rates of 2 basis points.

Comments on the NPR are due August 20, 2022. Among the questions the NPR poses is whether the FDIC should adopt an alternative plan with a one-time special assessment of 4.5 basis points. Industry is likely to prefer the more gradual approach as proposed, but some may comment that just a 1 basis point increase could be sufficient.

The Federal Deposit Insurance Act ("FDIA") sets a statutory minimum for the designated reserve ratio ("DRR"), currently designated by the FDIC as the DIF to average aggregate insured deposits of 1.35%. Because of the extraordinary growth in deposits that occurred in the first two quarters of 2020 for various reasons associated with the coronavirus pandemic, the DRR dropped to 1.30%, triggering the need for a restoration plan under the FDI Act. As of March 31, 2022, the DRR stood at 1.27%.

The FDIC noted that the proposed increase in deposit insurance assessment rates should increase the likelihood that the DIF will meet its minimum ratio of 1.35% prior to the statutorily mandated date of September 2028. Notwithstanding the statutory minimum of 1.35% for the DRR, the FDIC has stated that its long-term goal is to maintain a 2% DRR.

In Depth: Dissecting the Real Estate, Structured Finance and Financial Services Industries' Comment Letters on the SEC's Climate Disclosure Proposal


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


By **Melissa Farber**
Associate | Capital Markets


By **Daniel Meade**
Partner | Financial Regulation

By the time the comment period closed on June 17, 2022, the SEC had received thousands of comment letters from the public in response to the SEC's proposed climate disclosure rules (the "Proposal"), which is perhaps the most ambitious proposed rulemaking by the agency in at least two decades. Nestled among countless comment letters written by individual members of the public were comments submitted by trade associations representing the commercial real estate, structured finance and banking industries. This article summarizes notable highlights from letters put forward by some of the trade associations representing parts of the financial services industry, namely the Commercial Real Estate Finance Council ("CREFC"), the Bank Policy Institute ("BPI"), the Structured Finance Association ("SFA"), the American Bankers Association ("ABA") and a letter put forward jointly by a group of trade organizations representing real estate interests.

Commercial Real Estate Finance Council

CREFC generally agreed that climate disclosure rules could be beneficial, noting that "combatting climate change and laying the groundwork for a transition to net-zero emissions in a meaningful way requires a cooperative partnership between government and the private sector." CREFC advocated that the commercial real estate finance industry should be allowed to develop its own best practices that are tailored to its market participants, as existing industry efforts are "continuing with positive effect." CREFC described work it has already undertaken toward this goal, noting that it has already "analyzed what climate-related information is obtainable, relevant, and meaningful for borrowers, lenders, servicers, issuers, and investors and has developed preliminary climate-related data fields that can be incorporated into the existing Investor Reporting Package," which is "specifically tailored to the needs of CMBS investors."

CREFC expressed concerns with the Proposal's Scope 3 greenhouse gas emissions ("GHG") disclosure requirements and requested that the SEC provide more clarity and guidance regarding the extent the Proposal would apply to CREFC members, because of uncertainty regarding the extent to which Scope 3 disclosures apply to a lender's financed commercial real estate. The letter discussed foreseeable challenges to the potential disclosure requirements, warning that "obtaining the data necessary to calculate directly any of the categories of Scope 3 GHG emissions for the commercial real estate finance industry is at best difficult and at worst

impossible." Moreover, agreements regularly used in the commercial real estate finance industry, such as tenant leases, mortgage loan documents and servicing agreements, do not currently provide for a right to obtain the necessary GHG emissions data, and such rights would take substantial time to become accepted in the market.

Finally, CREFC drew the SEC's attention to the fact that many commercial real estate finance participants do not directly own real estate but rather own loans, bonds or debt instruments secured by real estate, including preferred equity. Under such commercial real estate transactions, participants are able to exercise remedies that result in ownership or control over the underlying real estate. CREFC warned that the ability to timely exercise remedies against the underlying real estate may be delayed by concerns and risks resulting from immediate reporting obligations imposed under the Proposal. As CREFC described, "timely exercise of remedies can be critical in preserving the value of commercial real estate." Thus, CREFC asked that the SEC adopt a two-year grace period for Scope 1 and 2 GHG emissions reporting in connection with any commercial real estate property acquired through a foreclosure or other comparable remedy.

Joint Real Estate Trade Organizations

A letter was proffered jointly by a group of trade associations on behalf of real estate owners, banks, operators, investors, lenders, builders, developers, hospitality/resorts, agents and service providers (specifically, CRE Finance Council, Housing Policy Council, Institute for Portfolio Alternatives, Mortgage Bankers Association, NAIOP, the Commercial Real Estate Development Association, Nareit, National Apartment Association, National Association of Home Builders of the United States, National Association of REALTORS, NMHC, The Real Estate Roundtable). Despite the organizations' general endorsement of the SEC's efforts to provide investors with climate-related disclosures, the organizations expressed genuine concern with certain aspects of the Proposal, which the letter described "would be difficult or impossible for many registrants to currently implement." The letter opined that the December 2022 adoption date hinted at in the Proposal is too aggressive and could ultimately "short circuit" the progress being made to develop climate-related disclosures that are specific to the real estate sector.

The joint letter also expressed concerns with the Proposal's Scope 3 emission disclosures, "some of which are difficult to clearly link to certain real estate activities" and suggested that such disclosures "should not be mandatory unless part of a clearly articulated emissions reduction plan." The letter recommends that the Proposal's current safe harbor for Scope 3 emissions should be strengthened, as it is "confusingly worded." The letter recommended that the "safe harbor should apply unless the registrant has actual knowledge that the third-party information it is using in connection with its Scope 3 disclosures is erroneous."

Bank Policy Institute

BPI's letter acknowledged BPI's support of consistent and reliable climate-related disclosure. However, BPI warned against overly detailed disclosure requirements. Specifically, BPI argued that the Regulation S-X financial reporting requirements "are largely inoperable, will not result in useful disclosure for investors, and should be removed or, at a minimum, significantly narrowed." In BPI's view, compliance with the Proposal which would require separate accounting for climate-related

factors would be "very difficult to impossible." BPI suggested that material climate-related financial impact disclosures would be more effective through qualitative nonfinancial disclosures and provided in the Management Discussion and Analysis section of 10-K filings. BPI noted that "banks are not able to look backwards to disaggregate the financial impact of any specific risk factor, and disaggregating climate-related risk would be even more challenging given the nascent and evolving state of climate risk management capabilities and the challenges around modeling a type of risk that is inherently uncertain."

The BPI letter also indicated that the Proposal's Scope 3 emissions disclosure requirements are overly broad and should be narrowed. Specifically, BPI cited significant problems with Scope 3 emissions information, including data quality, availability, organizational barriers and the evolving nature of calculation methodologies. In other words, current Scope 3 emissions disclosures would be largely subjective and would not provide data on which an investor could reasonably rely. BPI suggested that the SEC should promote Scope 3 emissions disclosures outside of SEC reporting documents or, alternatively, significantly narrow the Proposal's drafted requirements.

Structured Finance Association

The SFA, which has been proactively developing an ESG disclosure and reporting framework for the securitization market, also sent in a letter in response to the Proposal. Although the Proposal carved out asset-backed securities ("ABS"), it put forth several questions aimed at gauging how best to draft a regulation similar to the Proposal to cover asset-backed securities. The SFA's response indicated that any new regulation intended to cover ABS would be somewhat premature, and cautioned that the overly prescriptive reporting requirements of the Proposal, if applied to ABS, could impede public issuance of ABS and, in turn, disrupt a vital source of funding in ABS markets. Rather, the SFA favored a "smooth implementation" that allows ample time for the industry to digest and adopt proposed changes. Specifically, the SFA advised that "a principles-based approach to climate-related disclosures, combined with targeted asset-class specific metrics, might be an appropriate approach to ABS climate-related disclosure."

The SFA suggested that any future climate disclosure regulation covering ABS include safe harbors, which would add a level of protection and incentivize issuers to provide investors with material information relating to climate change. Specifically, the SFA recommended that any GHG emission disclosure requirement "contain a safe harbor that provides that underwriters and other persons who are not experts be subject to the same standard of liability for GHG emissions data as they would for expertised data under Section 11(b)(3)(C) of the Securities Act, and that such persons be deemed not to have 'scienter' under Section 10(b) of the Exchange Act if they had no reasonable ground to believe and did not believe that the relevant statement was untrue or misleading."

American Bankers Association

The ABA argued that the Proposal goes "far beyond the SEC's mandate to protect investors." The ABA highlighted certain concerns, including the broad nature of the Proposal, reasoning that "climate-related disclosure requirements should be limited to companies where there is a substantial likelihood that a reasonable investor would consider climate-related factors important when determining

whether to buy or sell the company's securities, or how to vote on company proposals." As such, the ABA recommended that the Supreme Court's "reasonable investor" standard should be applied to the Proposal.

The ABA discussed the "high costs of compliance and uncertain usefulness of GHG emissions estimates." The ABA suggested that Scope 3 financed emissions disclosure should be limited to publicly announced climate-related targets, as such emissions "are often poor and confusing indicators of transition risk due to unavoidable variances in data availability and methodology, as well as inherent differences in risk profiles to other Scope 3 emissions and between financial products." The letter also noted that the SEC should better coordinate with the banking regulators and other federal financial regulators. The ABA also observed that the Proposal "suggests that the SEC's goal is to use the reporting of emissions to discourage lending as a way to allocate capital away from certain industries," which is "wholly inappropriate" and "not within the SEC's authority."

Conclusion

A few overarching themes appear throughout the aforementioned letters sent in response to the Proposal. First, the Proposal's current "one size fits all" approach ignores industry-specific considerations. Next, the practical application of the Proposal would lead to ambiguous and subjective reporting metrics. Finally, the Proposal's year-end implementation timeframe is overly ambitious and does not allow industry participants ample opportunity to develop and adopt effective disclosure protocols.

Based on the general market response, we believe that it may take the SEC some time before either issuing a revised proposal or a final rule. On the other hand, the SEC may be eager to finalize the rule before the midterm elections or before the calendar year ends. In addition to the industry comments noted above, over 100 Republican Members of the House of Representatives signed on to a letter criticizing the Proposal and calling for it to be rescinded. In any case, we expect the final rule to face court challenges over whether the SEC has the authority to issue the regulation or whether it properly considered the Proposal's economic costs to registrants and benefits to investors. In sum, despite the general support in favor of consistent and reliable climate-related disclosures, industry comment letters in response to the Proposal expressed concerns that were shared across the real estate finance and banking industries regarding the breadth of the Proposal.

CRT Webinar: Part One Replay and Part Two Registration

In case you missed yesterday's first installment of our Capital Relief Trades webinar series, titled "CRT Overview and Regulatory Capital Basics," you can access a replay here.

The second installment is scheduled for June 29 from 1:00 p.m. to 2:00 p.m. Titled "Unpacking Regulation Q: CRT Structuring," the webinar – led by partners Jed Miller, Daniel Meade and Ivan Loncar – will cover:

- What types of risk-weighted assets can benefit from a capital relief trade?
- What terms must a capital relief trade have in order to offer capital relief?
- What terms must a capital relief trade not have?
- How should a bank invest proceeds from the issuance of credit-linked notes?

Register here.
