CADWALADER

What Shadow?

February 2, 2023

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In This Issue ...

Good ol' Punxsutawney Phil woke up and saw his shadow this morning, which, legend (and history since 1887!) tells us, means six more weeks of winter. But in true DC fashion, a stuffed groundhog, Potomac Phil, didn't see his shadow at the Dupont Circle fountain, suggesting an early spring.

Hard to imagine a disagreement in Washington!

Groundhog Day fun aside, we don't need either Phil to tell us that a shadow continues to hang over crypto assets, and the Federal Reserve Board has had lots to say about that in recent days.

And speaking of weather and climate, we've included two very timely items written for our sister publication, *Cadwalader Climate*, in today's newsletter.

As always, we look forward to hearing from you. Please drop me a here if there are any topics covered this week that raise some questions.

Daniel Meade
Editor, *Cabinet News and Views*

FRB Issues Policy Statement on Permissible Activities of State Member Banks While Denying Uninsured Crypto-focused Bank's Membership Application

By **Daniel Meade**
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The Federal Reserve Board ("FRB" or "Board") issued two seemingly related press releases late last week. The first announced the denial of the Federal Reserve membership application by Custodia Bank, a Wyoming special purpose depository institution. The second announced the issuance of a policy statement interpreting section 9(13) of the Federal Reserve Act (codified at 12 U.S.C. § 330) ("Policy Statement") that provides a rebuttable presumption that the FRB would not allow a state member bank ("SMB") to engage in activities as principal that are not permitted for a national bank or consistent with Section 24 of the Federal Deposit Insurance Act ("FDI Act"). On the same day, the Federal Reserve Bank of Kansas City ("FRBKC") and the FRB filed a motion to dismiss Custodia Bank's pending litigation with the Federal Reserve System as moot because the FRBKC had denied Custodia's request for a master account at the FRBKC.

These three coordinated actions make clear that the FRB believes the risks associated with crypto-asset related activities are not appropriate for state member banks as principal, and is consistent with the Joint Statement on Crypto-Asset Risks to Banking Organizations (the "Joint Crypto Risk Statement," as previously reported in *Cabinet News and Views*) that the FRB issued together with the Federal Deposit Insurance Corporation ("FDIC) and the Office of the Comptroller of the Currency ("OCC") in January. With regard to the Policy Statement, the FRB stated it would serve to "promote a level playing field for all banks with a federal supervisor, regardless of deposit insurance status."

Summary of the Policy Statement

As noted above, the Policy Statement sets out a rebuttable presumption that the FRB would limit SMBs "to engaging as principal in only those activities that are permissible for national banks – in each case, subject to the terms, conditions, and limitations placed on national banks with respect to the activity – unless those activities are permissible for state banks by federal statute or under part 362 of the FDIC's regulations."

The focus on activities as principal is very much in line with section 24 of the FDI Act and the FDIC's implementing regulations at 12 CFR Part 362, and the FRB noted that "[i]f the FDIC, by rule, permits insured state banks to engage in the activity, no [FRB] approval would be required to establish permissibility." The FRB stated that

"legal permissibility is a necessary, but not sufficient, condition to establish that a [SMB] may engage in a particular activity" and emphasized the need to focus on the safety and soundness of the activity. The Policy Statement noted the presumption of impermissibility discussed above could be rebutted "if there is a clear and compelling rationale for the Board to allow deviations in regulatory treatment among federally supervised banks, and the state member bank has robust plans for managing the risks of such activities in accordance with principles of safe and sound banking." While the Policy Statement is very much issued in the context of crypto-related activities, it applies broadly to any activity a SMB would want to engage in that isn't permissible for national banks.

The FRB discussed its current views on permissibility of some particular crypto-related activities. As custody services are not an as-principal activity, it stated that SMBs would not be prohibited "from providing safekeeping services for crypto-assets in a custodial capacity if such activities are conducted in a safe and sound manner and in compliance with consumer, anti-money-laundering, and anti-terrorist-financing laws." On the other hand, however, the FRB stated that it would presumptively prohibit a SMB from holding crypto-assets, such as Bitcoin and Ether, when it was holding them as a principal. The issuing of dollar tokens has been found permissible by the OCC, per Interpretive Letters 1174 and 1179, but pursuant to the conditions in those letters, the SMB would be required to seek the FRB's non-objection before conducting such an activity. Finally, the FRB also stated unequivocally that, consistent with the Joint Crypto Risk Statement, it generally believes that issuing tokens on open, public, and/or decentralized networks, or similar systems is highly likely to be inconsistent with safe and sound banking practices."

Impact on Cryptocurrency Activities in the United States

These actions involving Custodia Bank combine to demonstrate that U.S. bank regulators are taking strong action to prevent the contagion risk from volatile cryptocurrency markets from spreading to the banking system. While the vehemence of such action may be disheartening for proponents of a crypto-based future, there is still hope that cryptocurrency may yet be tamed sufficiently to become a part of the banking system eventually. Nevertheless, the clear takeaway is that cryptocurrency-related companies should no longer view themselves as being exceptional in terms of having greater capacity and flexibility when it comes to ensuring their own safety and soundness than more traditional financial institutions.

Custodia Bank Litigation

The same day the Policy Statement was issued, the FRB denied Custodia Bank's application to become a member of the Federal Reserve System, and the FRBKC denied its request for a master account. A master account provides access to the Federal Reserve's payment services and access to the wholesale payments system, among other benefits. Custodia – which markets itself as a "bridge connecting digital asset companies to the U.S. payments system" – sought a master account to eliminate transacting through correspondent banks. *See Custodia Bank v. Fed. Reserve Bd. of Governors*, Case No. 1:22-cv-00125 (D. Wy.), ECF No. 1 (Complaint).

Custodia is a special purpose depository institution chartered by the State of Wyoming. The bank specializes in payments and digital asset custody services.

Under the Federal Reserve Act, to obtain a master account, a financial institution must be either a member of the Federal Reserve System or a "depository institution," defined as either (1) a bank insured by the FDIC, or (2) a bank eligible to be insured by the FDIC. 12 U.S.C. § 461(b)(1)(A)(i). Custodia has claimed that, as a state-chartered SPDI, it is "eligible" to be insured by the FDIC because it is "authorized and expected to take deposits." Custodia Compl. ¶ 33.

On June 7, 2022, Custodia sued the FRB and the FRBKC for their "unreasonable delay" in deciding Custodia's application for a master account. It alleged that the FRB and FRBKC's delay in determining its application for a master account violated, among other things, the Administrative Procedures Act and the Constitution's due process clause. As a remedy, Custodia asked the court to compel the FRB and FRBKC to process and decide Custodia's application. *See generally* Custodia Compl.

As noted above, the FRB announced that it had denied Custodia's application to become a member of the Federal Reserve System. The Board noted that Custodia "proposed to engage in novel and untested crypto activities" and that its "business model and proposed focus on crypto-assets presented significant safety and soundness risks." The Board also found that "Custodia's risk management framework was insufficient to address" these concerns.

In the FRB and FRBKC's motion to dismiss Custodia's complaint, they stated that the FRBKC had denied Custodia's request for a master account and had provided a letter to Custodia "providing the basis for that decision." As a result, the FRB and FRBKC moved the court to dismiss Custodia's lawsuit as moot. The denial by the FRBKC appears to be consistent with final guidance issued by the FRB in August, and which we previously discussed.

We expect more to come in this litigation. Custodia will have an opportunity to respond to the motion to dismiss. In addition, Custodia may seek to amend its complaint to allege that the decision to deny the application was improper. For example, Custodia could seek to bring a claim under the Administrative Procedures Act alleging that the FRB and FRBKC's decision was arbitrary and capricious or contrary to law. Regardless, the case remains one to watch as companies specializing in digital assets seek access to the U.S. banking system.

ISDA Publishes Digital Asset Derivatives Definitions and Accompanying Whitepaper Addressing Netting and Collateral Issues

By **Michael Ena**
Counsel | Financial Services

On January 26, the International Swaps and Derivatives Association, Inc. (“ISDA”) published the ISDA Digital Asset Derivatives Definitions (the “Definitions”). The Definitions are intended for documenting privately negotiated derivatives transactions referencing digital assets based on the distributed ledger or similar technology using standard ISDA documentation architecture. The coverage of this initial version of the Definitions is limited to non-deliverable forwards and options on Bitcoin and Ether. The Definitions provide standard settlement, valuation, disruption event and termination terms and are designed to allow for future updates. It is expected that the coverage of the Definitions will be expanded to other types of derivative transactions and other classes of digital assets.

The recent collapse of the algorithmic stablecoin TerraUSD and related Luna token, as well as the bankruptcies of Three Arrows Capital, Voyager Digital, Celsius Network, BlockFi and FTX that resulted in billions of dollars in losses to investors, raised a number of novel legal and counterparty credit risk management issues specific to digital assets. Since the Definitions do not cover those issues, ISDA decided to publish two whitepapers intended to help market participants to better understand and address them. The first whitepaper, titled “Navigating Bankruptcy In Digital Asset Markets: Netting and Collateral Enforceability,“ which was released simultaneously with the Definitions, focuses on issues relating to counterparty risk management through close-out netting and taking of collateral.

The whitepaper argues that derivatives transactions referencing digital assets present unique challenges when it comes to bankruptcy proceedings due to the decentralized and often global nature of the digital asset markets. It explains that enforceability of close-out netting depends on bankruptcy and insolvency law in the relevant jurisdictions. To address legal certainty of close-out netting, ISDA intends to expand coverage of its close-out netting opinion library to include digital assets. Additionally, the whitepaper analyzes the challenges of using digital assets as collateral, including perfection of security interest, enforcement and collateral documentation issues. It recommends further collaboration between technology developers, legal scholars, regulators, and market participants to resolve existing issues and develop more effective and efficient ways to implement digital-asset-based collateral solutions.

The second whitepaper that is expected to be published later in the first quarter of 2023 will focus on issues related to holding digital assets through intermediaries.

New FCA Consumer Duty of Care

By Alix Prentice
Partner | Financial Regulation

UK firms manufacturing financial products that reach retail customers are facing a significant deadline this April to conform those products to meet the new consumer duty.

Back in July 2022, the United Kingdom's Financial Conduct Authority (the "FCA") published its approach to that duty in the form of final rules and guidance for an explicit "consumer duty of care," impacting all firms that distribute or manufacture products and/or services to retail customers. The new rules require a higher standard of care and protection for consumers of financial services by compelling firms to:

- end excessive charges and fees;
- make it as easy to switch or cancel products as it was to take them out in the first place;
- provide helpful and accessible customer support;
- provide timely and clear information;
- provide products and services that are right for their customers; and
- focus on the real and diverse needs of their customers, including those in vulnerable circumstances.

The FCA is giving firms until July 31, 2023 to implement the new rules for all new and existing products and services that are currently on sale. The rules will eventually be extended to closed book products (to come into force on July 31, 2024) to allow more time to bring older products up to the new standards.

By October 31, 2022, firms had agreed on implementation plans to meet the new higher standards. Currently, manufacturers are preparing themselves to meet the next milestone April 30, 2023 deadline to complete reviews in order to comply the outcome rules – those cross-cutting rules that should ensure that the required consumer outcomes are achieved. The FCA has also been putting information out on how they are going to support firms' implementation programmes through regular communication, including working closely with industry and consumer organisations to identify and share good and poor practice, but it is clear that the ball is firmly in the firms' court to ensure that the consumer duty is both embedded and in play in every aspect of the product lifecycle in good time for summer 2023.

(The author wishes to thank trainee solicitor Rizwana Haque for her important contributions to this news item.)

NYC Comptroller and Pension Funds Advocate for Banks to Establish Interim Absolute GhG Emissions Targets

By **Jason M. Halper**
Partner | Global Litigation

On January 2, the New York City (NYC) Comptroller, Brad Lander, the NYC Employees' Retirement System, the NYC Teachers' Retirement System, and the NYC Board of Education Retirement System, announced that they had submitted shareholder proposals to three U.S. banks and one Canadian bank. The proposals, addressed to Bank of America, Goldman Sachs, JPMorgan Chase and Royal Bank of Canada, seek to require the banks to disclose their absolute greenhouse gas (GhG) emissions targets for 2030. Specifically, the Goldman Sachs, JP Morgan Chase, and Royal Bank of Canada proposals call for interim GhG lending and underwriting emissions targets for the oil and gas and power generation sectors. The Bank of America proposal, co-filed with the New York State Common Retirement Fund, similarly calls for interim GhG lending and underwriting emissions targets in the bank's energy sector that align with the Paris Agreement's goal to limit warming to 1.5 degrees Celsius.

The press release adds that "while some other major U.S. and foreign banks have set absolute emissions reduction targets, these four banks have only set targets to reduce the intensity of their emissions" by 2050. The banks are members of the Net-Zero Banking Alliance (NZBA), which requires members to publish 2030 and 2050 decarbonization targets within 18 months of joining the alliance, with intermediate targets to be set every five years from 2030 onwards. In November 2022, the NZBA reported that over half of its 122 member banks had set intermediate (i.e., 2030) decarbonization targets and that 90% of the member banks due to publish targets by October 2022 had done so.

This development highlights the convergence of several trends. First, we have commented on the potential for increasing shareholder proposal activity in relation to climate change due to a number of factors. These include programs at some of the largest institutional asset managers to provide beneficial owners with greater say over how their shares are voted, recent updates to guidelines by proxy advisory firms ISS and Glass Lewis, the SEC's issuance of Staff Bulletin No 14L, which removed any requirement that there be a causal nexus between a social policy issue and the company's business as a basis for a company to exclude a shareholder proposal, and the SEC's adoption of a universal proxy card, which has the potential to benefit climate-related activist investors seeking to nominate directors to a company's board because the universal proxy permits shareholders to "split their vote."

Second, the shareholder proposals underscore challenges potentially posed by membership in financial industry collaborations such as the NZBA, the Glasgow Financial Alliance for Net Zero (GFANZ), and others. This past fall, some major U.S. banks acknowledged that they were considering withdrawing from GFANZ due to concerns over their ability to satisfy decarbonization commitments and the potential to be subject to litigation or enforcement actions as a result. Shortly

thereafter, GFANZ amended its membership rules by dropping its connection to the UN-supported Race to Zero campaign. In December, Vanguard announced that it was withdrawing from the Net Zero Asset Managers Initiative to provide clarity "about the role of index funds and about how we think about material risks, including climate-related risks − and to make clear that Vanguard speaks independently." That same month, Republican members on the House Committee on the Judiciary wrote a letter to the steering committee members of Climate Action 100+, Ceres and CalPERS, requesting documents and seeking information regarding antitrust compliance.

Third, these shareholder proposals reflect that actions by one industry participant are rarely isolated. The funds, which own a combined total of $850 million worth of shares in the four banks, likely are re-evaluating their own portfolios to meet ESG-related commitments. The press release states that the "proposals are a part of the pension funds' overall approach to achieving net zero emissions in their investment portfolio by 2040."

(This article originally appeared in Cadwalader Climate, a twice-weekly newsletter on the ESG market.)

Climate Activist Sends Shareholder Proposals to Multiple U.S. Banks

By **Jason M. Halper**
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By **Jayshree Balakrishnan**
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Environmental advocacy group As You Sow has sent climate-focused shareholder resolutions to five major U.S. banks. The resolutions request that the banks disclose their climate transition plans for meeting financed emissions reduction targets, "including the specific measures and policies to be implemented, reductions to be achieved by such measures and policies, and timelines for implementation and associated emission reductions." The institutions targeted are: Bank of America, Goldman Sachs, JPMorgan Chase, Morgan Stanley, and Wells Fargo. According to As You Sow, the "banking sector has a critical role to play in addressing the climate crisis and aligning financing activities with the Paris Agreement's net zero by 2050 goal" and that by "operationalizing and translating net-zero commitments into clearly disclosed and actionable strategies, each bank can assure investors and the public that they have a path forward to meet their 2030 goals."

Climate-related shareholder activity has become a feature of the corporate governance landscape, as we discuss in another post today. As You Sow states that it has made comparable shareholder proposals at various insurance companies asking them to measure and disclose their net-zero targets in their underwriting and investing activities. Earlier this month, we reported on a shareholder resolution sent to Glencore PLC, a multinational commodity trading and mining company, seeking details of the "specific plan" for Glencore "to align thermal coal production with emissions reductions commitments." Companies and their boards can prepare by proactively assessing enterprise risks and opportunities associated with climate transition and the accuracy and thoroughness of related disclosure.

(This article originally appeared in Cadwalader Climate, a twice-weekly newsletter on the ESG market.)

Welcoming Our New Leveraged Finance and Private Credit Team

We are delighted to announce the arrival of partners Ronald Lovelace, Patrick Yingling, Jared Zajac and Joseph Polonsky, substantially enhancing the firm's leveraged finance and private credit capabilities. The team joins from King & Spalding and will be resident in our Charlotte office.

This represents another step – along with the recent hire of financial restructuring partner Mike Rupe and the addition of Matthew Smith and Bevis Metcalfe in London – in building out a market-leading middle-market leveraged finance, private credit and special situations practice. The new team will expand the firm's ability to provide counsel on creditor-side restructuring and special situations work and will expand our existing capabilities in, among other areas, asset based lending, warehouse finance and NAV lending.

Ron joins the firm as Head of Leveraged Finance. He focuses on leveraged finance and other syndicated lending transactions, with significant middle-market acquisition finance and robust workout and special situations experience. He is recognized as a leading finance lawyer in North Carolina by *Chambers USA*, which describes his "strong reputation for his handling of acquisition finance, working capital finance and wider asset-based lending transactions on behalf of lenders and borrowers [with] additional expertise in restructuring and workout matters."

Patrick focuses on leveraged finance and other syndicated lending transactions. He advises financial institutions, other lenders and borrowers on a wide range of financing transactions, including syndicated credit facilities on both a leveraged and investment-grade basis, first-lien/second-lien arrangements, acquisition financings, recapitalizations and cross-border facilities.

Jared represents financial institutions, investment funds, lenders, and borrowers in leveraged finance, acquisition financings, first- and second-lien financings, syndicated credit facilities, and debtor-in-possession ("DIP") financings. He also has an extensive financial restructuring background, having spent a number of years at Proskauer Rose advising on bankruptcy and restructuring engagements, with particular experience advising on DIP financings.

Joey advises banks, private credit funds and other financial institutions that provide companies with the liquidity necessary to make acquisitions, refinance existing debt, make dividends to equity holders, and restructure their balance sheets. He works closely with public companies, large-cap companies, sponsor-backed companies and privately held companies on how to structure complicated

financings and debt & equity restructurings, including for first-lien and second-lien financings, asset-backed financings, unitranche financings, FILO financings, unsecured financings, and DIP financings.