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Cabinet **News and Views**

Informed analysis for the financial services industry

Taking a Gamble

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In This Issue ...

It was certainly interesting to read our colleague Peter Malyshev's news item about the CFTC's decision to require an online prediction market operated by the University of Wellington in New Zealand to shut down its operations by next year.

Why so interesting? Because PredictIt's event contracts allowed participants to bet – through the trade of futures contracts – on the outcome of political elections, including U.S. presidential elections. Since this is not an isolated case, Peter tells us that the CFTC will have to come up with more definitive guidance for political event contracts.

There's more this week: An important "Dear CEO" letter from the UK's Financial Conduct Authority and, back in the U.S., a closer look at public comments on the interagency Community Reinvestment Act proposed rule. And we're very excited to introduce noted white collar defense partners Ken Breen and Phara Guberman, who joined Cadwalader earlier this week.

As always, we welcome your thoughts. Just write to us here.

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

Unpredictable Future of Political Prediction Markets

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

On August 4, the U.S. Commodity Futures Trading Commission ("CFTC") had withdrawn its no-action letter (*i.e.*, permission to operate) with respect to PredictIt, an online prediction market operated by the University of Wellington, New Zealand and ordered PredictIt to shut down its operations as of February 15, 2023. This no-action letter was issued in 2014 and allowed the University of Wellington to operate a small-scale, not-for-profit market in futures or swaps event contracts for educational purposes, without registration as a designated contract market, foreign board of trade, or swap execution facility (*i.e.*, an exchange), and without registration of its operators.

Mainly, PredictIt's event contracts allowed participants to bet on the outcome of political elections – for example, PredictIt's contract was very accurate in predicting the win for Donald Trump in the 2016 U.S. Presidential elections. PredictIt was able to justify its social utility on the basis of the efficient market theory that financial markets operate on all available information and therefore are much more accurate than political polls. PredictIt lists actively traded futures contracts on the results of the 2022 elections as well as the 2024 upcoming presidential nomination and election.

Under the Commodity Exchange Act ("CEA"), the CFTC is required to oversee and regulate operation of commodity derivative markets and particularly scrutinize event markets, such as political elections results markets because these may not be in the public interest. Under the CEA, political events, such as elections or Congressional control results, are considered "commodities," and the public trading of futures contracts on commodities may qualify as an exchange. Previously the CFTC had already shut down a similar event market in 2012. However, years before, the CFTC had issued a similar no-action letter to the University of Iowa to operate a prediction market for educational purposes, which is still effective.

On August 26, the CFTC further signaled that all political event contract markets are under enhanced scrutiny by posting for public comment KalshiEX's proposed Congressional control futures contract.

Collectively the withdrawal of PredictIt's no-action letter and the review of KalshiEX's contract are indicative of the CFTC's increased reluctance to allow the development of political prediction markets. However, soon the CFTC will have to come up with more definitive guidance for political event contracts. On September 9, several academics, traders and a technology provider filed a suit in Texas seeking a court order blocking the CFTC's action (as arbitrary and capricious) and asking the court to allow all existing markets to resolve in an orderly manner past February 2023. This action is likely to force CFTC's hand in making a definitive finding whether political events futures contracts are gambling and not in the U.S. public interest under CEA 5c(C)(5)(c).

FCA's Supervision Strategy for Benchmark Administrators

By **Michael Sholem**
Partner | Financial Regulation

On September 8, the UK's Financial Conduct Authority ("FCA") published a "Dear CEO" letter setting out its strategy and supervisory priorities for overseeing benchmark administrators under the UK Benchmark Regulations ("UK BMR") and applicable FCA Principles and Rules. This form of letter is a common tool utilized by the FCA to focus the attention of firms' senior managers on particular issues.

Following the UK's withdrawal from the EU and the end of the transition period, the EU Benchmark Regulation has been brought into UK law. Under the UK BMR, the FCA is responsible for: (i) the authorization and registration of UK benchmark administrators; (ii) the recognition of third country administrators; (iii) the endorsement of third country benchmarks; (iv) enforcement; and (v) the supervision of benchmark administrators, users and contributors in the UK.

The FCA directs attention to the new consumer duty, which is intended to set high standards of consumer protection across financial services. Benchmark Administrators are not within the scope of this duty. It will likely apply, however, to firms within the distribution chain of products in which benchmarks are used. The initial phase of rules and guidance for this new duty will come into force on July 31, 2023.

The main content of the Dear CEO letter comprises the laying out by the FCA of its supervisory priorities for benchmark administrators. The FCA's priorities are as follows:

- Disclosure
- Quality of data and data controls
- Operational resilience
- Oversight and governance
- Competition

The FCA makes it clear that the list is not exhaustive and that their supervisory priorities may change to reflect the evolving nature of the markets and benchmark business. Furthermore, the FCA reminds all authorized firms that they must remain compliant with FCA Principle 11, requiring that authorized firms must deal with regulators in an open and cooperative way. The FCA gives an example of such compliance, stating that "you should inform us if you are making major changes to widely used benchmarks, or planning to make substantial changes to your business, such as substantially amending outsourcing arrangements, or actively considering relocating activities outside of the UK."

In Depth: Summary of Notable Comments to Federal Banking Agencies' Interagency Proposal to Update Community Reinvestment Act Rules

By Daniel Meade
Partner | Financial Regulation

As we reported in May, the Federal Deposit Insurance Corporation ("FDIC"), the Federal Reserve Board ("FRB") and the Office of the Comptroller of the Currency ("OCC") (together, the "Agencies") issued a notice of proposed rulemaking to amend and update the rules implementing the Community Reinvestment Act ("CRA"). The comment period on the proposal ended on August 5. We held off summarizing the comments until most people returned from, hopefully, some restful end-of-summer R&R.

Summary of the Proposal

The proposal stated that it would make substantive changes in five key areas:

1. Delineation of Assessment Areas: The proposal would retain the current "facility-based assessment areas" (focused on where banks have physical facilities, such as branches), but also adds a "retail lending assessment area" for large banks in areas where the bank originates over 100 home mortgage loans or over 250 small business loans in each of the preceding two years.
2. Overall Framework, and Performance Standards and Metrics: The three bank-size categories of the current rules would be retained, but all would have higher thresholds, with small banks being defined as having assets up to $600 million, large banks having assets of more than $2 billion, and intermediate banks in between those two levels. Large banks generally would be evaluated under the four proposed tests: (1) Retail Lending; (2) Community Development Financing; (3) Retail Services and Products; and (4) Community Development Services. Intermediate banks would be evaluated under the proposed retail lending test and the current community development test. Small banks would continue to be evaluated under the current small bank standards but would have the option of opting into the new proposed tests. The proposed tests would also incorporate broader use of metrics.
3. Community Development Activities: The proposed rule would continue to include activities that currently receive CRA credit as community development activities, but would also create more criteria for the type of activities that qualify for CRA community development credit, with possibly fewer geographic restrictions.
4. Data Collection, Maintenance, and Reporting: The proposal would aim to tailor data requirements based on bank size.
5. Performance Conclusions and Ratings: The proposal would assign ratings in the component tests under the familiar current ratings of Outstanding, High Satisfactory, Low Satisfactory, Needs to Improve and Substantial Noncompliance to result in overall final ratings called for in the statute (*i.e.*, no differentiation between high satisfactory and low satisfactory).

Comments on the Proposal

The Agencies received over 600 comments on the proposal. Below we summarize a sampling of the comments representing both the banking industry and community groups. Initial reactions to the proposal seemed mostly positive, but as stakeholders had time to dig in to the proposal, the volume of criticism seemed to grow.

American Bankers Association ("ABA")

The ABA noted that it supports the objectives of the Act itself and welcomes aspects of the proposal, such as "the provisions that will give banks greater certainty regarding the activities that will receive credit, allowing them to concentrate their efforts on providing the products and services that will address community needs instead of spending time and resources trying to figure out what will count. Accordingly, we support the proposed preapproval process and list of qualifying activities for community development; the increased specificity regarding what qualifies for community development credit; and the combination of community development lending and investments into a single community development financing test. We also support providing CRA credit at the bank level for community development activities that a bank conducts outside of its assessment area(s)."

However, the ABA goes on to note that there are aspects of the proposal that it believes could result in outcomes contrary to the Agencies' intent and the statute itself. The ABA also raised the point that aspects could be viewed as arbitrary under the Administrative Procedures Act ("APA"). The ABA noted the following points in its comment letter as things it believes the Agencies should change or amend:

- The agencies should re-open the comment period and fully explain their policy choices, including but not limited to why it is appropriate to establish thresholds that result in significant numbers of banks that will not pass their retail lending examinations.

- The final rule must simplify the highly complex, formulaic system of metrics, benchmarks, multipliers, and thresholds, and balance the formulaic approach with more flexibility to consider bank business models and particular community needs.

- Any final rule should provide a minimum two-year implementation period.

Americans for Financial Reform ("AFR"), the Greenlining Institute and Public Citizen

AFR, Greenlining and Public Citizen's main comment letter called the proposal thoughtful and noted that the "agencies should strengthen the regulations to better ensure that communities most impacted by redlining and environmental injustice receive the intended benefits of the CRA." Their letter provided the five following recommendations:

- Adopt the NPR's proposed "disaster preparedness and climate resiliency" definition under "community development activities" and list additional eligible activities under the definition.

- Explicitly utilize race as a metric in CRA exams in order to ensure that historically redlined communities, and those most vulnerable to climate change, have improved access to sustainable credit and services.

- Encourage banks to increase community engagement and relationship building with climate and environmental justice organizations, including through the use of Community Benefits Agreements ("CBAs").

- Scrutinize bank investments that have disproportionate impacts that further contribute to climate change and impair access to credit for communities as part of CRA exams.

- Do not raise the small and intermediate small bank asset thresholds.

Bank Policy Institute ("BPI")

BPI's comment letter was even more critical of the proposal than other bank trade associations, highlighting possible APA and Constitutional challenges to the proposal. Like other comment letters, BPI noted its support for the goals of the CRA itself. However, BPI noted that it believes "parts of the Proposal would stray from these core values and from the agencies' statutory mandate, resulting in a proposed framework that would be needlessly sweeping, complex, and punitive in its application." BPI summarized its comment letter with these seven points:

- [T]he Retail Lending Test is proposed to be calibrated so stringently that it could transform the CRA from a framework for ensuring credit availability into a mechanism for credit allocation.

- [M]andatory evaluation of banks' retail lending distribution in areas outside their facility-based assessment areas would be inconsistent with the agencies' statutory authority as evinced in the text, history, and purposes of the CRA.

- [S]everal elements of the proposed Retail Services and Products Test would appear to serve as a *de facto* requirement to offer specific deposit services, products, and features, which indicates that the agencies have ventured far from their statutory mandate of encouraging a bank to meet the credit needs of its entire community

- [T]he Proposal is unnecessarily complex. The Proposal's multiple new tests, subtests, and factors would subject numerous discrete areas of a bank's operation to evaluation, and the agencies have not explained why they did not offer more straightforward alternatives that would achieve similar objectives.

- [T]he Proposal would take a rigid, "one-size-fits-all" approach to evaluating large bank performance and would lack the flexibility to accommodate large banks with less traditional business models.

- [T]he proposed compliance period of just 12 months from the final rule's effective date would be far too short to be workable in light of the Proposal's complexity, the vast new data collection and reporting requirements that the Proposal would impose, and key ambiguities in and unintended consequences of the Proposal that the agencies will need to address.

- [T]he agencies have proposed to eliminate any reasonable constraints on their authority to downgrade a bank's rating based on a compliance violation.

House Democrats

A group of 76 Democrats in the House of Representatives led by House Financial Services Committee Chair Maxine Waters submitted a letter recommending that the final rule should ensure "(1) CRA exams take into account bank activities that impact communities of color as well as low-and-moderate income communities; (2) banks get CRA credit only when they make meaningful investments in communities; and (3) CRA exams become more rigorous."

National Community Reinvestment Coalition ("NCRC")

The NCRC comment letter summarizes its position on major issues as:

- CRA exams must explicitly consider banks' records in serving people of color and communities of color.
- Public input mechanisms in CRA exams and merger reviews must be robust and include consideration of community benefit agreements. The agencies and banks must proactively reach out to community organizations and members of the public.
- Improvements to exam rigor and more objectivity in performance measures are needed to reduce ratings inflation, and loopholes such as not examining major loan products must be closed.
- Enhancements to community development definitions are needed to more effectively target activities to communities in need.
- Data improvements must provide more insight into banks' records of meeting credit and community needs.
- Anti-discrimination and fair lending reviews must be more transparent. CRA exams must examine affordability and sustainability of lending in order to prevent abusive lending.
- Assessment area changes must sufficiently capture online lending and deposit-taking activity.
- The proposed asset threshold and bank classification changes would reduce community development financing and branching.

Conclusion

As can be seen above, the Agencies have their work cut out for them if they hope to achieve consensus between community groups and the banking industry. While all the comments sampled here note their support for the goals of the CRA, there is divergence on how to get there. Traditionally, the CRA has not used race-based tests, but many community groups appear to think race-based tests ought to be used. Banks applaud the unified approach of the proposal from the three Agencies, and the additional certainty the proposal provides on what counts for CRA credit, but raise concerns on some of the details on those tests.

It will be interesting to see what the Agencies choose to do in terms of next steps, and how much they may amend and refine the proposal. Additionally, a question they will need to consider is whether, in reviewing the comments received, they can finalize a rule or whether a re-proposal would be a next step. While there is no explicit deadline of when the Agencies would need to act on any CRA rule proposal, the one thing most stakeholders do agree on is that modernization of the CRA rules is well overdue.

Welcoming Nationally Renowned White Collar Defense Partners Kenneth Breen and Phara Guberman

We are pleased to welcome partners **Kenneth M. Breen** and **Phara A. Guberman** to our White Collar Defense and Investigations Group in New York.

Ken and Phara are highly experienced trial attorneys who join Cadwalader from Paul Hastings, where Ken most recently served as head of Paul Hastings' New York white collar group after 10 years as chair of the firm's global investigations and white collar defense team. Their practice focuses on defending corporations and senior executives in high-stakes investigations, trials, and appeals.

Together, they recently achieved major back-to-back, precedent-setting victories for clients in two of the highest profile white collar matters in the United States: *U.S. v. Connolly*, the major LIBOR case, and *U.S. v. Gibson*, which focused on accounting and securities fraud.

Ken is a first-chair trial attorney who has been consistently recognized among the leading white-collar attorneys in the country. Prior to private practice, Ken served as a federal prosecutor in the U.S. Attorney's Office for the Eastern District of New York, where he was Deputy Chief of the Business and Securities Fraud Section, and in the U.S. Department of Justice's Tax Division. He has tried 48 cases to verdict and argued 12 appeals as a federal prosecutor and defense attorney.

Phara is a highly regarded, versatile litigator considered a next-generation leader in the field. She was recently honored by *Benchmark Litigation* as one of the Top 250 Women in Litigation and by *Global Investigations Review* as one of 100 notable Women in Investigations.

Read the full announcement here.