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Cabinet **News and Views**

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A Flurry of Activity

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In This Issue ...

What a busy few weeks!

In this issue of *Cabinet News and Views* we cover several important developments from key U.S. agencies – including the DOL, FRB, CFPB and SEC – as well as some news from the UK's Financial Conduct Authority.

Speaking of news, I am delighted to welcome back to our firm Alix Prentice, a fellow financial regulatory partner who started last week in our London office. Alix knows Cadwalader very well, having been here as a special counsel from 2008-2012 before moving to King & Woods Mallesons, and she knows the financial regulatory space as well, with experience advising on regulatory requirements across a range of industries and asset classes. You'll be seeing Alix's thought leadership regularly in the weeks to come.

I always appreciate your feedback on our coverage and analysis and any thoughts you may have. Please reach out to me.

Daniel Meade
Editor, *Cabinet News and Views*

Vice Chair Barr Speaks on Capital Levels

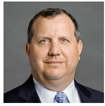
By **Daniel Meade**
Partner | Financial Regulation

On December 1, Federal Reserve Board ("FRB") Vice Chair of Supervision Michael Barr gave a speech at the American Enterprise Institute on Bank Capital. Vice Chair Barr noted that the FRB's holistic review of capital standards continues and that they "hope to have more to say about that review early in the new year."

Notwithstanding that the holistic review continues, Vice Chair Barr may be starting to socialize that this holistic review may bring higher capital requirements, at least for the largest banks. He noted that "[t]here is a body of empirical and theoretical research on optimal capital, which attempts to determine the level of capital that equalizes the marginal benefits of capital with the marginal costs. While the estimates vary widely, and are highly contingent on the assumptions made, *the current U.S. requirements are toward the low end of the range described in most of the research literature*." (emphasis added, citations omitted) He added, however, that "[w]e have strong capital levels today, and generally higher bank capital requirements in the United States after the Dodd-Frank Act…"

His theme for the speech was one of being humble – humble in the sense that we can't predict the risks that will occur, and that this "would argue for a higher overall capital level than one based solely on historical experience." Vice Chair Barr's theme of being humble echoed a theme that Acting Comptroller Hsu has been making in speeches that banks and bank regulators need to guard against complacency.

DOL Issues Final Rule Amending Investment Duties Regulation – Provides New Guidance on Consideration of ESG Factors in Plan Investing


By **James Frazier**
Partner | Executive Compensation, Benefits & ERISA

On November 22, the United States Department of Labor ("DOL") released its final rule (the "Final Rule") adopting certain revisions to its investment duties regulation under ERISA at 29 CFR Section 2550.404a-1 (the "Section 404a-1 Regulation"). The revisions in the Final Rule are intended to clarify the application to ERISA plan fiduciaries of the ERISA duties of loyalty and prudence in respect of investments and the use of written proxy voting guidelines and policies. The Final Rule clarifies that ERISA plan fiduciaries may consider climate change and environmental, social and corporate governance ("ESG") factors when making investment decisions and exercising shareholder rights for plans.

The Final Rule is the latest DOL action in the long-running back and forth in DOL guidance (depending on the political party of the administration in power) regarding the consideration of ESG factors in investment decisions. Briefly, the Final Rule modifies, and in some cases reverses, certain changes made in 2020 to the Section 404a-1 Regulation initiated under the Trump administration to address what the DOL noted at such time was a perceived heightened concern raised by ESG investing. In 2021, the DOL conducted a review of the 2020 changes to the Section 404a-1 Regulation and issued an enforcement policy statement providing it would not enforce the 2020 rule. In October of 2021, the DOL issued a Notice of Proposed Rulemaking to amend the Section 404a-1 Regulation. The DOL indicated that the intent of the 2021 proposed amendments was to address its concerns that the 2020 changes, and the discussion in the release applicable to such changes, created uncertainty around the consideration of ESG factors in investment and proxy voting decisions. In this regard, among other things, the DOL noted stakeholder concerns that the 2020 changes "had a chilling effect on appropriate integration of climate change and other ESG factors in investment decisions."

While the DOL made several changes in the Final Rule (as discussed below), the DOL stressed that the Final Rule does not change two important longstanding principles that: (1) the ERISA duties of prudence and loyalty obligate fiduciaries to focus on relevant risk-return factors and to not subordinate the interests of plan participants and beneficiaries to goals unrelated to the interests of participants and beneficiaries in their retirement income or other financial benefits under the plan; and (2) the fiduciary duty of managing plan assets that are shares of stock includes the management of rights appurtenant to such shares, including the right to vote proxies.

The following summarizes the most material (what the DOL characterizes in the preamble to the Final Rule as the "major") amendments to the Section 404a-1 Regulation:

(1) **Removal of "Pecuniary" and "Non-Pecuniary" Terminology.** The Final Rule removes the "pecuniary" and "non-pecuniary" investment terminology added to the Section 404a-1 Regulation by the 2020 amendments, which required fiduciaries to evaluate investments and investment courses of action based solely on pecuniary factors, except in certain limited circumstances. The Final Rule instead provides that a fiduciary's determination with respect to an investment or investment course of action must be based on factors the fiduciary reasonably determines to be relevant to a risk/return analysis, and that these factors may include the economic effects of ESG factors on such investment or course of action.

(2) **"Tie-breaker" Test Revisions.** The Final Rule revises the so-called "tie-breaker" test in the Section 404a-1 Regulation, which provided that a fiduciary may consider collateral benefits in certain circumstances as tie-breakers when choosing between investment alternatives. The 2020 amendments permitted a fiduciary to base an investment decision on non-pecuniary factors if the fiduciary is unable to distinguish between or among investments on pecuniary factors alone, provided the fiduciary satisfies certain documentation requirements. The Final Rule replaces this with a requirement that the fiduciary prudently conclude that competing investments or courses of action equally serve the financial interests of the plan over the appropriate time horizon. In such event, a fiduciary has flexibility to make a selection based on collateral benefits. The Final Rule also eliminates the specific documentation requirements applicable to the consideration of tie-breakers imposed by the 2020 amendments.

(3) **Elimination of Stricter Rules for QDIAs.** The Final Rule removes the restriction added to the Section 404a-1 Regulation in the 2020 amendments relating to "qualified default investment alternatives" (or "QDIAs"), which precluded plan fiduciaries from adding an investment option to a participant-directed defined contribution investment menu as a QDIA if such option's objectives, goals or principal investment strategies include, consider or indicate the use of one or more non-pecuniary factors. Under the Final Rule, a fiduciary selecting a QDIA is no longer subject to such a restriction, and must merely satisfy the otherwise applicable standard of care in the selection of a QDIA.

(4) **Clarification Regarding Consideration of Participant Preferences.** The Final Rule includes new language clarifying that fiduciaries do not violate the ERISA duty of loyalty solely by taking into account participant preferences when developing a menu of prudent investment alternatives for participant-directed defined contribution plans.

(5) **Removal of Certain Provisions Relating to Proxy-Voting.** Relating to proxy voting, the Final Rule removes language that the duty to manage shareholder rights appurtenant to shares of stock does not require voting of every proxy or the exercise of every shareholder right – the DOL expressed a concern that such language could be read to suggest that plan fiduciaries should be indifferent to the exercise of shareholder rights. The Final Rule also removes two "safe-harbor" examples relating to permissible voting policies that the DOL believes encourage abstention as the normal course. In addition, the Final Rule eliminates certain specific monitoring obligations and specific recordkeeping requirements added by the 2020 amendments.

The general effective date of the Final Rule is January 30, 2023. The DOL is delaying the applicability of certain provisions relating to proxy voting until December 1,

2023.

FRB Proposes Climate-Related Financial Risk Management Principles

By **Daniel Meade**
Partner | Financial Regulation

Last week, the Federal Reserve Board ("FRB") proposed principles for climate-related financial risk management for large financial institutions. The proposed guidance is open for comment until 60 days after publication in the Federal Register.

The FRB's proposed guidance is very much in line with guidance previously issued by the OCC and FDIC in December 2021 and March 2022, respectively. The FRB staff noted that they had worked with the staffs of the OCC and FDIC in this proposal with an eye toward all three agencies issuing interagency guidance. As we speculated in June when the Basel Committee on Banking Supervision issued its principles on climate-related financial risk management, the FRB may have been waiting for the Vice Chair of Supervision seat to be filled before issuing its version of the principles.

The proposed guidance/principles would cover six topic areas. They are: governance; policies, procedures, and limits; strategic planning; risk management; data, risk measurement and reporting; and scenario analysis. Like the OCC and FDIC principles, the guidance is proposed to apply to institutions with over $100 billion in assets.

Governor Waller voted against the proposal, issuing a statement: "I cannot support this issuance of guidance on climate change. Climate change is real, but I disagree with the premise that it poses a serious risk to the safety and soundness of large banks and the financial stability of the United States. The Federal Reserve conducts regular stress tests on large banks that impose extremely severe macroeconomic shocks and they show that the banks are resilient."

Governor Bowman voted in favor of issuing the proposal for comment, but in her statement, she noted that "I look forward to reviewing comments from the public on this proposal. While I support seeking public comment, this vote does not indicate my support for the finalization of this guidance. I will evaluate any future recommendation to finalize this guidance on its merits."

CFPB Takes Down High-Yield Savings Account Scam, Defendants Also Charged By the SEC

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

The Consumer Financial Protection Bureau ("CFPB") announced a proposed consent order on December 1 intended to address a scam engaged in by a company called Loan Doctor, as well as by the company's founder, Edgar Radjabli.

Loan Doctor purported to offer high-yield savings accounts into which customers could deposit funds and be assured not only of insurance coverage but also of obtaining an annual-percentage-yield (APY) on the amounts in the range of 5% to 6.25%. Director Chopra succinctly characterized the conduct: "Loan Doctor and its founder masqueraded as a traditional bank to open accounts for people seeking a high-yield savings product. In reality, this outfit and its ringleader were using customer funds for risky investments."

Since August 2019 at least 400 individuals put millions of dollars into a product called "Loan Doctor's Healthcare Finance Savings CD," with the belief that their deposits would be used to fund loans to healthcare professionals. Instead, the funds were placed into any of the following: a hedge fund controlled by Radjabli called Apis Capital Management, LLC; used to purchase crypto-assets; invested in actively traded securities; and loaned to investors who used their individual stock portfolios as collateral for the loans.

In a case related to the CFPB's investigation, the Securities & Exchange Commission ("SEC") got involved in stopping some of the conduct in August 2021, but the SEC was focused on additional violative behavior by Radjabli, Loan Doctor and the hedge fund. This included fraudulent issuance of Apis Tokens, a digital asset representing tokenized interest in the company's main investment fund, as well as market manipulation by announcing an unsolicited cash tender offer to purchase a publicly-traded artificial intelligence company called Veritone, when in truth, the SEC explained that there was no "financing or any reasonable prospect of obtaining the financing necessary to complete the deal." In sum, the defendants have been ordered to refund $19MM to approximately 400 depositors (which sum includes 6% APY on the so-called deposits), as well as $162,800 in disgorgement to the SEC, and an additional $419,330 of civil penalties to the SEC, and $150,000 of civil penalties to the CFPB. In addition Radjabli is permanently barred from the securities industry and from engaging in deposit taking activities.

Bond Traders Face Ban for Market Abuse in the UK

By **Camillo Di Donato**
Associate | Corporate

The Financial Conduct Authority ("FCA") has banned and fined three bond traders for placing large-sized orders for future contracts in relation to Italian government bonds that they did not intend to execute, while concurrently placing smaller orders on the opposite end of the order book over the period from June 1 to July 29, 2016. At the time the facts occurred, the three individuals were part of the Fixed Income Government Bond Trading desk at a global financial institution where they held the position of Managing Director, Director and Associate, respectively.

The FCA maintained that through the placement of those large orders, the traders worked in concert with each other for the common purpose of falsely representing to the market an intention to buy or sell, with the aim to impact trading activities in the wider market. In particular, the only purpose for the large orders (8-digit figures) was to assist the execution of the smaller ones (7-digit figures) that they genuinely wanted to make; the trading strategy was such that the large orders were placed "away from the touch" (that is, the highest price to buy and the lowest price to sell) and were quickly withdrawn before execution. The FCA considered that this pattern of abusive conduct was frequently repeated over the relevant period and determined that it gave false and misleading signals to the market as to demand and supply positions, amounting to market manipulation contrary to Article 15 of the EU Market Abuse Regulation ((EU) 596/2014).

In the FCA's view, such market manipulation was serious and directly undermined the integrity of the market, as other traders would "highly" likely have altered their trading strategies in response to it. The bans from performing any function in relation to any regulated activity and the related fines (almost £600,000 in the aggregate, based on the greater of 30% of income and £100,000 for each trader) that have been decided by the FCA reflect the nature of the breaches and should represent a "sufficient deterrent" to other market participants as well. Notably, in this respect, the FCA's assessment over the conduct at issue acknowledged that none of the traders derived any direct financial benefit from carrying out the market abuse itself (but also noted that the performance of the desk was a significant factor when calculating the traders' bonuses).

The traders have all appealed the FCA's decisions to the Upper Tribunal (Tax and Chancery Chamber), where they and the FCA will each present their cases. The decision notices (issued separately to the traders on October 31, 2022) were made public on December 7, 2022.

Welcoming Our New Financial Regulatory Partner Alix Prentice

We are delighted to announce the addition of financial regulatory partner Alix Prentice in the firm's London office. Alix has over 20 years of experience (some gained at the regulator level) of advising on regulatory requirements across a range of industries and asset classes, including family offices and private investors, hedge and other alternative fund managers, private equity, banks, broker-dealers, custodians, distributors and issuers.

You can read the full press release here.