CADWALADER

Cabinet News and Views

Informed analysis for the financial services industry

No Break on Spring Break

April 6, 2023

Table of Contents:

In This Issue ...

Holidays and spring break vacations couldn't slow down the news this week, especially when it comes to the continuing focus on the crypto industry.

But there was also lots to talk about on the ESG front, as well as an important development in LIBOR, a key CFPB directive and significant regulatory activity in the UK – all of which deserve attention.

Best holiday wishes to all celebrating ... and happy reading. Please reach out here if there’s anything you'd like to talk about.

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

First Attempt to Regulate Spot Digital Asset Activities

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

On March 29, the National Futures Association ("NFA") promulgated Compliance Rule 2-51, setting forth Requirements for Members and Associates Engaged in Activities Involving Digital Asset Commodities, which includes both derivatives and commodities traded on spot.

This is not the first time that the NFA stepped ahead of the Commodity Futures Trading Commission ("CFTC") and extended its regulatory reach over products that are not yet fully regulated by U.S. federal regulatory agencies, such as the CFTC or the Securities and Exchange Commission ("SEC").

The NFA is a self-regulatory organization ("SRO") and an industry association that is authorized under the Commodity Exchange Act ("CEA") to issue regulations and guidance for its members, such as registered futures commission merchants ("FCMs"), introducing brokers ("IBs"), and swap dealers ("SD"), along with commodity trading advisers ("CTAs") and commodity pool operators ("CPOs") and their associated persons ("APs").

The CEA grants the CFTC regulatory jurisdiction over *derivatives* on all commodities (including digital asset commodities), while only enforcement jurisdiction over commodity *spot markets*, meaning that the CFTC can only prosecute fraud and manipulation involving digital assets, such as crypto, if these digital assets are only traded on spot (*i.e.*, for settlement within typically two business days). Even though the NFA derives its jurisdictional reach from the CFTC, from time to time it promulgates guidance and rules for its members that go beyond what the CFTC can do; for example, in the early 2000s, the NFA promulgated rules for its members on retail forex transactions, which rules were subsequently codified in the CEA and CFTC regulations.

Over the past five years, the NFA has taken similar actions in connection with digital asset commodities and virtual currencies.

First, in December 2017, the CFTC mandated that its members report to the CFTC their activities involving virtual currencies, although these reporting requirements were limited to only derivatives on crypto, and applied to FCMs, CPOs and CTAs and IBs. Based on these reports, as well as NFA examinations, the NFA notes that, as of March 2023, "over 100 NFA Members have reported to NFA that they engage in digital asset-related business activities, both in commodity interest [i.e., derivatives] and spot markets."

Second, a year later, in 2018 the NFA promulgated Interpretative Notice 9073 – Disclosure Requirements for NFA Members Engaging in Virtual Currency Activities, which requires NFA members (FCMs, IBs, CTAs and CPOs) to provide specific disclosures to their customers in connection with *both* derivatives and spot virtual currency transactions. Notice 9073 also describes the specific manner in which these disclosures must be provided to members' customers. This notice was the first NFA action extending its supervisory reach over crypto traded not only as derivatives but also in spot and cash markets.

Third, in its most recent rulemaking, the NFA set forth specific standards for members and APs engaged in activities involving digital asset commodities. Specifically, NFA Rule 2-51: (1) imposes anti-fraud, just and equitable principles of trade, and supervision requirements on NFA Members and Associates that engage in digital asset commodity activities; (2) specifically applies to derivatives (such as futures, options and swaps) on digital asset commodities, as well as spot and cash transactions involving crypto; (3) at this time is limited to only digital asset commodities involving Bitcoin and Ethereum (which are currently the only underliers to futures contracts traded on designated contract markets – commodity exchanges); (4) includes by reference Notice 9073 requiring disclosures of virtual currency activities of NFA members; and (5) applies not only to FCMs, IBs, CTAs, and CPOs but also to SDs.

This means that, as of the effective date of this rule (May 31, 2023), members will be required to implement appropriate supervisory and compliance policies and procedures with respect to members' and their APs' derivatives and spot digital asset commodities activities, and the NFA, as an SRO, will have the ability to discipline all of its members, including SDs, if they commit fraud or similar misconduct with respect to members' and their APs' spot digital asset commodity activities.

CFTC Commissioner Caroline Pham noted that this is a significant regulatory development and that the NFA may expand the scope of "digital asset commodities" subject to this rule to other than Bitcoin and Ethereum digital asset commodities.

CFTC Charges Binance and its Founder with Multiple CEA Violations

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

On March 27, the Commodity Futures Trading Commission ("CFTC"), the U.S. derivatives regulator, charged three Binance entities (collectively "Binance") and its founder and chief compliance officer ("CCO") with numerous violations of the Commodity Exchange Act ("CEA") and CFTC regulations.

CFTC's complaint does not break new ground by advocating novel legal theories, but it is remarkable in its thoroughness (73 pages), depth and the comprehensive nature of the allegations, and gives the impression that the CFTC decided to take this opportunity to clearly explain the reach of its jurisdiction and the application of the CEA to virtually all aspects of the digital asset commodity industry.

At the core of CFTC's complaint is the allegation that Binance, its founder and the CCO "chose to knowingly disregard applicable provisions of the CEA while engaging in a calculated strategy of regulatory arbitrage to their commercial benefit." The complaint further explains application of the CEA and identifies the following violations:

- The CFTC has jurisdiction over this matter because Binance operated a facility for trading of certain digital assets, such as Bitcoin, Ether and Litecoin (each qualifying as a "commodity") in interstate commerce for U.S. persons.
- Binance traded these digital asset commodities as contracts in spot markets as well as derivatives, such as futures, options and swaps.
- Many of these contracts were offered to "retail" U.S. persons, *i.e.*, those who were not eligible contract participants ("ECPs").
- These retail contracts were offered on a margined and leveraged basis, and therefore these contracts qualified as "futures" and "options" that must only trade through designated contract markets ("DCMs"), *i.e.*, CFTC-registered commodity exchanges and brokered only by registered futures commission merchants ("FCMs").
- None of Binance entities were registered as DCMs or FCMs.
- Because Binance had operated as an FCM (albeit unregistered), it should have implemented a compliance program, such as "know your customer" and screening for terrorist activity.
- Binance operated as a swap execution facility ("SEF") by facilitating the trading of swaps on digital asset commodities without registering as a SEF.
- Binance used an autodeleting messaging service when communicating with U.S. customers to destroy the audit trail evidence.

- Binance operated as an intentionally opaque global platform to deliberately evade regulation by the CFTC, and the CCO aided and abetted Binance in these violations.

The complaint is asking for a draconian set of remedies, including a permanent ban on participating in spot or derivative markets involving digital asset commodities and a permanent registration ban with the CFTC – meaning that if Binance chose to remedy its violations of the CEA by registering as an FCM, a DCM or a SEF, it will not be allowed to do so, which effectively means a complete ban on Binance's operations in the U.S. In addition, the CFTC is asking for a full disgorgement and restitution of all gains from doing business in the U.S. (and theoretically this disgorgement and restitution may apply not only with respect to only U.S. customers, but all of Binance's customers). Finally, the complaint is asking for civil monetary penalties under the CEA, which can be interpreted very broadly and may exceed billions, as demonstrated by CFTC's previous enforcement actions.

SDNY Accepts Argument That Crypto Is Subject to Electronic Fund Transfer Act/Regulation E

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

In an Opinion and Order issued on February 22, 2023, Judge Denise Cote of the Southern District of New York ("SDNY") permitted class action plaintiffs to survive a motion to dismiss and proceed against Uphold HQ, Inc. on a variety of claims, including that cryptocurrency is subject to the Electronic Fund Transfer Act ("EFTA") and Uphold failed to comply with the disclosure and other requirements of the EFTA.

The EFTA, which is implemented by Regulation E, 12 CFR 1005, is a consumer financial services law that applies to "electronic fund transfers." Generally speaking, electronic fund transfers include every transaction that occurs electronically other than wires, from debit card transactions and credit card transactions to loading prepaid cards and sending funds internationally. Judge Cote surmises that because Uphold could be viewed as a financial institution under the EFTA and holds cryptocurrency funds on behalf of customers in accounts, the transfer of cryptocurrency therefore could be viewed as an electronic fund transfer. To date, as noted by Judge Cote, the Consumer Financial Protection Bureau (which is the agency responsible for interpreting the EFTA) ("CFPB") has not taken a position regarding whether the EFTA applies to cryptocurrency transfers, because it "continues to analyze the nature of products or services tied to virtual currencies." 81 Fed. Reg. 83934, 83978-79 (Nov. 22, 2016). Cryptocurrency exchanges to date have not attempted compliance with the EFTA and its provisions in part because the law and Regulation E fits imperfectly with the way cryptocurrency works. For example, the requirement that a financial institution reverse and refund a transaction upon finding that an unauthorized person caused transfers to occur from a consumer's account would not be possible with cryptocurrency because transactions cannot be reversed on the blockchain.

While the Opinion and Order's conclusion that cryptocurrency transfers are subject to the EFTA does not carry the force of law, should the SDNY eventually conclude in this case that cryptocurrency transfers are electronic fund transfers for purposes of the EFTA, then an entire raft of disclosures, error resolution protocols and other requirements would apply to all exchanges facilitating cryptocurrency transfers. Crypto and consumer protection enthusiasts alike will be watching this case carefully.

FCA Compels the Publication of 'Synthetic' USD LIBOR

By **Lary Stromfeld**
Partner | Financial Regulation

After USD LIBOR stops being published on June 30, 2023, "synthetic" USD LIBOR will continue to be published for a limited period, according to the UK's Financial Conduct Authority ("FCA"). The FCA said that the "synthetic" version of USD LIBOR will not be a "representative" rate provided by panel banks but instead would be based on the CME Term SOFR Rate plus the same credit spread adjustment used for legacy contracts by ISDA and the Alternative Reference Rates Committee ("ARRC").

The FCA said it was compelling LIBOR's administrator to publish "synthetic" versions of USD LIBOR in 1-, 3- and 6-month tenors in order to provide for a more orderly transition of "a small but material subset of contracts that will not be able to transition away from using USD LIBOR" by June 30, 2023. The synthetic version will be available for at least 12 months. The FCA said that it intends to use its powers to compel the publication of the synthetic USD LIBOR until the end of September 2024, "but not beyond that date."

The primary focus of the FCA's action is legacy USD LIBOR contracts that are not governed by U.S. law. The FCA has previously acknowledged that most legacy U.S. law contracts would transition away from LIBOR under workable contractual fallbacks (such as those published by the ARRC or implemented through ISDA's protocol) or pursuant to the federal Adjustable Interest Rate (LIBOR) Act. The ARRC and ISDA fallback provisions specifically include a "trigger" that occurs when LIBOR is no longer "representative" (*i.e.*, is published in a "synthetic" version). Similarly, the Federal law applies to legacy contracts within its scope when LIBOR is no longer representative.

However, there are certain legacy contracts governed by U.S. law that do not fall into either of those categories, such as those that fall back to the prime rate when LIBOR "is no longer available" or similar language. The language of these contracts must be analyzed closely to determine whether their conditions to implementing the new rate (*e.g.*, prime) have been satisfied or whether the synthetic version of USD LIBOR would apply. Given the difference in value between the two rates, the outcome of that analysis could have significant economic consequences for the parties.

Small Business Lenders Subject to New CFPB Data Reporting Rule

By Mercedes Kelley Tunstall
Partner | Financial Regulation

Resulting from a lawsuit by the California Reinvestment Coalition against the Consumer Financial Protection Bureau ("CFPB") in 2019 for its failure to promulgate a small business lending data rule in compliance with the Consumer Financial Protection Act sections of Dodd-Frank, and in order to comply with the resulting court order, the CFPB announced that it had finalized a rule regarding small business lending data. For purposes of the 888-page Final Rule, small businesses are those that have a gross revenue of $5M or less.

The Rule requires lenders that originate at least 2,500 loans annually to start collecting the data identified on October 1, 2024. Lenders that originate at least 500 loans annually must collect data starting April 1, 2025, and lenders that originate at least 100 loans must collect data starting January 1, 2026. While these compliance dates seem generous, requiring compliance by the largest lenders first puts substantial burden upon their very complex systems to be reconfigured for reporting purposes. Some changes from the proposed rule, which caused widespread concern among industry participants, eliciting 2,100 comments, include:

- Placing the burden of reporting demographic data upon the small business themselves, and similar to how consumers may choose not to report their demographic data, the small businesses will not be required to respond;
- Any loans that are reportable under existing Home Mortgage Disclosure Act requirements will not need to be reported; and
- Data submitted under the CFPB's rule will satisfy relevant Community Reinvestment Act requirements that lender banks must comply with.

The Final Rule specifies several exceptions to the credit extensions that must be reported. While generally all credit extended to small businesses is covered, HMDA-reportable loans do not need to be reported, nor do so-called trade credit transactions ("financing arrangements wherein a business acquires goods or services from another business without making immediate payment in full to the business providing the goods or services"), insurance premium financing, public utilities credit, securities credit, factoring, leases, consumer credit that is used for business or agricultural purposes, and purchases of a partial interest in a credit transaction. In addition, extensions, renewals and other amendments of existing transactions do not need to be reported, but refinancings do need to be reported. While small businesses have the burden to provide demographic data, regardless of whether they do so, lenders must collect and report a variety of data points.

The CFPB's Executive Summary of the Final Rule provides a good summary of the applicable data points. The Final Rule includes a sample data collection form that lenders may use to collect the applicable demographic information, as well as to provide required fair lending notices prescribed by the rule.

Finally, the CFPB has already published a set of Filing Instructions for those lenders who must begin reporting in 2024. Such instructions are crucial for large lenders to be able to properly configure their systems for reporting.

A Brief Round-Up from the UK

By **Alix Prentice**
Partner | Financial Regulation

By way of diversion from the current crisis mode of regulators the world over, here we discuss positive regulatory initiatives on bank liquidity, CDS clearing and the development of Long Term Asset Funds.

UK bank regulators give feedback on High Quality Liquid Assets usage

The Bank of England and Prudential Regulation Authority ("PRA") have published a joint Feedback Statement ("FS") on their Discussion Paper 1/22 on '*The prudential liquidity framework: Supporting liquid asset usability'*. While the FS contains no policy proposals or indications on how the PRA '*is considering to support banks in prudently using their [liquid assets] when facing liquidity pressures in the future'*, it does discuss their concern that banks are '*overly reluctant*' to use their stock of High Quality Liquid Assets ("HQLA"). A sufficient reserve of HQLA available to meet payment obligations in situations of severe short-term stress is a requirement of the post-GFC requirement of a Liquidity Coverage Ratio ("LCR") to help build up banks' resilience in such circumstances.

Feedback indicates that banks' reluctance to use HQLA stems chiefly from concerns about regulatory reactions to the fall in their LCR that would follow use of HQLA, including the amount of time that would be allowed to restore levels. Unsurprisingly, respondents to the Discussion Paper were also concerned about how markets would react to a deployment of HQLA and a consequent fall in LCR below 100%. Suggestions for improving HQLA usability include improving communication and guidance from authorities, particularly on the extent to which banks' LCRs can fall without regulatory consequences.

ICE Clear Europe ceases clearing for all classes of credit default swaps (CDS)

ICE Clear Europe has announced that it is ceasing clearing for all classes of CDS from 27 October 2023, meaning that all counterparties will need to close out positions and move to an alternative CCP before that date. The UK's Financial Conduct Authority has announced that, in order to achieve an orderly migration, it will not be requiring counterparties to migrating trades who elect to execute those trades outside a trading venue, and who are subject to the obligations in the UK Markets in Financial Instruments Regulation's obligations to execute on a trading venue, to observe the trading obligation or publicly report those trades.

The UK authorises the first Long Term Asset Fund (LTAF)

In 2021, the UK's Financial Conduct Authority ("FCA") created a new regulatory regime that allowed the inception of the LTAF, a new category of open-ended authorised fund that enables investment in long-term illiquid assets including venture capital, private equity, private debt, property and infrastructure. While investment in LTAFs remains restricted to professional investors, certified and self-certified sophisticated investors and certified high-net-worth individuals, the authorisation of the first such fund arrives shortly before the results of an FCA consultation on broadening access due in the first half of this year.

Diversity on Boards of UK-Listed Companies and Large Private Companies

By **Jack Andrew Kelly**
Special Counsel | Financial Regulation

Substantial efforts are underway in the UK to promote board diversity and inclusion among both UK-listed companies and large private companies, with the UK's Financial Conduct Authority ("FCA") introducing new Listing Rules aimed at increasing disclosure obligations for in-scope listed companies as well as the Parker Review Committee setting new targets for all FTSE 350 companies and the 50 largest private companies in the UK.

What this means for UK-listed companies

The new Listing Rules apply to UK and overseas issuers with equity shares, or certificates representing equity shares, admitted to the premium or standard segment of the FCA's Official List, excluding open-ended investment companies and shell companies, but including closed-ended investment funds and sovereign-controlled companies.

The new Listing Rules are designed to encourage a broader consideration of diversity at board level and provide investors with improved, comparable information to assess progress in this area. In particular, the new Listing Rules will require in-scope listed companies to provide the following information in the company's annual financial report (as at a chosen reference date within its accounting period):

- a statement on a "comply or explain" basis setting out whether (i) its board comprises at least 40% women, (ii) at least one senior position on its board (*i.e.*, chair, chief executive, senior independent director or chief financial officer) is held by a woman, and (iii) at least one individual on its board is from a minority ethnic background. In cases where the company has not met some or all of these targets, the company is required to explain that the targets have not been met and provide reasons for not meeting those targets; and

- numerical data on the ethnic background and gender identity or sex of the individuals on the listed company's board and its executive management.

The FCA's disclosure guidance and transparency rules ("DTRs") have also been amended to require in-scope listed companies to consider wider diversity characteristics, including ethnicity, sexual orientation, disability, and socio-economic background, in reporting their board diversity policies.

In addition to the FCA's changes to the Listing Rules, the Parker Review Committee has made a series of voluntary targets on ethnic diversity of FTSE 350 company boards. The Parker Review Committee encourages companies to take a more active approach to ensure equal opportunities in senior management levels and will require FTSE 350 companies to set a percentage target by December 2023 for ethnic minorities in their senior management teams to be achieved by December 2027 and report this target to the Committee. This is in addition to the previous targets set for ethnic minority directors over the last few years.

The target date of 2027 will give companies nearly five years to implement a strategy and associated initiatives that will help them to increase opportunities for ethnic minority executives within their executive pipeline, ensuring they are fully in line with those for other executives.

What this means for large private companies

To date, the Parker Review Committee has only focused on listed companies in the FTSE 350. However, the latest report published by the Parker Review Committee has asked 50 of the UK's largest private companies with reference to turnover and to number of employees (listed within the report) to provide the Committee with information about their ethnic diversity each year from December 2023 onwards. The Committee asks that the largest 50 private companies:

- have at least one director on their main board who self-identifies as being from an ethnic minority by December 2027;
- set an ethnicity target by December 2024 for their senior management team that is designed to be met by December 2027; and
- report progress against their targets annually in their company reports and to the Parker Review Committee.

It is worth noting that while the Parker Review Committee's requests remain a series of "recommendations" and "voluntary targets," there has been significant uptake over recent years with regards to the Committee's target on FTSE 100 and FTSE 250 companies having at least one ethnic minority director on the board, with 324 listed companies (all of the FTSE 100 and 224 of the FTSE 250) responding to the Committee's latest census. The Committee noted that 96 out of the FTSE 100 companies met their targets, with 49 of these companies exceeding the target by having more than one ethnic minority director on its board. With regards to FTSE 250 companies, 149 out of the 224 companies that submitted data (representing 60% of all FTSE 250 companies) currently meet the December 2024 target, with 28 of these companies already exceeding the target by having more than one ethnic minority director.

(The author wishes to thank paralegal Queenie Je for her important contributions to this news item.)

Nuclear Power Classified as Environmentally Sustainable in UK's Green Taxonomy

By **Duncan Grieve**
Special Counsel | White Collar Defense and Investigations

On March 15, the UK's Chancellor of the Exchequer, Jeremy Hunt, announced that nuclear power will be classified as "environmentally sustainable" in UK's green taxonomy, "giving it access to the same investment incentives as renewable energy." He stated that "because the wind doesn't always blow and the sun doesn't always shine, we will need another critical source of cheap and reliable energy. And that is nuclear." The inclusion of nuclear power within the UK green taxonomy mirrors a similar move including nuclear within the EU green taxonomy last year.

The inclusion of nuclear in the UK Taxonomy, while controversial, is not surprising given the UK's stated commitment to building its nuclear fuel capacity. In a 2022 policy paper titled "British energy security strategy," the Johnson government committed to increase the portion of energy generated from nuclear power to 25%, and to launch a variety of related initiatives, including "backing Great British Nuclear with funding to support projects to get investment ready and through the construction phase." Great British Nuclear is planned to be a civil service body within the Department for Business, Energy & Industrial Strategy (BEIS). Additionally, up to £20 billion has been allocated to support early development of Carbon Capture Usage and Storage, a suite of technologies that enable mitigation of carbon emissions. The Sunak government has not yet released its energy security strategy, but Sunak hinted that its strategy will continue the ongoing commitment to increase the UK's nuclear energy capacity, by focusing on carbon capture and storage, small modular reactors and the like.

Taking the Temperature: The British government increasingly has been actively pursuing investment and developing regulation related to a green transition. Early this year, BEIS received a report it had commissioned inquiring into the government's approach to delivering on net zero commitments. BEIS itself is being broken up along with the creation of four new departments, including the Department for Energy Security and Net Zero, which is tasked with "securing [Britain's] long-term energy supply, bringing down bills and halving inflation," and financial and competition regulators have issued updated climate-related guidance.

On the challenges of attractive capital to fund climate initiatives, the Green Technical Advisory Group's ("GTAG") paper, which we discussed earlier this month, argued that significant progress must be made by the UK to attract global capital commitments and suggested that the UK adopt the same broad concepts, methodologies, and metrics as the EU taxonomy, where possible. The UK's addition of nuclear power in the green taxonomy still under consideration follows similar steps in the EU last year. The European Commission believes there is a role for private investment in gas and nuclear activities in the green transition. It is worth noting, however, that although that the EU Taxonomy Delegated Act is in force, a regulation for UK's green taxonomy is not and there is no clear timeline for implementation. Rather, the UK government announced in December 2022 a delay in implementation following stakeholder engagement and in light of the complexity inherent in a climate taxonomy, which involves "multiple sectors of the economy and various legislative and regulatory frameworks."

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