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Cabinet **News and Views**

Informed analysis for the financial services industry

Hit Parade

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In This Issue ...

I guess it's time to add AI to the weekly regulatory hit parade that already includes crypto, ESG (especially the "E" for environmental), risk management and other popular topics.

First we had a much-publicized survey paint a doomsday picture of AI, with 42 percent of CEOs at the Yale CEO Summit warning that AI has the potential to destroy humanity five to ten years from now. Then, in a much less breathless pronouncement, Acting Comptroller of the Currency Michael Hsu still cautioned in an American Bankers Association speech that regulators need to arrive at a place "where responsible and purposeful innovation can be brought to market and a combination of controls, culture and common sense can prevent irresponsible innovations from emerging." My colleague Mercedes Tunstall takes a closer look at these noteworthy observations from Acting Comptroller Hsu.

Lots more to read this week, including important guidance from the CFTC and, in the UK, the FCA, along with a look at comments from Assistant Attorney General Jonathan Kanter on the ongoing review of Bank Merger Guidelines.

What are your experiences in these areas? I'd love to discuss. You can reach me here.

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

Ask Permission, Not Forgiveness for Responsible Innovation: Acting Comptroller Hsu Discusses Tokenization and AI

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

In a speech given at the American Bankers Association's Risk and Compliance Conference on June 16th, Acting Comptroller Michael J. Hsu discussed the importance of responsible innovation in financial services, with a special focus on tokenization and artificial intelligence ("AI").

Acting Comptroller Hsu started his comments by remarking that, "[i]n banking, the responsible approach to innovation is the better way: by progressing in tightly controlled stages where the risks can be identified, measured, and managed at each stage, by building the brakes and the engine at the same time, and by working with regulators, instead of around them. This takes discipline and time. It requires engagement by, and trust in, risk managers and compliance professionals from the get-go through every step of the process."

Then he discussed the "promise and perils of tokenization and AI" for financial services. Tokenization, in this context, refers to the practice of using trusted blockchains to "improve settlement efficiency through tokenization of real-world assets and liabilities." Today, there is a lag between when the terms of a transaction are agreed upon and when settlement of that transaction is deemed final. The lag occurs because multiple entities must reconcile and verify the transaction, and other steps and legal requirements must be met. For example, if a share of stock is "tokenized" (*i.e.*, represented by a block on a blockchain), then as soon as the instruction is given by the trader, the trusted blockchain solution can immediately transact and settle the trade. To this end, Acting Comptroller Hsu references that others have estimated that tokenization of real-world assets "could save 35 to 65 percent across the settlement value chain, including, for instance, cost savings of up to $5 billion for equity-post trading." Many questions, legal and otherwise, still need to be worked out with respect to tokenization, including defining the relationship between owning the token and the underlying real-world asset or liability, what happens when bankruptcy occurs, and what is the process for un-tokenizing an asset or liability. But, once those legal foundations for tokenization are developed, then, Acting Comptroller Hsu commented, "tokenization innovations can be sustained and trusted over time."

Acting Comptroller Hsu then turned to discuss the use of AI by banks, observing that, so far, their approach has been cautious. However, he identifies a palpable sense of FOMO (fear of missing out) in the banking community, especially as ChatGPT and other public AI platforms have captured the imagination of a wide variety of businesses and consumers. Indeed, he observes, "[t]he use of AI has the potential to reduce costs and increase efficiencies; improve products, services and performance; strengthen risk management and controls; and expand access to credit and other bank services." However, Acting Comptroller Hsu notes that AI systems have outputs that are not predictable and oftentimes cannot be explained, especially as the AI system learns more and strays from its initial programming. In

addition, he pointed out, “AI systems . . present unique bias and discrimination challenges” and enable increasingly sophisticated frauds to be perpetrated by way of mimicking human communication and creating synthetic identities.

As banks grapple with these two kinds of innovation in particular, Acting Comptroller Hsu referred to OCC guidance regarding New, Modified, or Expanded Bank Products and Services, as well as guidance on Model Risk Management (*i.e.*, for algorithms) and regarding Third-Party Risk Management (which guidance has recently been updated and was covered by *Cabinet News and Views* here). Emphasizing that for these two areas of innovation in particular “asking for permission, not forgiveness” is the right approach, Acting Comptroller Hsu concluded his speech by acknowledging that regulators need to have a more responsive approach to create a path “where responsible and purposeful innovation can be brought to market and a combination of controls, culture and common sense can prevent irresponsible innovations from emerging.”

CFTC Enforcement Encourages Carbon Markets Whistleblowers

By Peter Y. Malyshev
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By Jason M. Halper
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On June 20, following a number of consultative papers, reports, committee hearings and public speeches by representatives of the Commodity Futures Trading Commission ("CFTC"), the staff of CFTC's Division of Enforcement ("DOE") has published its first alert on voluntary carbon markets ("VCMs"). The alert: (i) describes the CFTC's jurisdiction over VCMs; (ii) lists typical offenses involving VCMs; (iii) explains how to identify fraud and manipulation in VCMs; and (iv) lays out how to report alleged violations to the DOE.

Carbon credits (also known as offsets) and allowances, as well as many other environmental products, are generally recognized as "commodities." As a result, the CFTC has enforcement authority to pursue fraud and manipulation claims relating to interstate transactions in these commodities. Many of these contracts trade bilaterally over the counter or on spot exchanges. Further, carbon credits and other environmental commodities trade as futures contracts on CFTC-regulated exchanges (designated contract markets – "DCMs"), where the CFTC can exercise its full regulatory jurisdiction.

The CFTC provided a list of examples of misconduct involving VCMs for potential whistleblowers to "be on the lookout for," including manipulative and wash trades in futures carbon contracts; manipulation of tokenized carbon markets; and fraud in underlying spot carbon markets, such as listing of ghost (or illusory) credits on carbon market registries, double counting, and "fraudulent statements relating to material terms of the carbon credit, including, but not limited to: quality, quantity, additionally, project type, methodology substantiating emissions claim, environmental benefits, the performance or duration, or the buffer pool."

It is clear that the CFTC has the view that all VCM products underlying listed futures contracts are within the CFTC's jurisdiction. Given that there are approximately 200 such VCM-based listed futures contracts in the U.S., the CFTC has jurisdiction over a vast majority of VCM products. For example, if a carbon credit product underlies a DCM-traded futures contract and purports but falls materially short of achieving actual carbon reduction, the CFTC would have the authority to pursue based on alleged fraud and manipulation all those who had listed that carbon credit on a registry. However, it is not clear whether an unrelated entity will be subject to the CFTC's enforcement authority if such entity based corporate disclosures on these carbon credits and therefore arguably engaged in greenwashing. It appears, however, that at a minimum, the CFTC would nevertheless like to hear from whistleblowers about this conduct.

The alert notes that currently the VCM is estimated at $2 billion and is expected to grow to $250 billion by 2050 as more market-based initiatives are implemented to

mitigate climate change and transition to a low-carbon economy. As a commodity market regulator, the CFTC would play a critical role in policing VCMs and environmental commodity markets for potential fraud and manipulation. To further study these markets the CFTC had established in 2021 a new Climate Risk Unit within the CFTC.

DOJ Antitrust Assistant AG Speaks on Bank Merger Policy

By **Daniel Meade**
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Earlier this week, Jonathan Kanter, Assistant Attorney General for the Antitrust Division of the Department of Justice ("DOJ"), delivered remarks at the Brookings Institution titled "Merger Enforcement Sixty Years After Philadelphia National Bank." In his remarks, Assistant AG Kanter noted that the Antitrust Division invited public comment on changes to the 1995 Bank Merger Guidelines, and that the Division is considering the comments received during the two rounds of public comment they requested. He also noted steps the Division is already undertaking.

Said Assistant AG Kanter: "The division is modernizing its approach to investigating and reporting on the full range of competitive factors involved in a bank merger to ensure that we are taking into account today's market realities and the many dimensions of competition in the modern banking sector." He went on to note that "[t]hese analyses will include consideration of concentration levels across a wide range of appropriate metrics and not just local deposits and branch overlaps."

Assistant AG Kanter stated that the division will pay particular interest to two areas as it prepares its competitive factor reports: (1) "the division will closely scrutinize mergers that increase risks associated with coordinated effects and multi-market contacts," and (2) "the division will carefully consider how a proposed merger may affect competition for different customer segments." On the first point, smaller community banks will likely be heartened to hear that Assistant AG Kanter believes "we will not limit our analysis to small and local bank acquisitions."

As we discussed over a year ago, the banking agencies are also considering updates to their bank merger policies as part of the whole-government response to the President's Executive Order in July of 2021. There are some who may be somewhat disappointed in Assistant AG Kanter's remarks, as they seem to indicate an increasing scrutiny of bank mergers from the DOJ. Some had hoped that a thawing in bank and financial regulators' views on bank mergers may have recently occurred in the wake of March and April bank failures. The interaction between and amongst the DOJ and the banking agencies with regard to bank merger review will continue to be of great interest.

CFTC Issues Notice of Proposed Rulemaking in Connection with Risk Management Program Regulations for SDs, MSPs and FCMs

By **Peter Y. Malyshev**
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By **Nikita B. Cotton**
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By **Kathryn Garland**
Associate | Financial Regulation

The Commodity Futures Trading Commission, on May 31, published an Advance Notice of Proposed Rulemaking seeking public comment in connection with potential amendments to the regulations under the Commodity Exchange Act relating to the risk management program requirements for swap dealers, major swap participants and futures commission merchants registered with the CFTC. Additionally, the CFTC is seeking comment on how to alter the current periodic risk reporting regime for such market participants. The changes the CFTC has proposed could result in either significant operational efficiencies or greater operational burdens for market participants if implemented; accordingly, market participants should consider submitting comments.

You can access our Clients & Friends Memo here.

The United Kingdom Introduces New Rules for Marketing Cryptoassets

By **Alix Prentice**
Partner | Financial Regulation

The UK's Financial Conduct Authority ("FCA") has introduced robust new rules for those marketing cryptoassets to UK consumers. In Policy Statement PS23/6, new requirements covering financial promotions for all firms aimed at UK consumers, regardless of where the promoter is based or what technology they use, designate cryptoassets as "Restricted Mass Market Investments." This means invitations or inducements to engage in investment activities in relation to "qualifying cryptoassets" will be subject to the restrictions outlined below. Broadly, a qualifying cryptoasset is any cryptographically secured digital representation of value or contractual rights that is transferable and fungible but does not include e-money (as defined), nor an existing controlled investment.

Legal Promotions of Cryptoassets

There will now be four ways to promote to UK consumers legally: (1) the communication is made by an FCA-authorised firm (whose authorisation is not solely under the Electronic Money Regulations nor the Payment Services Regulations); (2) the communication is approved by an authorised firm that has passed through a regulatory gateway legislation which is currently with Parliament; (3) the communication is made by or on behalf of a cryptoasset business that is registered with the FCA under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 but which is not otherwise authorised by the FCA; or (4) the communication falls under an exemption in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 ("FPO"). Note that existing FPO exemptions for promotions to high-net-worth individuals and self-certified sophisticated investors will not apply to cryptoassets, and the UK Government is also carving out exemptions for associations of high-net-worth or sophisticated investors and promotions in association with the sale of goods and supply of services.

Risk Warnings and Summaries

The new rules include requirements for risk warnings, including wording, prominence, and a link to a risk summary. Prominence is calibrated to different mediums – for example, digital promotions should not require consumers to take any further steps in order to see the full risk summary after they have clicked on the hyperlink in the risk warning.

Other Restrictions

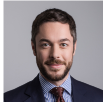
1. Incentives to invest, such as "refer a friend" and new joiner bonuses, are now prohibited.
2. There must be a "cooling off" period of 24 hours between the consumer receiving a direct offer financial promotion and the consumer being able to

invest.

3. There are new requirements for personalised risk warning pop-ups.
4. Appropriateness rules for promotions are now more robust, so consumers' knowledge and experience are thoroughly vetted.

The rules are expected to have effect from 8 October 2023.

UN-Initiated and Bank-Led Working Group Formed to Encourage Banks to Achieve Biodiversity Targets


By **Duncan Grieve**
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By **Sharon Takhar**
Associate

On May 4, the United Nations announced the formation of a 35-member bank-led working group to promote nature- and biodiversity-related target setting that is aligned with the Kunming-Montreal Global Biodiversity Framework ("GBF") adopted at COP15 last year, as well as to implement other climate-related market standards such as the recommendations of the Taskforce on Nature-related Financial Disclosures ("TNFD"). The Co-Leads of the Working Group are UBS, Crédit Agricole S.A. and First Abu Dhabi Bank, and all working group members are signatories to the Principles of Responsible Banking ("PRB").

In a statement setting out the mandate of the working group, the UN stated that the global decline of nature "at an alarming and unprecedented" rate presents a significant risk to businesses, and particularly to those in the financial sector given that the majority of the world's GDP – as much as $58 trillion – relies on nature in some way. Banks participating in the working group will focus on how banking activities affect the natural world by analyzing resources that are currently available and determining what is needed to close the biodiversity financing gap. The banks will also suggest measures to encourage the development of environmentally friendly business. Additionally, the working group will take into account the rights of indigenous peoples and local communities as it develops nature targets and practices. Existing climate mitigation and net-zero targets also will be integrated into the plans for addressing biodiversity loss.

The PRB builds on the existing Guidance on Biodiversity Target-Setting, which encourages the banking sector to take action to achieve biodiversity targets using a systematic approach. The guidance is supported by stakeholders that focus on the environment, including the Science Based Targets Network ("SBTN"), TNFD, UNEP World Conservation Monitoring Centre ("UNEP-WCMC"), and the Finance for Biodiversity Foundation. The working group will seek to promote alignment and consistency with existing frameworks, such as the PRB Biodiversity Community and UNEP FI-led TNFD projects. It will also offer high-level recommendations on how financial institutions can align their portfolios with PRB targets and GBF goals.

The guidance created by the working group will seek to effectively tackle "the loss of biodiversity and nature to apply a holistic and systemic approach to set and achieve nature targets," said the UN.

Taking the Temperature: In January we reported on the GBF reached at the conclusion of COP15, which amplified the importance of nature and biodiversity concerns and established them as a permanent feature of the sustainability discussion. This has informed recent EU policy initiatives, which include

biodiversity considerations as part of the EU's goal to achieve carbon neutrality by 2050. It is also notable that the European Green Deal also includes an aim to promote biodiversity in line with the EU's Biodiversity Strategy for 2030.

As we discussed previously, nearly 200 countries have adopted the Kunming-Montreal Global Biodiversity Framework and are working to achieve the goals set out by that regime, which includes four goals for 2050 and 23 targets for 2030, creating "an ambitious pathway to reach the global vision of a world living in harmony with nature by 2050."

The establishment of the PRB is one more step in this direction to address climate change and loss of biodiversity. The 35 signatories constitute about half of the world's global assets and hail from 24 countries, indicating that the banking industry is taking forward-looking steps to address the biodiversity financing gap and other issues facing nature, joining, as we have noted in the past, other sectors, including the insurance industry.

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