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# No Surprises

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## In This Issue ...

It was hardly surprising to hear Federal Reserve Board Governor Michelle Bowman suggest earlier this week that it's time to update the bank merger framework. This is one we've heard before and makes a lot of sense.

Speaking of no surprises, there's the decision by the Second Circuit to vacate a February 2021 Southern District of New York ruling in favor of the defendant loan managers who had been told that they did not have to return an accidental payment by Citibank N.A. of approximately $500 million in what has been come to be known simply as "Revlon." All the legal wrangling aside, this seems like one of those cases where common sense prevailed in the end. We take a closer look this week in a detailed Clients & Friends Memo.

And surprise, surprise, there's no way to get through an issue of *Cabinet News and Views* without an important crypto-assets story, so thanks to Peter Malyshev for this week's write-up on the CFTC's assertion of jurisdiction over decentralized autonomous organizations ("DAOs").

I would also encourage you to read Keith Gerver's analysis of a new directive from the White House to CFIUS on "evolving national security risks."

Any thoughts on this week's articles? Anything on your mind? Just drop me a note here.

**Daniel Meade**
Editor, *Cabinet News and Views*

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## FRB Governor Bowman Speaks on Banking Competition

By **Daniel Meade**
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On September 28, Federal Reserve Board ("FRB") Governor Michelle Bowman spoke to the Community Banking Research Conference regarding the landscape for banking competition. Governor Bowman noted, as many have, that it is past time to update the bank merger framework, which was last updated in 1995. Governor Bowman said that in light of banking industry changes, "we need to change how we think about competition for banking products and services and modernize our approach to competitive analysis that promotes a healthy banking and financial system, supports consumer choice, and creates the right incentives for continued innovation."

Governor Bowman pointed out that the current guidelines for banking markets continue to be local banking markets, and define a market with a Herfindahl-Hirschman index ("HHI") of 1,800 or higher as concentrated, but Department of Justice ("DOJ") guidelines for horizontal mergers in other industries draw that line at the 2.500 level. Governor Bowman suggested that it might be time to revisit the stricter levels for the banking industry. She also noted that the "cluster" of banking products defined in *United States v. Philadelphia National Bank*, 374 U.S. 321 (1963) faces increasing competition in the form of community-based credit unions, on-line banks, and non-bank finance companies.

In light of those competitive forces that aren't accounted for under the current merger framework, Governor Bowman had three recommendations to include as regulators work to modernize their framework for analyzing bank mergers: (1) include credit unions in all competitive analyses in a more systemic way; (2) factor in deposits at digital banks; and (3) consider nonbank financial firms in all competitive analyses.

Governor Bowman, a former banking commissioner in Kansas, noted that the current bank merger framework seems to particularly disadvantage community banks, and hopes that as the agencies and DOJ take a closer look at the framework, these considerations are considered.

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## DAOs in CFTC's Enforcement Crosshairs

By Peter Y. Malyshev
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On September 22, the Commodity Futures Trading Commission ("CFTC") asserted its jurisdiction over a decentralized autonomous organization ("DAO") and its founders, signaling for the industry that even an unincorporated association cannot violate U.S. commodity derivatives regulations. This enforcement action exemplifies a novel approach to liability for violations under the Commodity Exchange Act ("CEA") and the CFTC's jurisdictional reach over decentralized markets in digital assets. CFTC Commissioner Summer K. Mersinger issued a dissent, arguing that this action is regulation by enforcement and an impermissible exercise of CFTC's jurisdiction.

First, the CFTC announced that it had reached a settlement with bZeroX, LLC (a decentralized Blockchain-based software protocol) and its founders for illegally offering leveraged and margined commodity transactions for retail participants in digital assets without being registered as a designated contract market ("DCM"), engaging in activities of a futures commission merchant ("FCM") without registration and failing to adopt a customer identification program.

Second, simultaneously with the settlement, the CFTC filed a federal civil enforcement action in California charging Ooki DAO (a successor to bZeroX) with the same violations as the first action. Ooki is an unincorporated association comprising holders of Ooki DAO Tokens ("Ooki Tokens") who vote these tokens to operate the Ooki Protocol. CFTC's reach over Ooki DAO Protocol via the Ooki Token is, according to Commissioner Mersinger's dissent, regulation by enforcement. However, even the dissent noted that "blatant" violation of the CEA cannot be tolerated, especially if it was the intention of the founders to make the new venture (*i.e.*, the DAO) enforcement-proof while knowing that the CEA was violated.

The CFTC presented the following analysis:

1. Cryptocurrencies are "commodities," which has been established law for several years now. As such, the CFTC has "general" jurisdiction to prosecute for fraud and manipulation in the interstate commerce.
2. If there is a leveraged contract on a "commodity" (*i.e.*, a contract is margined), then the CFTC immediately can exercise its "exclusive" jurisdiction, meaning it can dictate how, where, under what circumstances, and when a derivative contract can trade. Contracts offered through the Ooki DAO Protocol were clearly derivatives and, therefore, the CFTC could exercise its exclusive jurisdiction.
3. If a derivative is offered to a "retail" participant (*i.e.*, entities that are not eligible contract participants (ECPs)), then these contracts can only be traded on a registered DCM. Ooki DAO is not registered as a DCM.
4. Only FCMs can act as brokers or facilitators to execute retail commodity transactions and hold customer margin. Neither bZeroX (and its successor,

Ooki DAO) nor its founders were registered as FCMs.

5. It is noteworthy that the CFTC did not charge Ooki DAO Protocol for operating as but failing to register as a DCM. In all likelihood, the CFTC could not reasonably argue that an unincorporated association governed by Ooki DAO Token holders can register as a DCM because it is not a legal entity. CFTC prior enforcement action in January 2022 involving another DeFi entity specifically sanctioned this entity for failure to register as a DCM.
6. Finally, this enforcement action and a complaint stand out in the context of SEC's Wahi complaint, which was also characterized as "regulation by enforcement" by CFTC Commissioner Caroline D. Pham. In the Wahi complaint, unlike in the Ooki complaint, DAO tokens were characterized as securities.

It is clear that the CFTC's Ooki settlement and complaint and the SEC's complaint in Wahi are breaking new ground for both CFTC and SEC jurisdictional reach while the agencies grapple with conceptualizing new technology and what entities would constitute a trading facility. The CFTC generally has been expanding the scope of a "trading facility" – *e.g.*, with respect to swap execution facilities ("SEFs") in September 2021. The SEC has done the same with its Reg ATS proposal in January 2022, and so did the ESMA in the EU with the April 2022 trading facility proposal. It is clear that the concept of a trading facility is undergoing a fundamental reevaluation, and there is no doubt it will be much broader and much more flexible in the very near future.

Likewise, in the absence of clear guidance from Congress, the CFTC and the SEC will continue to grapple on an *ad hoc* basis with their jurisdictional and definitional matters.

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## New Executive Order Directs CFIUS on Review of Covered Transactions

By **Keith M. Gerver**
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On September 15, President Biden issued an Executive Order on "Ensuring Robust Consideration of Evolving National Security Risks by the Committee on Foreign Investment in the United States" in response to "an evolving national security landscape and the nature of investments that pose related risks to national security."

The Executive Order directs CFIUS to consider five specific "sets of factors" as part of its review of covered transactions (*i.e.*, transactions that could result in control of a U.S. business by a foreign person, as well as certain non-controlling investments in a limited set of U.S. businesses). The White House describes two of the factors as "elaborations" on the illustrative national security factors that Congress included in section 721(f) of the Defense Production Act, while the remaining three are not among the 721(f) factors.

Specifically, the five factors are:

- ***Elaborating on § 721(f)(3), a given transaction's impact on supply chain resilience and security inside and outside the defense industrial base***, including in such areas as "critical materials (such as lithium and rare earth elements)" and "elements of the agriculture industrial base that have implications for food security." The EO makes clear that CFIUS should not only consider the "degree of involvement of the foreign person who is a party to the covered transaction and who might take actions that threaten to impair the national security of the United States as a result of the transaction," but also a foreign person "who might have relevant third-party ties that might cause the transaction to pose such a threat," as well as the overall degree of diversification across the supply chain.

- ***Elaborating on § 721(f)(5), a given transaction's effect on U.S. technological leadership in areas affecting U.S. national security*** in sectors such as "microelectronics, artificial intelligence, biotechnology and biomanufacturing, quantum computing, advanced clean energy, climate adaptation technologies, and elements of the agricultural industrial base that have implications for food security."

- ***Incremental investments by a foreign person or country in a particular industry*** that would facilitate sensitive technology transfer in key industries in a way that an individual acquisition or limited investment would not.

- ***Cybersecurity risks*** associated with a foreign person (or their third-party ties) – namely, whether the transaction provides them with a greater ability to conduct cyber intrusions or other "malicious cyber-enabled activity."

- ***Risks to U.S. persons' sensitive data***, especially in light of technological advances and the availability of large data sets that may enable re-identification or de-anonymization of what had been considered unidentifiable data.

While arguably CFIUS already could – and likely did in many instances – consider the three new factors in its review of covered transactions, the formal nature of an Executive Order both will regularize the practice and send a message that the Biden administration is focused on these particular factors. Concerns regarding U.S. person data are especially high, as various Treasury officials made clear during the CFIUS Conference in June 2022. Of the new factors, the directive for CFIUS to take into consideration incremental investments by foreign persons or countries in a particular industry likely will introduce the most uncertainty on the part of parties to transactions. It is not difficult to imagine CFIUS applying additional scrutiny to a transaction involving a limited acquisition by a particular foreign person in light of transactions in the industry involving *other* foreign persons from the same country. To the extent they already were not doing so, parties to transactions in sensitive industries now will need to consider how best to present their particular transaction in the context of such industry trends.

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## Second Circuit Rules in Favor of Citibank in Accidental $500m Transfer in Revlon Loan Transaction

By **Steven M. Herman**
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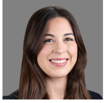

By **Calla Abrunzo**
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In a decision rendered on September 8, a three-judge panel for the United States Court of Appeals for the Second Circuit vacated a February 2021 decision by the United States District Court for the Southern District of New York in favor of the defendant loan managers of certain institutional lenders, which held that the loan managers were not obligated to return an accidental payment by Citibank N.A. of approximately $500 million. Citi served as administrative agent to the lenders for a $1.8 billion syndicated seven-year loan to Revlon, Inc. pursuant to a credit agreement entered into in 2016. Read our Clients & Friends Memo here.

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