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Cabinet News and Views

Informed analysis for the financial services industry

We Remember and Honor

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In This Issue ...

There has certainly been a lot going on in recent months with regard to the U.S. financial system and the global implications of recent bank failures, and we cover several recent developments in this week's *Cabinet News and Views*.

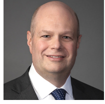
So in both the U.S. and the UK, it will be nice to enjoy a long weekend, with Memorial Day and late May bank holiday, respectively.

It is tempting in the U.S. to view the holiday as the unofficial start of the summer season, with a long weekend of outdoor activities, picnics and barbecues, and shopping. But let's step back for a moment and remember that Memorial Day reminds us of the heroic men and women of the U.S. Armed Forces who sacrificed their lives for our freedom. Earlier today, soldiers of the 3rd U.S. Infantry Regiment – the oldest active-duty infantry unit in the Army, dating back to 1784 – began to carry out a decades-old tradition, placing American flags at each of the 400,000 gravesites at Arlington National Cemetery in Virginia. And on Monday, at 3 p.m. local time, musicians all across the country will participate in "Taps Across America" – playing the traditional 24-note melody for fallen heroes on bugles and other musical instruments.

As we honor the true meaning of Memorial Day in the U.S., let's remember these words: “Our flag does not fly because the wind moves it. It flies with the last breath of each soldier who died protecting it.”

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

FDIC Chair Speaks on Importance of Financial Inclusion and Safety of Deposit Insurance



By **Daniel Meade**
Partner | Financial Regulation

Federal Deposit Insurance Corporation ("FDIC") Chair Martin Gruenberg gave remarks to the Cities for Financial Empowerment Fund 2023 Bank On National Conference yesterday in which he said that the FDIC "shares the Bank On movement's commitment to advancing Americans' economic inclusion in the banking system."

Chair Gruenberg noted that the Bank On account standards are consistent with the FDIC's own SAFE Account template, and he praised the work and growth of the Bank On coalition since 2015, noting that the effort has grown from four insured depository intuitions to over 300 institutions, representing more than 61% of domestic deposits, that now offer certified accounts.

Chair Gruenberg discussed the 2021 National Survey of Unbanked and Underbanked Households, released by the FDIC in October 2022 (which we discussed last year), noting his belief that programs such as Bank On have helped to reduce the number of unbanked and underbanked households. In his view, "the easiest way for most consumers to have confidence that their money is safe is to deposit it in an insured bank account."

Chair Gruenberg concluded his remarks by pointing to the importance of safety deposit insurance in light of the stress some institutions and crypto providers have experienced recently. He said: "I would be remiss if I did not remind you that since the FDIC started insuring accounts in 1934, depositors have not lost a single penny in insured deposits to a bank failure."

CFTC Issues Advisory on Prime Brokerage Arrangements on SEFs and DCO Registration Requirements

By **Peter Y. Malyshev**
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On May 17, the staff of Commodity Futures Trading Commission ("CFTC") Division of Clearing and Risk ("DCR") issued an advisory ("Advisory") that encourages entities using prime brokerage ("PB") arrangements that provide credit substitution on a centralized basis on swap execution facilities ("SEFs") to assess whether these activities qualify as those of a derivatives clearing organization ("DCO") and are therefore subject to registration with the CFTC. DCR notes that the Advisory was prompted by recently proposed arrangements on SEFs where a single PB would be providing credit substitution to multiple SEF participants, which, in DCR's view, would qualify these PBs as DCOs that must register.

The Advisory asserts that these PB arrangements fit within the definition of a DCO in § 1a(15)(A)(i) of the Commodity Exchange Act ("CEA"), which states that an entity, facility, system, or organization "that, with respect to an agreement, contract, or transaction … enables each party to the agreement, contract, or transaction to substitute, through novation or otherwise, the credit of the [DCO] for the credit of the parties." The Advisory goes on to explain that DCR staff reviews all facts and circumstances and that it does not believe that all PB arrangements will qualify as DCOs.

Considering the text of the Advisory, the staff of DCR recognizes the following factors as relevant:

- the market structure is a PB arrangement;
- it is used with trading on a SEF;
- there is only one centralized PB used for multiple participants on the SEF;
- credit substitution is provided to all SEF participants;
- credit substitution is provided through "novation or otherwise"; and
- PB may or may not be a provisionally registered swap dealer ("SD").

The specific nature of these factors may limit this Advisory to specific fact patterns, distinguishing this Advisory from CFTC's advisory issued on September 29, 2021 also relating to SEFs, but with a much broader reach to commodity trading advisers and introducing brokers that, in CFTC's view, may qualify as SEFs. Future CFTC action will clarify how broadly the staff of the CFTC is prepared to interpret the Advisory. For example, in the wake of the September 29, 2021 SEF advisory, the CFTC had already settled two enforcement actions that specifically reference that advisory.

It is also likely that DCR staff will need to clarify what it considers a “credit substitution” that would be sufficient to trigger the DCO registration requirements. In a CFTC no action letter No. 19-06 issued on March 22, 2019, the CFTC also considered PB arrangements involving SDs and disclosure requirements under CFTC regulation § 23.431 and described PB arrangements where “PB performs a credit intermediation role in the transaction because the [t]rading [c]ounterparty is able to obtain a variety of prices from SEF participants but only faces its PB with respect to credit risk…” CFTC letter 19-06 did not discuss whether any PB arrangements would qualify as DCOs, and did not emphasize the relevance of the number of PBs involved (*i.e.*, if there is a single PB or multiple). Likewise, neither the CEA nor CFTC regulations note the quantity of PBs and risk substitution intermediaries as a factor in determining whether such entity is or is not a PB.

Finally, on December 5, 2022, several provisions of the CFTC’s rewrite of Part 43 and 45 reporting provisions became effective where reporting counterparties for the first time need to report to swap data repositories (“SDRs”) information about PB arrangements. Given the availability of reportable data coming from SDRs relating to PB arrangements, it is likely that the CFTC will further explore PB arrangements. Therefore, any SEF or entity providing PB services, either an SD or not, should conduct a thorough analysis of its operations.

ESMA Publishes Consultation Paper on ELTIF Draft Regulatory Technical Standards

By **Michael Newell**
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On 23 May 2023, the European Securities and Markets Authority ("ESMA") published a consultation paper (ESMA34-13000232-124) on draft regulatory technical standards ("RTS") under the Regulation on European Long-Term Investment Funds ((EU) 2015/760) ("ELTIF Regulation") as amended by Regulation (EU) 2023/606, which comes into force in its amended form on 10 January 2024.

The ELTIF Regulation established a type of investment fund called an ELTIF, which is a regime applied to EU alternative investment fund managers and EU alternative investment funds to allow both professional and retail investors to invest in companies, debt and real assets. The original regulation was too restrictive in scope, and not a great success in terms of product launches, and the revised formulation coming into force in January makes or clarifies certain important amendments to the regime to allow greater product flexibility, including:

- ELTIFs may now clearly have a worldwide mandate. Certain spread and concentration limits are relaxed (with more ability to have substantial holdings in cash and non-eligible assets), especially for professional investor-only funds and the latter has a revised 100% leverage limit.
- Broader scope of eligible investments: simple securitizations, EU green bonds, simplified definition of real assets (removal of the minimum threshold for individual value of real estate assets).
- Greater scope for indirect investments, co-investments, master-feeders and fund-of-funds.
- Retail distribution restrictions have been relaxed to align suitability with MIFID requirements.

Another major problem with the original ELTIF is considered to be the closed-ended nature of the product with little ability to incorporate hybrid liquidity options, which the amending regulation seeks to address by enabling the introduction of periodic redemption and matched trading options. The thrust of this consultation is to seek views on proposed new RTS which will specify the way new requirements of the revised ELTIF Regulation, and specifically the provisions on the redemption policy and matching mechanism, will apply.

In particular, ESMA is seeking views on:

- The circumstances in which the life of an ELTIF may be considered compatible with the life-cycles of each of the individual assets, as well as different features of the redemption policy of the ELTIF.

- The circumstances for using a trade matching mechanism (*i.e.*, full or partial matching of transfer requests of units or shares in the ELTIF with transfer requests by potential investors).
- Costs disclosure.

The deadline for responding is 24 August 2023. ESMA will consider feedback received in the autumn and expects to publish a final report and submit the final draft RTS to the European Commission for endorsement by 10 January 2024.

Exploring UK Regulatory Reform Amid Global Bank Failures

By **Alix Prentice**
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By **Carl Hey**
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Given recent stresses in the global financial system and the associated high-profile bank failures, there has understandably been much attention focused on bank liquidity.

While this attention is clearly justified, the significant work to address issues surrounding prudential liquidity provisioning on foot since the global financial crisis of 2007/2008 should not be overlooked.
In this *Law360* article, we examine some of the prudential liquidity reforms implemented following the global financial crisis and the current status of the ongoing regulatory review in the UK.

We will also look at how, while the purpose of these measures is to ensure that banks create a "rainy day" fund to tap into in times of emergency, deploying these funds in times of stress is possibly easier said than done.

Read the article here.