CADWALADER

Cabinet News and Views

Informed analysis for the financial services industry

Resolutions and Revolutions

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My colleague Mercedes Tunstall discusses the FDIC incorporating crypto risks into its annual Risk Review, a major milestone in recognizing the influence of cryptocurrencies.

Peter Malyshev and Nikita Cotton dissect the recent DC Court ruling that recharacterized futures contracts as security futures.

Plus, we've included key industry updates, including the CFTC's appeal to potential whistleblowers in the carbon markets, and more from my UK colleagues Alix Prentice, Sukhvir Basran and Duncan Grieve.

Daniel Meade
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FDIC Chair Speaks on Resolution of Large Regional Banks

By **Daniel Meade**
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On Monday, Federal Deposit Insurance Corporation ("FDIC") Chair Martin Gruenberg gave remarks to the Brookings Institution on "The Resolution of Large Regional Banks." Chair Gruenberg did not say "I told you so" in his prepared remarks, but Brookings basically did it for him. The Brookings Institution's description of Chair Gruenberg's remarks note his 2019 speech to the Brookings Institution when he was a member of the FDIC Board "warning about the underappreciated resolution challenges and financial stability risks that would emerge upon the failure of a large regional bank … [calling for] require[ing] loss absorbing debt at these types of banks and urged stronger resolution planning requirements." Brooking went on to say that "[h]is words proved prophetic this March when Silicon Valley Bank and Signature Bank failed, resulting in regulators exercising systemic risk authority to protect uninsured deposits."

Now in 2023, Chair Gruenberg called again for rulemaking to improve that ability to resolve larger regional banks without the expectation of invoking the systemic risk exception, as occurred this spring. He stated that he believes that changes are needed in four main areas to improve the resolvability of large regional banks: (1) capital regulation; (2) resolution planning requirements, including long-term debt; (3) bank supervision; and (4) deposit insurance pricing.

With regard to capital regulation, Chair Gruenberg noted the July 27 proposal to implement the Basel III Endgame capital rules included an important provision that would address the three bank failures this spring – recognition of unrealized losses on available for sale securities for all banks larger than $100 billion in assets. On long-term debt, Chair Gruenberg stated that "the banking agencies will in the near future propose a long-term debt requirement for banks with $100 billion or more in assets." He also noted that the FDIC "will soon propose changes to the IDI plan requirements that would make them significantly more effective." Chair Gruenberg stated that while SVB and First Republic Bank had filed IDI plans, one of the lessons learned from those failures was that "far more robust plans would have been helpful in dealing with the failure of these institutions." Chair Gruenberg then noted that bank supervision and deposit-insurance pricing are areas that the FDIC will be focusing on to address the risks of uninsured deposits and the contagion risk that became very apparent this spring.

In concluding his remarks, Chair Gruenberg stated, with regard to the lessons learned this spring (and perhaps the closest he came to actually saying "I told you so"), "[t]hese are perhaps lessons we should have learned from the 2008 financial crisis. The events of earlier this year provide us with another opportunity. This time I don't think we'll miss."

FDIC's Annual Risk Review Includes Crypto Risks for First Time

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The Federal Deposit Insurance Corporation ("FDIC") published its annual Risk Review this past Monday, providing an overview of banking conditions for 2022 through early 2023. The FDIC started providing Risk Reviews to the marketplace in 2019, at which point it focused upon key risks in two categories – credit risk and market risk. However, in the 2022 Risk Review, the FDIC also covered operational risks as well as credit risks and market risks, with a particular focus on cyber threats and illicit activities, and addressed climate-related financial risk as well. This year's Risk Review adds a fifth category of risks presenting challenges to the banking system: crypto-asset-related markets and activities, which the FDIC included largely due to the "failure of three large banking institutions in March and May" of this year.

Characterizing the response of the banking industry to the three bank failures as "resilient," the FDIC nevertheless warns that "banking conditions [remain] stressed and vulnerable to additional adverse market developments." Specifically, the biggest factors overall involve higher interest rates, high inflation, recession concerns and weaker overall economic conditions in 2023. In terms of credit risks, asset qualities remained favorable, but there are some weak spots, particularly with respect to stress on commercial real estate due to "structural decline in office demand and weak rent growth"; consumer loan past-due rates rising for credit cards and auto loans; a sharp slowdown in corporate debt issuance; and small business lending declining resulting from high inflation, labor market shortages and the winding down of lending under the Paycheck Protection Program. According to the FDIC, "Market risks were primarily related to the effects of higher interest rates. Deposit outflows along with high levels of unrealized losses could [continue to] pressure liquidity for some banks" in the remainder of 2023.

In terms of cyber risks, the FDIC points to risks to banks as a result of ransomware attacks as well as to cyber attacks on critical infrastructure such as banks that have doubled in the last year, according to the Microsoft Digital Defense Report from November 2022. The cyber portion of the Risk Review also focuses on the intersection between cyber events and anti-money laundering ("AML") efforts, emphasizing the importance for banks to obtain beneficial ownership information for all of their customers and encouraging limited use of third parties to perform AML services. Moreover, climate-related risks were observed as being ongoing, with the FDIC commenting that it recognizes that bank risk management practices are evolving and that the FDIC is "expanding efforts to understand climate-related financial risk in a thoughtful and measured manner that emphasizes a risk-based approach and collaboration with other supervisors and the industry."

Finally, the 2023 Risk Review included a new section addressing crypto-asset risk and states that due to crypto-asset sector volatility in the past year, several vulnerabilities in the banking system were exposed, including "possible contagion risk." Specifically, "[s]ome of the key risks associated with crypto-assets and crypto-asset sector participants include those related to fraud, legal uncertainties, misleading or inaccurate representations and disclosures, risk management practices exhibiting a lack of maturity and robustness and platform and other operational vulnerabilities." In response to the risk posed by crypto-assets, the FDIC pointed to several actions it has taken itself (including Financial Institution Letter 016-2022 requiring banks to inform the FDIC of crypto-related activities, the updated rule regarding the availability of deposit insurance, and enforcement actions taken against more than 85 entities that were misrepresenting the nature, extent or availability of deposits insurance), as well as actions taken by the FDIC in conjunction with other federal banking agencies, especially the joint statement in January 2023 on crypto-asset risks to banking organizations and the joint statement in February 2023 on "Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities." Concluding that crypto-assets present novel and complex risks that are difficult to fully assess, the FDIC states that it "continues to closely monitor crypto-asset-related exposures of banking organizations" and that it "will issue additional statements related to engagement by banking organizations in crypto-asset-related activities."

DC Court Recharacterizes Futures Contracts into Security Futures


By **Peter Y. Malyshev**
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On July 28, 2023, in *Cboe Futures Exchange, LLC v. Securities and Exchange Commission*, the United States Court of Appeals for the District of Columbia (the "Court") issued an order vacating an exemptive order granted by the Securities and Exchange Commission ("SEC") in November 2020 that provided exemptive relief to the Minneapolis Grain Exchange, Inc. ("MGEX") in respect of its listing of SPIKES Volatility Index Futures (the "SEC Exemptive Order"). This decision is remarkable in that the Court does not afford the usual regulatory deference to the SEC and further explains that substantively the SPIKES volatility product should be treated as "security futures" and not as a "futures" product essentially concluding that "futures" products afford less protection to investors than do "security futures."

In the SEC Exemptive Order, the SEC found that while SPIKES contracts fit the statutory definition of "security futures" under § 3(a)(55)(A) of the Securities Exchange Act of 1934 ("Exchange Act") and § 1a(44) of the Commodity Exchange Act ("CEA"), SPIKES contracts should be exempt from regulation as "security futures," subject to certain conditions, in order to "foster competition" as "an alternative to the only comparable incumbent volatility product in the market." The SEC Exemptive Order thus allowed SPIKES to be subject to the regulatory regime under the Commodity Futures Exchange Commission ("CFTC") applicable to "futures," as defined in the CEA.

By way of background, the SEC and the CFTC have joint jurisdiction over the regulation of "security futures." "Security futures" are thus more heavily regulated than "futures," which are regulated solely by the CFTC. Pursuant to the Exchange Act, "security futures" (as securities) are subject to, *inter alia*, listing standards, national exchange enhanced compliance, margin and disclosure requirements. The CEA regime for "futures" allows for a different margin, exchange compliance and disclosure treatment that may be considered more lenient as compared to that applicable to "security futures"; in addition, generally "futures" products are subject to a more favorable tax treatment. In 2004, the SEC and the CFTC had issued a joint order providing exemptive relief from regulation as "security futures" to contracts traded on a "similar, but not identical" (in the words of the Court) index, the Cboe Volatility Index (known as the "VIX Index"). The petitioner in this case lists "futures contracts" in the VIX Index on its exchange.

In vacating the SEC Exemptive Order, the Court found that the SEC's exemption was "arbitrary and capricious" in that the SEC failed to adequately establish its reasoning, in either the text of the SEC Exemptive Order or in the case record, as to why SPIKES contracts should be regulated as "futures" rather than "security futures." Absent a rehearing on the matter, the Exemptive Order will be vacated as of November 1, 2023 allowing a three-month period for MGEX, relevant intermediaries and the traders to ensure compliance with SEC requirements applicable to “security futures.”

The UK Proposes Changes to the Regulation of Equity Secondary Markets

By **Alix Prentice**
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In Policy Statement 23/4 (PS23/4) on "Improving Equity Secondary Markets," the UK's Financial Conduct Authority sets out its final proposed amendments to:

- Post-trade transparency requirements, including a new "designated reporter regime" ("DRR");
- Pre-trade transparency waivers;
- The tick size regime;
- Market resilience measures during trading venue outages; and
- Requirements that speak to the way retail orders are executed.

As part of the Wholesale Markets Review being conducted with the UK's Treasury, these measures are intended to improve execution quality and price formation, lower costs of trading, enhance liquidity and streamline reporting obligations through the changes summarised below. Trading venues, investment firms and Approved Publication Arrangements consolidating reports will need to update their systems, including changes to reporting fields and trade flags that may have a knock-on effect on transaction reporting systems.

Improving the Contents of Post-Trade Transparency

Measures include:

- An exemption for inter-fund transfers has been expanded to recognise as exempt interactions with another investment firm for the sole purpose of facilitating the operational transfer from one fund to another;
- There is now a recognised exemption for transfers between segregated discretionary funds that align with transfers between collective investment undertakings;
- Amendments to the definitions of exempt give-up and give-in transactions to exclude requests for market data;
- Amendments to the exemption from post-trade transparency for inter-affiliate transactions to make sure that the exemption is not restricted to specific risk management practices (centralised booking);
- Removing a duplicative exemption for transactions in the context of margin or collateral requirements for the purposes of clearing; and
- Revisions to certain flags.

Pre-Trade Transparency Waivers

Measures include targeted changes to the reference price waiver and order management facility waiver to allow reference prices to be derived from non-UK trading venues, provided they are reliable, transparent and consistent with best execution.

Tick Size Regime

The FCA is maintaining its position of allowing trading venues to use the minimum tick size of the primary market where the share was first admitted to trading located overseas if it is smaller than the tick size that results from calculations using UK data.

Improving Market-Wide Resilience During Outages

The FCA is working with sub-committees and IOSCO in this area and will propose amendments to the waivers' regime to allow for reference prices from multiple markets. It is also working with the UK's Treasury on developing the consolidated tape to enhance market resilience during outages.

The UK Market for Retail Orders

The FCA will continue to discuss with stakeholders concerns about the disadvantages faced by retail investors, including through failures to provide best execution.

Timing

The new post-trade transparency requirements will be in force as of April 2024, and the changes to waivers from pre-trade transparency and to the tick size regime apply immediately. PS23/4 also notes that rules in this area are currently under review in the EU, so further divergence may follow.

CFTC Urges Potential Whistleblowers to Report Carbon Credit Misconduct


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The Whistleblower Office of the Division of Enforcement of the Commodity Futures Trading Commission ("CFTC") issued an alert on June 20, 2023 advising the public on how to identify and report potential violations connected to fraud or manipulation in the carbon markets, including:

- Manipulative and wash trading in carbon market futures contracts;
- "Ghost" or "illusory" credits listed on carbon market registries;
- Double counting or other fraud related to carbon credits;
- Fraudulent statements relating to material terms of the carbon credits, including quality, quantity, additionality, project type, environmental benefits, permanence or duration, or the buffer pool; and
- Manipulation of tokenized carbon markets.

Voluntary carbon markets can help support the transition to a low-carbon economy through market-based initiatives in which high-quality carbon credits, also called carbon offsets, are purchased and sold bilaterally or on spot exchanges, the CFTC said in a statement. Carbon credits are the underlying commodity for futures contracts that are listed on CFTC designated contract markets ("DCMs"). The commission has enforcement authority and regulatory oversight over DCMs and any trading in those markets.

The alert directs individuals with a potential CEA claim to complete a Form TCR (Tip, Complaint, Referral) on the CFTC's Whistleblower Program website. Whistleblowers may be eligible for confidentiality and anti-retaliation protections, as well as an award of between 10% and 30% of the monetary sanctions collected from a subsequent enforcement action. Whistleblower awards are paid from the CFTC Customer Protection Fund, which is financed through monetary sanctions paid to the commission. Since 2014, the CFTC has granted whistleblower awards totaling approximately $330 million. Awards associated with enforcement actions have resulted in monetary sanctions totaling more than $3 billion.

Final Thoughts

The CFTC's whistleblower alert follows a request by a group of Democratic senators in October 2022 that the Commission improve regulation of the carbon credits market, as we previously reported. The carbon credit market has grown – and is expected to continue to grow— rapidly, as the world aims to reach net zero goals by 2050. Estimates of the value of the market vary widely. According to a report issued by Morgan Stanley in April of this year, the voluntary carbon offsets market is expected to grow from approximately $2 billion in 2022 to $100 billion by 2030, and to $250 billion by 2050.

However, the carbon offset market has come under heavy scrutiny, including by the United Nations and at COP27 in November 2022, with critics (including the Democratic senators in their letter) pointing to the potential for companies to engage in greenwashing and the risk that carbon credits may in fact reduce incentives for corporations to actively work towards carbon reduction. As the Democratic senators' letter points out: "The purchase of offsets allows many of these multinational companies to make bold claims about emission reductions and pledges to reach 'net zero,' when in fact they are taking little action to address the climate impacts of their industry. Several studies have highlighted that carbon offset projects are frequently illegitimate, and those that do contribute to meaningful emissions reductions are often representative of broader 'pay to pollute' schemes that place profit over protecting frontline communities."

The letter exhorted the CTFC to take action across a number of fronts, including "[p]ursu[ing] cases of individual project fraud," and "[d]evelop[ing] a working group to study both the risk to investors associated with carbon offsets and derivatives (legal, reputational, and regulatory) and the systemic climate financial risk created by their availability and usage." The senators closed by reminding the CTFC that it "has a duty to promote the integrity of U.S. markets through sound regulation and to hold companies accountable for fraud or misrepresentation, and we urge you to set meaningful standards to address these issues in the offset market." The decision by the CTFC to bring carbon credits within their whistleblowing awards remit indicates that it may be starting to comply with calls to act to prevent fraud associated with carbon credits. As we have previously discussed, it remains unclear how the CFTC would exercise its regulatory authority in practice and what the implications are for the developments of voluntary carbon markets. The UK Financial Conduct Authority (FCA) is also paying close attention to potential fraud in the carbon credit trading markets, has established an information and reporting portal and has taken enforcement action against individuals using carbon credits to defraud investors.

As we have noted, the regulation of the carbon offset market is a topic of international interest, with the International Organization of Securities Commissions (IOSCO), an international policy forum for securities regulators, announcing the publication of a consultation report and discussion paper on carbon markets in November 2022, and publishing its final report on "Compliance Carbon Markets" just last month, in July 2023.

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

ESMA Outlines Expected Sustainability Disclosures in Prospectuses


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On July 11, 2023, the European Securities and Markets Authority ("ESMA") issued a Public Statement outlining its expectations for sustainability-related disclosures to be incorporated into prospectuses. In its statement, ESMA recognized that sustainability-related matters are of importance to investors but as it currently stands, incoming legislation is either too far from being implemented (*i.e.*, the Listing Act) or "is not expected to give details of the sustainability-related disclosures that should be included in prospectuses drawn up under the Prospectus Regulation." The clarifications seek to promote a more coordinated and informative approach to sustainability reporting under the Prospectus Regulation for both equity and non-equity transactions.

ESMA's primary objective is to promote harmonized and coordinated action by national competent authorities ("NCAs") concerning the inclusion of sustainability-related disclosures in prospectuses under the current legislative framework. ESMA recognizes the evolving landscape of sustainability disclosures and aims to bridge the gap between the present disclosure requirements under the Prospectus Regulation and the anticipated future requirements, such as those of the Listing Act and the regulation on European green bonds.

- **Material Disclosure in Prospectuses:** ESMA underscores the importance of including "material sustainability-related disclosures" in both equity and non-equity prospectuses, aligning with Article 6(1) of the Prospectus Regulation, which provides that prospectuses shall contain the necessary information which is material to investors. This requirement seeks to ensure that investors have access to pertinent information necessary for making informed investment assessments.

- **Basis for Sustainability Profile Statements:** Issuers are advised to provide a clear basis for any statements regarding their sustainability profile or that of the securities they issue. This could involve referencing market standards, underlying data, assumptions, research, or analysis by third parties, while ensuring a balanced presentation of positive and negative information.

- **Sustainability-Related Disclaimers:** While issuers may acknowledge potential differences in sustainability expectations between themselves and investors, ESMA cautions against using sustainability-related disclaimers to excuse non-performance of factors under issuer control, highlighting the need for accountability and transparency.

- **Comprehensible Disclosure:** ESMA emphasizes the importance of complying with Article 37(1) of Commission Delegated Regulation 2019/980 (CDR

2019/980) to ensure the comprehensibility of sustainability disclosures. Issuers should provide clear definitions of technical terminology and transparently describe mathematical formulas and product structures.

- **Incorporation of Non-Financial Reporting:** ESMA encourages issuers to integrate material sustainability-related disclosures from their non-financial reporting, in line with the Non-Financial Reporting Directive and future Corporate Sustainability Reporting Directive, into equity prospectuses.

- **Non-Equity Securities with ESG Components:** ESMA outlines expectations for prospectuses related to non-equity securities that consider specific ESG components or objectives, such as "use of proceeds" bonds and "sustainability-linked" bonds. Detailed disclosure requirements are provided for these and ESMA urges issuers and advisers to reach out to them if there are any uncertainties.

- **Consistency Across Advertisements and Prospectuses:** ESMA highlights the importance of consistency between sustainability-related disclosures in advertisements and prospectuses. If sustainability disclosure is material under the Prospectus Regulation, it should be included in the prospectus to ensure alignment and transparency.

Final Thoughts

Regulatory authorities are increasingly acknowledging the importance of alignment and harmonization of non-financial reporting and disclosure across the EU. The timing of this move to publish guidelines as to what ESMA expects to find in prospectuses reinforces this since it is a measure aimed to plug the gap while issuers and investors await incoming regulations. This coordinated effort is aiming to minimize inconsistent standards across EU Member States and, ideally, create a more a level playing field for issuers across the EU and enhance transparency for investors.

ESMA is engaged in further studies on a number of other key topic areas. ESMA published Progress Reports in June 2023, with other EU supervisory authorities, to the European Commission on greenwashing in the financial sector. The Progress Reports define greenwashing and outline mitigation efforts companies can take to avoid greenwashing claims. Final greenwashing reports are due in May 2024. Separately, ESMA is working with the European Commission to address shortcomings related to "how ESG factors are incorporated into methodologies and disclosures of how ESG factors impact credit ratings."

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

EU Commission Adopts Final Sustainability Reporting Rules

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On July 31, 2023, the European Commission announced its adoption of the European Sustainability Reporting Standards ("ESRS") for companies subject to the Corporate Sustainability Reporting Directive ("CSRD"). The long-awaited ESRS represent a significant milestone in the implementation of the CSRD, which aims to update the existing EU sustainability reporting framework and expand the number of companies required to report on sustainability-related impacts, opportunities and risks.

The European Financial Reporting Advisory Group ("EFRAG") was tasked with preparing the ESRS, and in November 2022, it submitted its final draft to the Commission in the form of technical advice. The Commission made certain modifications to the framework, including the materiality approach, the phasing-in of certain requirements, the conversion of certain requirements into voluntary disclosure, the introduction of greater flexibility in a number of disclosure requirements, and the introduction of technical modifications. The Commission's adoption of the ESRS is effected by way of the Delegated Regulation on the European Sustainability Reporting Standards. The CSRD, scheduled to apply from the beginning of 2024, replaces the 2014 Non-Financial Reporting Directive (the "NFRD") and introduces more comprehensive reporting requirements on environmental, social and governance issues. Compliance with the CSRD will be mandatory for all large European companies, and companies listed on EU-regulated markets including EU subsidiaries of non-EU parent companies.

Key Provisions of the ESRS

Materiality-based Reporting: The ESRS retain the mandatory nature of some sustainability disclosures but introduce a materiality-based reporting approach. While general disclosures under ESRS 2 are compulsory for all reporting entities, specific disclosure requirements will apply only if deemed material to a company's business model and activity. The materiality assessment process must undergo external assurance.

Phase-in for Selected Disclosures: The Commission has introduced additional phase-ins for certain reporting requirements, particularly for companies with fewer than 750 employees. This approach aims to ease compliance for smaller companies. The phase-ins mainly apply to reporting on biodiversity and social issues.

Voluntary Disclosures: Some data points have been designated as voluntary, including reporting a biodiversity transition plan and specific indicators related to the workforce.

Interoperability: The ESRS were developed with a high degree of alignment with the International Sustainability Standards Board ("ISSB") and the Global Reporting Initiative ("GRI") standards. The Commission emphasized that companies required to report under ESRS on climate change will report similar information to those using the ISSB climate standard, but ESRS go further by providing additional information on impacts relevant for stakeholders beyond investors.

Next Steps and Scrutiny

The adopted ESRS delegated act will undergo a two-month scrutiny period in the EU Parliament and Council. These bodies have the authority to reject the ESRS cannot make amendments. Once the scrutiny period concludes, companies subject to the NFRD and large non-EU listed companies with over 500 employees will be required to start reporting under ESRS for the financial year 2024, with the first reports due in 2025. Other large companies will follow a year later, and listed SMEs will start issuing their first ESRS sustainability statements in 2027, with the option to opt out for up to two years.

Final Thoughts

Although not entirely without criticism, the adoption of the ESRS represents a significant development in the EU's sustainable finance agenda. We have frequently discussed the importance of reporting and disclosure frameworks, without which investors are unable to compare sustainability credentials from company to company. Even following adoption of the ESRS, however, there remains a continuing need to "align" with international standards, including the ISSB, and promote consistency with other EU directives. While a jurisdictional and, to some extent, global alignment process will continue, it remains to be seen how long it takes and the extent to which consensus ultimately is achieved. On a positive note, the ISSB has agreed to reference the ESRS within the S1 appendix "as a source of guidance companies may consider, in the absence of a specific ISSB standard, to identify metrics and disclosures if they meet the information needs of investors."

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