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Cabinet News and Views

Informed analysis for the financial services industry

A Meaningful Fourth

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In This Issue ...

It's never too hard to tell when a big holiday is upon us.

The traffic heading into Washington, DC today was moving at a steady pace – a stark difference from the normal rush-hour gridlock of cars heading to the capital from Maryland and Northern Virginia.

But while thoughts of barbecues, beaches and fireworks may be on a lot of minds, there is no holiday at the U.S. regulatory agencies, where some serious work is being done. With so much in the news in Washington over the past couple of weeks, the OCC's Semiannual Risk Perspective may have flown under the radar a bit. But there was some important news in that area, as well as some announcements this week following the Fed's stress test, and we take a closer look.

Over in the UK, no one is taking a holiday from ESG, and we examine important news from the European Union's European Securities and Market Authority and the UK's Financial Conduct Authority. We also explain a just-announced FCA consultation on the winding down of synthetic sterling LIBOR and the future of US Dollar LIBOR.

For our readers in the U.S., we wish you an enjoyable and meaningful Fourth of July weekend.

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

Federal Reserve Releases Results of Stress Tests and Large Bank Holding Companies Follow Up with Their Stress Capital Buffer Requirements

By **Daniel Meade**
Partner | Financial Regulation

On June 23, the Federal Reserve Board issued the aggregate and individual results of the supervisory stress test (also known as the Dodd-Frank Act Stress Test or DFAST, as these tests are required by Section 165 of the Dodd-Frank Act), which assesses whether banks are sufficiently capitalized to absorb losses during a severe recession.

The Federal Reserve concluded that the 34 large banks that participated in the 2022 stress tests "have sufficient capital to absorb more than $600 billion in losses and continue lending to households and businesses under stressful conditions. In large part, this is due to the substantial buildup of capital since the 2007–09 financial crisis."

Following the DFAST results last week, many banks released their stress capital buffer ("SCB") requirements under the Comprehensive Capital Analysis and Review ("CCAR") on June 27 in various securities filings. The Federal Reserve is likely to publish all applicable banking organizations' SCBs in August. The SCB is driven by the DFAST results and is calculated by adding the maximum decline in each banking organization's common equity tier 1 ("CET1") ratio under the DFAST's severely adverse scenario plus four quarters of planned dividends. The minimum SCB is 2.5%. This is added to the 4.5% capital regulation minimum and any G-SIB surcharge or countercyclical capital buffer in place to show the total CET1 required.

Three banking organizations – Bank of America (SCB increase from 2.5% to approximately 3.5%), Citigroup (SCB increase from 3.0% to 4.0%), and JPMorgan Chase (SCB increase from 3.2% to 4.0%) – have announced the need to increase their stress capital buffers after the stress test results. Other institutions that don't have the need to increase their SCB could be likely to increase dividends or other capital distributions.

OCC Issues Its Semiannual Risk Perspective

By **Daniel Meade**
Partner | Financial Regulation

The Office of the Comptroller of the Currency ("OCC") issued its Semiannual Risk Perspective for Spring 2022 on June 23. This was the same day the Federal Reserve released the results of its stress test for large bank holding companies, so the OCC's Risk Perspective may have flown beneath the radar.

The OCC highlighted operational, compliance, interest rate, and credit risks among the key risks. The OCC's stated highlights from the report include:

- Bank financial performance faces challenges from inflation, a rising interest rate environment, and other implications related to the pandemic and geopolitical events.
- Operational risk is elevated as banks respond to an evolving and increasingly complex operating environment. Cyber risk remains elevated.
- Compliance risk is heightened as banks navigate the current operational environment, regulatory changes, and policy initiatives.
- Credit risk remains moderate as banks face some areas of weakness and potential longer-term implications related to the pandemic, inflation, and direct and indirect impacts of the war in Ukraine.
- Across key risk areas, banks are experiencing challenges retaining and replacing staff with specialized experience due to increasing turnover. During this period of increasing volatility, these staffing challenges present increased risk.
- The report also highlights an OCC initiative to act on climate-related financial risks to the federal banking system.

Of note, the OCC mentioned the challenges banks face with staffing in both the operational and compliance risk sections of the report. With regard to compliance risk, the report stated: "[t]he OCC has observed an increase in the competition for compliance subject matter experts, at both the bank management and staff levels."

ESMA Overview of the Market for ESG Ratings Providers in the EU and FCA Feedback on ESG Integration in UK Capital Markets

By **Michael Sholem**
Partner | Financial Regulation

Here is a summary of ESG announcements from the European Union's European Securities and Markets Authority ("ESMA") and the Financial Conduct Authority ("FCA").

European Union

On June 27, the European Securities and Markets Authority ("ESMA") published a letter it sent to the European Commission ("EC") on June 24 on the outcome of ESMA's call for evidence on the market characteristics of environmental, social and governance ("ESG") ratings and data providers operating within the European Union ("EU"). ESMA launched its call for evidence in February 2022, and it received 154 responses.

ESMA concludes that the feedback indicates the market for ESG ratings and data providers is an "immature but growing market" that has "seen the emergence of a small number of large non-EU headquartered providers" and that the market resembles that which currently exists for credit ratings. The letter also states that there are currently 59 active ESG ratings providers operating in the EU.

ESMA's findings include the following:

- The current structure of providers in the market is divided between a small number of very large non-EU entities on the one hand and a large number of much smaller EU entities on the other. As a generalization, the EU entities providing ESG ratings can be characterized as small or medium-sized enterprises.

- The majority of users of ESG ratings typically source these products from multiple providers simultaneously. As mentioned above, there are a small number of large ESG ratings providers, and the majority of ESG ratings users utilize their services. This suggests a not insignificant degree of concentration in the market.

- Respondents to the call for evidence identified a lack of coverage on industry, type of entity and granularity of data as having a "fundamental impact" of the usability and relevance of ESG ratings.

- Furthermore, respondents highlighted concerns with the current system of assessment of covered entities and their interaction with ESG ratings providers. Shortcomings highlighted in these interactions included the level of transparency as to the basis for the rating, the timing of feedback or the correction of errors.

ESMA has stated that it will continue to support the EC in its assessment of the need for introducing "regulatory safeguards for ESG ratings." It seems likely, based on the direction of travel, that providers of ESG ratings used in the EU will, in the near future, be brought within the scope of the EU financial regulation.

United Kingdom

On June 29, the Financial Conduct Authority ("FCA") announced the publication of its consultation feedback on ESG integration in UK capital markets. Furthermore, the FCA set out its policy response and "potential next steps." On the same day, the FCA published its Primary Market Bulletin newsletter, which further elaborated on the FCA's response to feedback and gave some clarity on the regulator's expectations of issuers of ESG-labelled debt instruments.

FCA Consultation on the Winding Down of Synthetic Sterling LIBOR and the Future of US Dollar LIBOR

By **Michael Sholem**
Partner | Financial Regulation

Earlier today the Financial Conduct Authority ("FCA") announced a consultation seeking comments on the winding down of one-, three- and six-month synthetic sterling LIBOR settings and on the future of the remaining US dollar ("USD") LIBOR settings.

Background

On December 31, 2021, publication of 24 LIBOR settings ended. For one-, three- and six-month sterling and Japanese yen LIBOR settings, the FCA required the administrator of LIBOR to continue publication on a synthetic (and unrepresentative) basis from the end of 2021. Under revised regulatory rules in the UK, publication of a synthetic rate can only be compelled to be published by the FCA for up to one year at a time for a maximum period of ten years. This was to give the holders of certain legacy contracts more time to complete transition.

Meanwhile, the FCA also permitted five US dollar LIBOR settings to continue to be calculated based on panel bank submissions until the end of June 2023.

Consultation

The FCA is seeking views on the following:

- progress by market participants towards completing transition away from one-, three- and six-month sterling LIBOR settings;
- ceasing the requirement to continue publication of the one- and six-month synthetic sterling LIBOR settings at the end of March 2023 and when it will be possible for the three-month synthetic sterling LIBOR setting to cease;
- the size and nature of remaining exposure to USD LIBOR where transition is not already provided for either by contract or legislation;
- the plans of market participants to transition remaining USD LIBOR exposures before the end of June 2023; and
- challenges or issues that might result from the publication of any USD LIBOR settings on a synthetic basis.

The deadline to submit comments in response to the consultation is August 24, 2022.

Inadvertent FCM Sanctioned by CFTC

By Peter Y. Malyshev
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On June 24, the Commodity Futures Trading Commission ("CFTC") sanctioned Starberry Limited, a Cyprus entity, for operating in the U.S. as an unregistered futures commission merchant ("FCM") and ordered it to pay $1.3 million in penalties. Starberry opened a proprietary account in the U.S. with a registered U.S. FCM and conducted 12,500 NYMEX WTI futures trades, generating $86 million in profits for its foreign customer while collecting $1.3 million in commissions and fees.

This is one in a series of recent CFTC enforcement actions demonstrating CFTC's focus on three typical fact scenarios involving unregistered FCMs:

(1) Acting as a foreign broker and failing to meet the requirements of Sec. 3.10(c)(2) of CFTC regulations by operating its own proprietary futures trading account in the U.S., while using this account not for its own proprietary trading but for its customer's trading and collecting margin to facilitate this trading (Starberry Limited);

(2) Acting as a de facto broker for U.S. customers through proprietary accounts at registered FCMs to execute futures contracts not for its own book (as required for proprietary accounts) but instead for its customers with separate margined accounts to record the off-exchange futures contracts (Upstream Energy in 2019 and Davisco Foods in 2017); and

(3) Acting as an unregistered broker with respect to commodity derivatives contracts (typically on digital assets) for retail participants (*i.e.*, entities that do not qualify as eligible contract participants, as defined in Sec. 1a(18) of the Commodity Exchange Act of 1936) (First Global Credit in 2019 and 14 cases in 2021).

These cases, together with CFTC enforcement actions involving unregistered commodity trading advisers ("CTAs"), indicate that the line between activities that do not require registration is very easily crossed into the scope of activities that require a registration or where an exemption from registration should be sought.

Capital Relief Trades Webinar Series, Part 3 on July 13

Cadwalader's financial services team will host the third part of its four-part series focused on capital relief trades on July 13. Part 3, titled "U.S. Legal and Regulatory Considerations" and led by partners Jed Miller, Daniel Meade and Ivan Loncar, will look at: Securities Law (Disclosure); Risk Retention; Tax, Swap Regulation; Commodity Pool; Insurance Regulation; Volcker Rule; Regulation W; and the Banking Holding Company Act.

You may register here for the July 13 (1-2 p.m.) webinar.

You may also view replays of Parts 1 ("CRT Overview and Regulatory Capital Basics") and 2 ("Unpacking Regulation Q") of the webinar series.