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The Verdict Is In

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In This Issue ...

Much-anticipated reports from the FRB, the FDIC and the GAO on the Silicon Valley Bank and Signature Bank failures have been released, and the bottom line is exactly what we anticipated: subpar governance and risk management practices and serious issues around managing liquidity risk, with a little bit of self-criticism on how supervision could have been better.

We also take a look this week at an important development: considerations for counterparties whose swaps are transferred from First Republic to J.P. Morgan.

Our London financial services regulatory partner Alix Prentice provides important coverage of the FCA's new consultation paper on equity listing rules – a direct response to what Alix calls "a precipitous decline in the number of listed companies in the UK of around 40% from a 2008 peak."

A good "listen" this week is the podcast featuring our ESG Finance and Investment partner Sukhvir Basran on sustainability-linked loans.

As always, please reach out here if there's anything you'd like to talk about.

Daniel Meade
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FRB, FDIC and GAO Release Reports Reviewing Supervision of Silicon Valley Bank and Signature Bank

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Last Friday, the Federal Reserve Board ("FRB") and Federal Deposit Insurance Corporation ("FDIC") released reports evaluating their supervision of the failed Silicon Valley Bank ("SVB") and Signature Bank ("Signature"), respectively. On the same day, the Government Accountability Office ("GAO") released its preliminary review of the actions taken by relevant federal agencies, including the FRB and FDIC, relating to the bank failures. You can refer to our Financial Markets Resource Center for further background and resources.

Both of the FRB's and FDIC's reviews found that the issues underlying the bank failures were deficient governance and risk management practices, particularly with respect to managing liquidity risk in the face of the rapid growth of both banks. (SVB's total assets more than tripled from $56B to $209B between 2018 and 2022, while Signature's more than doubled from $47B to $110B during the same period, primarily due to large, uninsured deposits that they relied on to support their growth.) Such issues had been identified by the regulators in prior supervisory cycles but remained unresolved by SVB's and Signature's management. The releases of the FRB and FDIC reviews also include release of a great deal of supervisory material that is usually not public and closely guarded as confidential supervisory information.

The GAO's report included review of: (1) bank-specific factors that contributed to the bank failures; (2) the supervisory actions taken by regulators leading up to the bank failures; (3) the Secretary of the Treasury's invocation of the systemic risk exception that allowed the FDIC to guarantee SVB's and Signature's deposits in excess of $250,000; and (4) the FRB's establishment of the Bank Term Funding Program. The GAO's review found that FRB's and FDIC's supervision were "inadequate" and "lacked urgency" in that the regulators failed to issue supervisory actions sufficient to force the banks to remediate their deficiencies prior to their failures, and that more decisive actions taken by the regulators could have helped the banks mitigate their weaknesses.

SVB was subject to regulation by the Federal Reserve and was supervised by examiners in the Federal Reserve Bank of San Francisco ("FRBSF"). The FRB's review found that SVB had been highly vulnerable prior to its failure, having failed its own internal liquidity stress tests and not having workable plans to access liquidity in times of stress. SVB's depositor base was primarily technology and venture capital companies, whose deposits dwindled as the interest rate environment became less favorable to investment in those sectors. Though FRBSF had found weaknesses in SVB's liquidity and management practices as early as 2018, FRBSF consistently gave SVB ratings of "satisfactory" regarding its overall

condition between December 2018 and June 2022, and the highest and second-highest available Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk (“CAMELS”) ratings for its liquidity and management practices, respectively, during such period. After SVB became subject to a new examination team and more rigorous supervisory requirements as a result of reaching over $100B in assets, in June 2022, FRBSF downgraded SVB’s ratings and found that SVB’s board did not provide effective oversight of the bank’s risk management or hold the bank’s management accountable for the bank’s deficiencies. Notably, the FRB found that SVB “changed its own risk-management assumptions to reduce how [its interest rate risk was] measured rather than fully addressing the underlying risks” in order to focus on short-run profits.

In August 2022, FRBSF indicated the deficiencies in a supervisory letter to SVB and stated its intent to initiate an informal, nonpublic enforcement action that was to be designed to hold the bank’s board and executives accountable. The action – a memorandum of understanding between SVB and its holding company – and a downgrade to SVB’s CAMELS rating related to interest rate risk deficiencies dating back to 2020 were still being finalized in March 2023 when SVB failed. The FRB asserted that its supervisory failures of SVB were due in part to supervisory practices that “placed a greater emphasis on reducing burden on firms, increasing the burden of proof on supervisors, and ensuring that supervisory actions provided firms with appropriate due process,” which “led to slower action by supervisory staff and a reluctance to escalate issues” – in essence, what bank examiners often cite as the “tone at the top.”

As Signature was not a member of the Federal Reserve System, the FDIC was Signature’s primary federal bank regulator. The FDIC’s review found that Signature’s “board of directors and management pursued rapid, unrestrained growth without developing and maintaining adequate risk management practices and controls appropriate for the size, complexity and risk profile of the institution.” However, the FDIC had assessed Signature’s overall condition to be “satisfactory” between 2018 and 2021, though it identified liquidity and management deficiencies at the bank during the same time period. The FDIC issued repeat matters requiring board attention and supervisory recommendations related to such deficiencies that remained unresolved. Signature’s liquidity issues became exacerbated by its reliance on deposits by players in the digital asset (*i.e.*, cryptocurrency) market, which experienced a sharp decline in 2022. According to FDIC staff, “Signature’s management was unable to fully understand the bank’s liquidity positions in the days and hours before failure” due to the bank’s poor governance.

Despite Signature’s significant and persistent deficiencies, the FDIC only issued an interim CAMELS rating downgrade to Signature on the day before it failed. The FDIC also stated that it had been considering escalating its supervisory actions against Signature, including a potential enforcement action, but any such action would have only taken place in Q2 2023. The FDIC cited a lack of resources for its supervisory failures – specifically, the FDIC noted that its New York Regional Office, which was responsible for examining Signature, was not able to adequately staff an examination team dedicated to Signature due to persistent staffing shortages within its examiner ranks. As a result, certain targeted reviews of Signature were not completed in a timely manner or at all due to resource shortages.

In its review, the GAO issued a recommendation that the federal banking regulators incorporate noncapital triggers into its prompt corrective action framework that would encourage earlier action by banks when their financial conditions are deteriorating. The GAO also noted that further reports and assessments relating to the bank failures will be forthcoming.

Additionally, in its review, the FRB stated that it is planning to re-evaluate its stress-testing approach as well as its supervision and regulation of banks' management, interest rate, and liquidity risk, and how to improve the Federal Reserve's capital requirements in light of lessons learned from SVB. The FRB noted that any such adjustments to the liquidity and capital requirement rules would be subject to normal notice-and-comment rulemaking and thus not effective for several years. The FRB outlined a number of policy and implementation issues that should be considered by policymakers to enhance the FRB's supervisory oversight program, including continuing to draw upon lessons learned from earlier bank failures. Such further issues for consideration revolved around four broad themes: (1) enhancing risk identification for both banks and their supervisors; (2) promoting resilience in period of rapid change and heightened uncertainty; (3) changing supervisor behavior such that supervisors move more decisively and focus on inherent risk; and (4) strengthening oversight processes by simplifying and tailoring the framework.

Some of those enhancements to the supervisory programs can be undertaken with just internal changes at the agencies relatively rapidly. For instance, changing supervisory processes and hoping for changes in examiner behavior can just be implemented as new policy at the agencies. However, changes to categorization under the tailoring rule will require notice-and-comment rulemaking and, as acknowledged by Vice Chair Barr in the FRB report, will take time. The agencies should, in most cases, however, be able to implement the enhancements suggested in the report through existing authority, and not necessarily require new legislation.

Considerations for Counterparties Whose Swaps Are Transferred from First Republic to J.P. Morgan

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On May 1, 2023, the Federal Deposit Insurance Corporation ("FDIC") seized control of First Republic Bank ("First Republic") and then, as receiver of First Republic, entered into a purchase and assumption agreement ("P&A") with JPMorgan Chase Bank, National Association, Columbus, Ohio ("JPM"), to assume all of the deposits and substantially all of the assets of First Republic, including qualified financial contracts ("QFCs"). The asset transfer was thus carried out via the P&A Agreement, in accordance with the Federal Deposit Insurance Act ("FDIA") and became effective without the consent of counterparties under those QFCs.

Previously, subsequent to the failure of Silicon Valley Bank ("SVB") and Signature Bank ("Signature"), on March 13, 2023, the FDIC also facilitated the transfer of QFCs from the failed banks to newly established bridge banks, Silicon Valley Bridge Bank, N.A. and Signature Bridge Bank, N.A., respectively, and ultimately to First Citizens BancShares, Inc. and Flagstar Bank, respectively. While the transfer of First Republic's QFCs to JPM was similar in most respects to the SVB and Signature transfers, there is at least one significant difference: JPM, unlike First Republic or the SVB and Signature successor entities, is a provisionally registered swap dealer with the Commodity Futures Trading Commission ("CFTC"), a security-based swap dealer with the Securities and Exchange Commission ("SEC") and has a U.S. Prudential Regulator ("USPR").

Importantly, a swap dealer, such as JPM, is subject to certain provisions of the Commodity Exchange Act ("CEA") as well as certain regulations by USPRs that do not apply to non-swap dealers (such as First Republic). Its counterparties should assess the potential legal and economic implications resulting from the transfer of their QFCs to JPM, as well as the necessary next steps. We note that, from a practical perspective, given JPM's prominence in the financial markets, many counterparties that were trading swaps with First Republic likely have existing swap trading relationships and documentation (such as ISDA Master Agreements ("ISDAs") and related Credit Support Annexes ("CSAs")) in place with JPM. The focus of this summary is on QFCs that qualify as swaps.

For Non-Swap Dealer Counterparties of First Republic

First Republic was not a CFTC-registered swap dealer. Therefore, where it faced another non-swap dealer, First Republic presumably did not collect regulatory variation margin ("VM") or initial margin ("IM") in connection with swaps exposure. Non-swap dealers that now face JPM should be aware that as a swap

dealer, JPM must establish bilateral exchange of regulatory VM and collect IM from CPs that are "Financial End Users" (as defined in the USPR margin rules, "FEUs") with "Material Swaps Exposure" (as defined in the USPR margin rules, "MSE"). Even if First Republic and a counterparty maintained a CSA that provided for the contractually agreed exchange of margin and/or collateral, its terms are not likely to be the same as for regulatory VM and IM.

Therefore, some form of regulatory relief from USPRs, such as the Office of the Comptroller of the Currency ("OCC") as the relevant regulator of JPM, would be appropriate to resolve the tension between the counterparties' contractual obligations under the legacy swap documentation and JPM's regulatory obligations as a swap dealer. From a policy perspective, such relief would be consistent with the "grandfathering" of legacy swaps when the regulatory margin requirements first went into effect. In that case, the relief was appropriate because the law changed; here the relief is appropriate because the facts (*i.e.*, the counterparty) changed. In both cases, the change would affect the economics of the contract without consent.

As with any novation or assumption, the transfer of each swap contract from First Republic to JPM should qualify as a "life-cycle event" and, as such, would need to be reported to a swap data repository ("SDR"). JPM will be responsible for such reporting as a provisionally registered swap dealer. Also, ISDAs and confirmations transferring to JPM will require significant documentation changes, including revisions to representations, notice provisions, deliverable documents, legal entity identifiers, appropriate ISDA protocols, safe harbors and elections under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

For Swap Dealer Counterparties of First Republic

Where First Republic's counterparty was a registered swap dealer, that swap dealer now faces JPM, another swap dealer. Given JPM's prominence in the derivatives markets, it is highly likely that counterparty already has a swaps trading relationship with JPM, such as documented under the ISDAs. The two swap dealers will need to reconcile the two sets of documentation (*i.e.*, the preexisting and the one transferring from First Republic), including the scope of "margin affiliates," their margining models for one another, netting and set off provisions for their swaps trading relationships, and whether the transferred swaps will be aggregated with existing swaps or sit in a separate portfolio. Even though there are provisions in the CFTC and USPR uncleared margin rules that allow separate portfolios for netting purposes, guidance from the USPRs and CFTC for CFTC-only registered swap dealers will provide clarity in these unprecedented circumstances.

Additionally, just as is the case for non-swap dealer counterparties, the transfer of each swap contract from First Republic to JPM should qualify as a reportable "life-cycle event." The swap dealers will determine which party will carry out the reporting. The swap dealers will also need to amend their documentation to reflect JPM as the counterparty to the transferred swaps.

In conclusion, the transfer of First Republic's QFCs to JPM in connection with the FDIC's receivership under the P&A Agreement did not involve the consent from First Republic's counterparties. The resulting regulatory and contractual issues should be addressed as soon as is practicable. In the interim, market participants would benefit if the CFTC, USPRs and SEC (with respect to security-based swaps)

issued no-action relief (similar to the CFTC's relief in connection with the SVB and Signature failures) and refrained from initiating enforcement actions against market participants caught up in the QFC transfers.

(The authors wish to thank counsel Michael Ena for his important contributions to this news item.)

The UK's Financial Conduct Authority Proposes Significant Reforms of Listing Rules

By Alix Prentice
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On 3 May, the UK's Financial Conduct Authority ("FCA") issued Consultation Paper CP23/10 setting out significant proposals to reform equity listing rules.

There has been a precipitous decline in the number of listed companies in the UK of around 40% from a 2008 peak, and between 2015 and 2020, the UK hosted only 5% of Initial Public Offerings globally. In light of this decline, and following on from earlier review exercises and recommendations (including Lord Hill's UK Listing review and the Kalifa Review on UK fintech), the FCA is now proposing changes to the listing rulebook to replace current "standard" and "premium" listing segments with a single segment for "equity shares in commercial companies" ("ESCC"). The FCA is hoping that simplifying the listing regime and removing those eligibility requirements and other regulatory burdens that are perceived as deterring early-stage companies will propel London's international competitiveness. In order to reflect the diversity of listed issuers the UK wants to retain and attract, underneath this single listing structure will be "categories" of different issuer and security types, namely: commercial companies (including strategic investment companies); closed-ended investment funds; sovereign-controlled commercial companies; open-ended investment companies; SPACs and cash shells; other shares including secondary listings, preference shares and deferred shares; debt and debt-like securities; certificates; securitised derivatives, and miscellaneous securities.

New listing category for equity shares in commercial companies

In CP23/10, the FCA is consulting on a new, single category for ESCC with commensurate proposals on eligibility and ongoing listing requirements, with the aim of improving the accessibility and competitiveness of the UK listing regime. The changes proposed include:

- Removing the current premium listing requirements to provide historical financial information, a revenue-earning track record and information to satisfy the FCA that the applicant has sufficient working capital;

- Modifying current premium listing requirements to demonstrate that the applicant for listing carries on an independent business as its main activity and retains operational control over that business. This will facilitate more flexibility to take account of diverse business models and more complex corporate structures, including those that act as strategic investors by taking non-controlling positions (but which are not fund vehicles) and SPACs or shells that do not have operating activities;

- Reforming dual class share structures to allow enhanced voting rights to be exercised on all matters and at all times, but with conversion to ordinary shares with one share, one vote after 10 years rather than the current maximum sunset period of 5 years;

- Ceasing to require a shareholder vote and shareholder circulars for related party transactions, including when that related party is a controlling shareholder;
- Reframing the requirement for a controlling shareholder agreement to a comply or explain approach under which the absence of an agreement would require specific disclosures and inclusion in the prospectus and annual report of relevant risk factors; and
- Removing current mandatory shareholder approvals and shareholder circular requirements in relation to large “significant” transactions.

Single set of Listing Principles

These will underpin the reformed regime and combine the current Listing Principles and Premium Listing Principles into a single body of principles that are tailored according to different categories of listing. A further consultation in the autumn will consider the interaction with UK company law and directors’ fiduciary duties. The autumn consultation will also consider further details on proposals to accommodate different segments of issuers and securities.

Our thoughts

This is the most significant shake-up of the UK’s listing regime in decades, and while the direction of travel has been largely welcomed by the market, concerns about investor rights have also been voiced, which will certainly play out in the consultation process.

Unlocking Sustainability-Linked Loans

By **Sukhvir Basran**
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Cadwalader recently hosted a breakfast discussion with the Loan Market Association and LSTA with the aim of "Unlocking Sustainability-Linked Loans." During the session, Cadwalader ESG Finance and Investment partner Sukhvir Basran was joined by the LMA's Gemma Lawrence-Pardew and the LSTA's Tess Virmani in a conversation addressing some of the most frequently asked questions raised by market participants in respect of sustainability-linked loans.

Click here to listen to the discussion.

Click here to read a summary.