CADWALADER

# Legacy LIBOR

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## In This Issue ...

Just a couple of hours before our colleague Sophie Cuthbertson was scheduled to participate earlier this week in the LIBOR panel at SFVegas, the biggest structured finance conference in the U.S., the Federal Reserve issued a notice of proposed rulemaking – we all know it as an NPR – that provided guidance on identifying SOFR rates related to legacy contracts. With her deep knowledge of LIBOR and some last-minute cramming on the new Fed guidance that would have made her law professors proud, Sophie was able to incorporate some of this new thinking into her panel presentation.

While the June 30, 2023 end of LIBOR as we know it is no surprise, the regulators still have some work to do here, and so announcements like Tuesday's, even though anticipated in the industry, did create a bit of a scramble. We will continue to provide updates and guidance in the weeks and months to come.

We also encourage you to read our "Cadwalader Corner Q&A" with Prof. Pete Hahn, highly respected in the financial services community in Europe as a former regulator, banker and academic at The London Institute of Banking & Finance. In particular, take a look at Prof. Hahn's views on fintech and cryptocurrencies.

As always, we welcome your thoughts on this week's issue of *Cabinet News and Views* and other timely topics. Just write to us here.

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

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## Federal Reserve Issues Proposed Rules under LIBOR Act

By **Lary Stromfeld**
Partner | Financial Regulation

On July 19, the Federal Reserve issued a notice of proposed rulemaking ("NPR") that would implement the Federal LIBOR Act. The NPR focuses primarily on identifying the particular version of SOFR that will apply to legacy contracts covered by the Act. For contracts that reference 1-, 3-, 6- or 12-month LIBOR, the NPR would apply the following SOFR-based rates plus a spread adjustment (as specified in the Act):

- For most contracts and securities, Term SOFR rate with a comparable tenor;
- For derivatives, the SOFR rate used in the ISDA protocol (30-day compounded SOFR in arrears);
- For contracts and securities issued by the GSEs (Freddie, Fannie), 30-day average SOFR; and
- For consumer contracts, Term SOFR but the spread adjustment would be implemented over a one-year period starting with the end of LIBOR.

The NPR also requests comment on "synthetic" LIBOR. The UK's Financial Conduct Authority has indicated that it may direct the LIBOR administrator to publish a "synthetic" version of USD LIBOR after June 30, 2023 (which would primarily be designed to assist non-U.S. law contracts that reference USD LIBOR and that are not covered by the Act). If "synthetic" LIBOR were published, it would no longer be a "representative" rate, but it could arguably be considered to be "available" under the language of legacy contracts that do not include a "pre-cessation trigger" (*i.e.*, a trigger to replace LIBOR when LIBOR is no longer representative). The Federal Reserve stated that it believes that it is consistent with the purpose of the Act for those contracts to fall back to their replacement rate even if LIBOR continues to be published in its synthetic form. It is requesting comment on whether, for clarity, the final rule should allow a determining person to replace LIBOR with the benchmark specified in the contract, even in the event a nonrepresentative rate called "LIBOR" in the form of synthetic LIBOR continues to be published on or after the LIBOR replacement date.

The proposed rulemaking also addresses other issues of importance to the market:

- Many legacy contracts (especially in the consumer space) reset their interest rate by "looking back" to the LIBOR rate in effect at an earlier date (*e.g.*, 45 days). The proposed rule clarifies that if the reset occurs after the LIBOR Replacement Date (*i.e.*, June 30, 2023) but looks back to a date occurring *before* the LIBOR Replacement Date (when LIBOR was still available), then the reset would be based on LIBOR (until a reset that looks back to a date occurring *after* the LIBOR Replacement Date).

- In general, the Act does not apply to legacy LIBOR contracts that have fallbacks to specific non-LIBOR rates (such as Fed Funds or Prime). However, the NPR would clarify that a determining person may choose the SOFR-based rate identified by the Fed.

Finally, the transition from LIBOR to SOFR-based rates will require some technical changes to legacy LIBOR contracts to administer the new rate (known as "Benchmark Replacement Conforming Changes"). The Act contemplates that Fed rule-making may define the scope of such changes that become a part of the legacy contract by operation of the Act. Changes to non-consumer contracts are also permitted if required in the reasonable judgment of the person calculating payments under the legacy contract. However, the Fed declined to recommend any such Benchmark Replacement Conforming Changes at this time, but specifically asked for comment on this issue.

Comments on the proposal are due 30 days after publication in the Federal Register.

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## CFPB Imposes Several New Duties on Big Data Brokers

By Mercedes Kelley Tunstall
Partner | Financial Regulation

The Consumer Financial Protection Bureau ("CFPB") has issued several statements affecting the credit reporting industry in the last few months, including one on medical debts and one on auto financing, while at the same time emphasizing that the definition of a consumer reporting agency ("CRA") should be interpreted broadly to include not just credit reporting companies and tenant screeners but also "other data brokers." This means that any company collecting "Big Data" and hoping to convert that data into profit by offering reports on individual consumers should beware and consider themselves a CRA that is subject to the Fair Credit Reporting Act ("FCRA") and the CFPB.

CRAs now must provide consumers with a means to remove, challenge or update items on their credit report that appear because the consumer has been the victim of a severe form of human trafficking or sex trafficking. This means that CRAs must develop new processes to accept, evaluate and police these kinds of reports from consumers. New changes to Regulation V, the implementing regulation of the FCRA, require completely new processes to be established to accommodate and manage such reports, and these obligations apply not just to the nationwide credit bureaus but to all companies that qualify as a CRA. Another new duty all CRAs will have to face is to track and monitor state laws addressing credit reports, as a result of the CFPB's Interpretive Rule that seeks to limit the preemptive effects of the FCRA. As the CFPB says in the rule, this means that, "[s]tates therefore retain substantial flexibility to pass laws involving consumer reporting to reflect emerging problems affecting their local economies and citizens."

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## CFTC Penalizes an Inadvertent Commodity Trading Advisor

By Peter Y. Malyshev
Partner | Financial Services

Once in a while, a Commodity Futures Trading Commission ("CFTC") enforcement action confirms market participants' worst fears that the CFTC is prepared to, and is able to, find violations of the Commodity Exchange Act ("CEA") where no such violations had previously existed. The July 19, 2022 CFTC settlement order involving Powerline Petroleum and its principals is one such case.

The facts of this case are generally similar to other enforcement actions involving commodity trading advisors ("CTAs") – for example, the 2016 Angus Partners order. An entity that provides either consulting services relating to physical energy commodity transactions (Angus) or acts as a registered introducing broker ("IB") (Powerline) provides some additional service to clients that, in the view of CFTC's division of enforcement, inadvertently or intentionally becomes an advisory service that requires (a) registration as a CTA and (b) making certain disclosures under CFTC Part 4 regulations. As the Angus and Powerline orders illustrate, the line separating an unregulated or exempted advisory activity from the regulated CTA activity is very blurry and continues to shift, as noted in CFTC Commissioner Mersinger's dissent.

Powerline is a small business that for 20 years has been registered with the National Futures Association ("NFA") as an IB in good standing and, in this capacity, assisted retail gas station operators in hedging their market exposure to RBOB gasoline, mainly by executing block trades in CME futures. The CFTC notes that a registered IB can be exempted from also registering as a CTA if the advisory services are "solely in connection with" its brokerage business (CFTC Part 4.14(a)(6) Regulations). In this case, the CFTC concluded that Powerline's advisory services were beyond the "solely in connection" boundary because Powerline also had marketed itself as a consultant and advisor in the fuel industry.

Having concluded that Powerline was an unregistered CTA, the CFTC proceeded to claim that the company had failed to make several required disclosures, mainly in connection with charging the markup on client block trades and failing to disclose that it had actually acted as a principal vis-à-vis its customers.

Further, Powerline admitted that it had provided materially misleading information to the CME in connection with its trading, which constituted fraud. As part of the settlement, Powerline was ordered to pay $875,000 in penalties and restitution to its customers (for charging them a hidden markup and not disclosing to them Powerline's principal status in block trades) and was prohibited from registering with the NFA for a period of three months (presumably as a CTA to remedy its violations).

There are several takeaway points from this order: (a) business practices involving hedging, particularly relating to energy commodities, should be periodically reviewed for potentially regulated CTA services; (b) any exemptions or exceptions

from CTA (or any other) registration will be interpreted by the CFTC very narrowly; and (c) deficiencies in disclosure or communications with the regulated exchange are likely to lead to further investigation and potentially a CFTC enforcement action.

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## FRB Vice Chair Brainard Touts CRA Proposal and Positive Impacts on Native American Communities

By **Daniel Meade**
Partner | Financial Regulation

On July 19, Federal Reserve Board ("FRB") Vice Chair Lael Brainard gave remarks to the National Native Coalition Virtual Series sponsored by the National Congress of American Indians. Her remarks focused on the joint proposal from the FRB, Federal Deposit Insurance Corporation ("FDIC"), and the Office of the Comptroller of the Currency ("OCC") (together, "The Agencies") to modernize the Community Reinvestment Act ("CRA"). As we mentioned briefly in our newsletter in May, the comment period on the proposal will be open until August 5, 2022.

In her remarks, Vice Chair Brainard encouraged those attending the virtual conference to provide feedback by the August 5 deadline, noting "your feedback is key to ensuring that we get CRA reform right." She also stated that "[t]his is a once-in-a-generation opportunity to strengthen the CRA to bring greater credit, investment, and banking services to the communities that have faced the greatest challenges. For the first time, the CRA will provide powerful incentives for banks to make investments in communities that do not have access to branches, such as in Native lands.

Vice Chair Brainard highlighted parts of the CRA proposal that would provide "greater incentives for community investments in Native Land Areas by providing enhanced clarity and specificity about what activities qualify for CRA credit." She also noted the importance of the Agencies' proposal of "providing positive qualitative consideration if banks operate branches located in Native Land Areas" and that even if banks don't have branches on Native Land areas, the proposal should "result in greater CRA activity outside of where banks have branches and physical locations in order to address unmet needs in communities that have more limited access to bank branches."

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## Introduction of the UK Financial Services and Markets Bill

By **Michael Sholem**
Partner | Financial Regulation

On July 20, the Financial Services and Markets Bill (the "Bill") was introduced in the UK's House of Commons ("HoC"). This first formal stage in the legislative process (called the "first reading") does not allow for debate of the Bill.

The Chancellor announced the introduction of the Bill on July 19 in a speech at Mansion House. The Government states that the Bill will, among other things:

- implement the outcome of the Future Regulatory Framework Review;
- eventually repeal all retained EU law relating to financial services (*i.e.*, EU law that was "onshored" into UK law at the time of Brexit);
- give the UK's financial regulators a new secondary objective to "facilitate growth and competitiveness";
- provide for the implementation of mutual recognition agreements ("MRAs") and for the UK to recognize equivalent Simple, Transparent and Standardised ("STS") securitisations issued by entities outside of the UK;
- give the Bank of England new tools to mitigate the risk of failure of critical financial institutions and enhance the UK's insolvency arrangements for insurers;
- bring stablecoins into the scope of regulation when used as a form of payment and enable Financial Market Infrastructure firms to explore technologies in temporary pilot schemes; and
- introduce measures supporting financial inclusion to ensure continued access to cash, along with enhancing protection for victims of authorised push payment scams.

There is a long process for the Bill to travel before it passes into law. There will be several further "readings" where the content of the Bill is debated in the HoC, together with committee and report stages. The Bill will then be voted on (at the third reading) where the HoC decides if the Bill should be approved. A similar process (including several debates, committee and report stages) will then take place in the House of Lords. There will likely be multiple amendments proposed and considered during the course of the Bill's progress through the UK Parliament.

The "second reading" in the HoC is currently scheduled to take place on September 7, 2022.

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## New Guidance from the FDIC on Brokered Deposits Affects Insured Depository Institutions

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

On July 15, the Federal Deposit Insurance Corporation ("FDIC") issued an updated Q&A regarding how companies involved in managing deposits can determine whether such deposits should be considered brokered, and/or whether they are deposit brokers themselves.

The updated portions of the Q&A emphasize that when a company that has received a primary purpose exemption from the brokered deposit definition uses any third party to place deposits at an Insured Depository Institution ("IDI"), it is necessary to consider whether that third party is facilitating the placement of deposits or engaging in matchmaking activities and, thereby, the deposits being placed should be reported as brokered by the IDI. Practically speaking, this means that all IDIs should update their Call Report processes such that, when the source of the funds has a primary purpose exception, those deposits are identified and examined for whether a third party was involved in the placement. The FDIC provided an updated list of companies (as of 6/24/22) that have a primary purpose exception here.

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## Cadwalader Corner Q&A: Pete Hahn, Emeritus Professor, The London Institute of Banking and Finance

*Pete Hahn is Emeritus Professor of Banking and Finance at The London Institute of Banking and Finance.*

*Prof. Hahn holds non-executive director roles on the boards of the Isle of Man Financial Services Authority, the Association of Corporate Treasurers, and Kalgera Limited – a fintech business working to protect the vulnerable. He retired as Dean and Henry Grunfeld Professor at The London Institute of Banking & Finance in early 2020.*

*Over a long career in banking and finance, Prof. Hahn has served as Senior Adviser to the Bank of England Prudential Regulatory Authority – and its predecessor, the UK Financial Services Authority – and worked in banking roles in New York and London for more than two decades.*

***What do you envision will be the toughest challenge facing bank regulators in the next five years?***

Throughout the world, bank consolidation has often resulted in 3-5 dominant national providers. Some may think resolution is the answer to both market failures and the ultimate regulatory tool if supervision or the market has not worked out. Yet I see the toughest challenge for regulators is that these large dominant banks have become public-private partnerships. That may sound simple or you might say "so what?". But the public (politicians and regulators) and private sectors can have very different priorities at different times in the economic cycle – indeed, no more so than politicians and regulators. Imagine entering a recession where regulators would traditionally encourage prudence while their political masters want to encourage risk augmentation to support weakening businesses and consumers? Would UK banks be able to act prudently on mortgage arrears in the current political climate?

***Can the UK financial services sector succeed in the long term without equivalence to EU regulations?***

The UK has parallel banking systems, domestic clearing that is overwhelmingly mortgage-focused, and the true City of London, a vast wholesale market. Wouldn't the City love the deal that Northern Ireland has (*i.e.*, inside the UK but also inside the EU for economics)? Hard to see in the current political climate, but perhaps more realistic governments on both sides of the Channel could see the advantages

in a short time. The City needs to identify the correct counterparts. Despite the public image, I think the Commission can be practical. No EU "City" has emerged since Brexit, fragmentation has resulted in higher costs, some businesses have evolved to stay in London, and, while the UK instigated the process, business has been lost to New York. A solution is required for stronger business support in the UK and the EU. I'm a long-term optimist.

***What do you make of the UK Government's plans to make the UK the "very best place in the world to start and scale crypto-companies"?***

Perhaps we should stick to SPACs – only joking. But the point is being careful about getting caught up in trends. The UK was pushing SPACs after their weaknesses had already been exposed and the market for SPACs had peaked across the Atlantic.

So, let's separate the obvious from the big unknowns. Fintech is great. It is modernizing the finance business everywhere, and the UK should want to be the most welcoming place to establish and grow fintechs – but not all parts of the digital financial sphere have the same prospects or add the same value. I think we're currently at a good point to review the value added by many digital businesses that have appeared over the past decade. Up to now it has been more about excitement than financial success. I've long been amused at the term "unicorns" for super valuations. The market seems to think that unicorns are rare beasts – but unicorns are imaginary. The UK government, like any other, doesn't know the future or shouldn't think it's in the same risk/reward position in the marketplace – especially with taxpayer money. The UK should avoid picking winners here. Fintech, yes. Crypto, good luck to them.

***What books are on your nightstand these days?***

I'm an active pre-bed reader and am partially through *Around the World in 80 Plants* (by Jonathan Drori) and *Six Days in September: Black Wednesday, Brexit and the Making of Europe* (by William Keegan, David Marsh and Richard Roberts) – the latter on the exit from ERM in 1992. I also have a French detective mystery on my Kindle for reading on the Tube once I've finished my five daily newspaper subscriptions. I've just finished *Carpet Ride to Khiva: Seven Years on the Silk Road* (by Christopher Aslan Alexander), a non-fiction travel book, and *A Brief History of Motion* (by Tom Standage), which looks at the development and likely disappearance of the automobile and provided some neat perspective on financial services, too. A great plus of being largely retired is that I get to read so much more that isn't related to keeping up day-to-day with work.

Over my working career, the great digital information explosion has required us to commit more time to focus, but at the expense of perspective. This is a great loss to society … we see it everywhere.

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