CADWALADER

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Global Change

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This week, we're featuring a diverse range of topics and insights, including financial regulation, climate action and biodiversity initiatives. My colleague Peter Malyshev discusses the latest on the U.S. District Court's consent order and sanctions imposed on an entity that significantly broadens the scope of the definition of a commodity trading advisor. I dive in and discuss recent reactions to the U.S. prudential bank regulator's Basel III Endgame Proposal.

Mercedes Turnstall provides insights into the National Institute of Standards and Technology's report on stablecoins, focusing on security and stability concerns. We also discuss the UK's approach to securitization reform post-Brexit, insights from the UK Climate Change Committee's latest report, and the joint plan between France and the UK to launch a biodiversity credits scheme.

We're always here for comments and questions. Just drop me a note here.

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

CFTC Further Expands the Definition of CTA

By Peter Y. Malyshev
Partner | Financial Regulation

On August 29, 2023, the U.S. District Court for the Western District of Texas entered a consent order ("Order") and imposed sanctions on Barelt Media and its owner Ryan Masten for operating an unregistered commodity trading advisor ("CTA"). This Order resolves litigation against Barelt filed by the Commodity Futures Trading Commission ("CFTC") and significantly broadens the scope of the definition of CTA.

The Order stated that for several years Barelt Media, doing business as SignalPush, "offered customers and potential customers the ability to obtain trade signals and to automate trading on binary options platforms using those trade signals." The Order further explains that Barelt Media acted as a CTA by, "for compensation or profit, engaging in the business of advising others, either directly or through publications, writing, or electronic media, as to the value or advisability of trading in any commodity option, and failed to register as such, in violation of [the Commodity Exchange Act]". It further states that Masten also acted as an associate person of a CTA without registration.

Because the Order is very sparse on the facts, and because the resulting outcome now would require trade signal providers to register as CTAs, CFTC's Commissioner Caroline D. Pham noted that this enforcement action is yet another example of CFTC's regulation by enforcement and not the first time that the CFTC has attempted to expand its interpretation of the CTA. Two years ago, on September 29, 2021, the CFTC published its advisory explaining that some registered CTAs may also be performing the services of a swap execution facility ("SEF") and accordingly must register as such. Even though an advisory is just that – an advisory – the CFTC referred to this advisory in its September 26, 2022 settlement against a registered CTA – Asset Risk Management LLC – claiming that it also acted as a SEF without registration.

Commissioner Pham further noted, citing from CFTC's Nadex Advisory Notice, that "a technology provider that sells software capable of receiving and aggregating trade signals, and submitting orders to the [e]xchange based upon those signals and parameters customized by the trader is not likely required to register with the CFTC as the trade advice does not originate from the technology provider."

Given the Order and prior CFTC's actions on CTAs, all entities that may be deemed providing "advice," or some form of recommendation, or direction to others in trading derivatives, should carefully analyze its operations and conduct a compliance overview consistent with CFTC's new interpretation of CTA.

Industry Trades Really Don't Like the Basel III Endgame Proposal

By **Daniel Meade**
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As we covered previously, on July 27, 2023, the U.S. prudential bank regulators (the Federal Deposit Insurance Corporation ("FDIC"), the Federal Reserve Board ("FRB") and the Office of the Comptroller of the Currency ("OCC") (together, the "Agencies") proposed new capital requirements for large banking organizations. As we noted, the proposed changes in the calculations of risk weights in the denominator of the calculation would likely result in increased capital requirements for most large banking organizations.

Although comments aren't due until November 30, industry trade associations have already come out swinging against the proposal. Many may have missed the first volley when the American Bankers Association ("ABA") and the Bank Policy Institute ("BPI") submitted a letter to the Agencies on August 22 calling on suspension of work on the update to revised rules to implement the Community Reinvestment Act, as the proposed capital rules would have an unknown impact.

This week BPI upped the proverbial ante when it unveiled a much larger advertising campaign in opposition to the proposal. The campaign includes its own dedicated website: www.stopbaselendgame.com. BPI's campaign notes the increased capital costs and estimates that it will increase capital requirements for banks by approximately 20%, and asserts that those increased costs will be felt by American consumers and businesses.

We will see on November 30 if the campaign creates a grass-roots effort to go along with the comment letters the trades will certainly be filing, or if the Agencies modify their proposal. Stay tuned.

NIST Stablecoin Report Highlights Security and Stability Concerns

By **Mercedes Kelley Tunstall**
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The National Institute of Standards and Technology ("NIST"), a non-regulatory governmental agency that focuses upon the technological aspects of a wide variety of products and services, mostly non-financial in nature, published a final Internal Report titled, "Understanding Stablecoin Technology and Related Security Considerations" on September 5, 2023. An early draft of the report was first published in October 2022.

NIST explains that the report is intended to offer "a technical description of stablecoin technology to enable reader understanding of the variety of ways in which stablecoins are architected and implemented [and] then uses that technical foundation to explore related security, stability and trust issues." While the Cabinet is generally focused upon regulatory financial and economic considerations, the NIST report nevertheless provides an excellent grounding in stablecoin terminology and concerns that will be useful for any institution or regulator seeking to deal with stablecoins.

The report begins by identifying four "properties" that typically apply to all stablecoins. Stablecoins are "tokenized", meaning that they are a cryptocurrency token managed by smart contracts. Stablecoins also are "fungible", meaning that they can be substituted for each other and are not unique, but also meaning that they have little to no pricing volatility, relative to their pegged asset or index. They are "tradeable", and finally, they are "convertible" in that they can be converted to other currencies or the pegged asset.

The report then identifies six different use cases for stablecoins that are defined by the common properties discussed above and a combination of ten characteristics such as whether the stablecoin is designed in a custodial context or a management context. The use cases include: 1) fiat currency-backed stablecoins; 2) cryptocurrency-backed stablecoins; 3) non-currency asset-backed stablecoins (*i.e.*, "a stablecoin whose value is backed through reserves that are non-currency assets or financial vehicles tracking the price of such assets"); 4) algorithmic non-collateralized stablecoins (*i.e.*, "a stablecoin whose value is stabilized through an algorithm that shrinks and expands the supply of non-collateralized coins to adjust price"); 5) hybrid stablecoins; and 6) private institutional stablecoins (*i.e.*, stablecoins issued for use on private blockchains).

The security issues identified in the report potentially could apply to all stablecoin use cases, and include the following: 1) unauthorized or arbitrary minting of stablecoins could occur in certain situations; 2) vulnerability in smart contract codes could lead to the theft of the stablecoin's on-blockchain collateral or reserves; 3) smart contract codes used in conjunction with stablecoins could be maliciously hacked or updated; 4) the data streams that provide stablecoin smart contracts with off-blockchain information such as the price of a currency (which are called "data oracles") could be disrupted through denial-of-service attacks and thereby disrupt the functionality of the stablecoin; and 5) the underlying blockchain could be attacked, although this security risk is characterized as being "unlikely."

The stability and trust issues the report identifies vary based upon the use case of the stablecoin, as well as the kind of marketplace that the stablecoins are traded upon. For example, centralized finance marketplaces ("CeFi") can be more vulnerable to trust concerns due to their greater reliance on human trustworthiness, while decentralized finance marketplaces ("DeFi") can be more vulnerable to security issues due to "increasing smart contract code complexity and critical functionality." Other kinds of stability and trust issues discussed include some of the problems that already have arisen with some stablecoin ventures. These issues include topics such as data oracles not providing data to the stablecoin smart contract fast enough, mass user departure from the stablecoin, and native cryptocurrency devaluation.

In evaluating the security, stability and trust issues identified, the NIST report remarks that they "found that two stablecoins that function almost identically in third-party markets and enable the buying and selling of goods with coins at a pegged price can have vastly different risk profiles." Accordingly, companies and financial institutions that are interested in developing stablecoin projects must carefully weigh the security implications tied to the architecture, use case and marketplace for the stablecoin and design technological, as well as operational, controls to address those security problems, but also any applicable stability and trust issues.

UK Securitization Reform Opts for Modest Approach, for Now

By **Alix Prentice**
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By **Assia Damianova**
Special Counsel | Capital Markets

Since leaving the European Union on Jan. 31, 2020, the UK has been in a position to choose whether or not to mirror future EU rules and regulations and when to adopt new domestic requirements.

You can read our most recent article exploring the framework's potential implications for market participants here.

UK Climate Change Committee's 2023 Progress Report Urges Action to Meet Climate Targets

By **Sukhvir Basran**
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By **Simon Walsh**
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The UK Climate Change Committee (CCC) recently released its 2023 statutory report, evaluating the UK's progress towards reducing greenhouse gas emissions and meeting carbon reduction targets. This report, mandated by the Climate Change Act, offers a comprehensive analysis of the nation's efforts in tackling climate change. The CCC is a non-departmental public body, sponsored by the Department for Energy Security and Net Zero, that advises the government on emissions targets and reports to Parliament on progress made in reducing greenhouse gas emissions.

The CCC's report, published on June 28, 2023, sheds light on critical aspects of the UK's climate journey. The report was prompted by the government's release of the Carbon Budget Delivery Plan (CBDP) in March 2023, which detailed policies aimed at achieving carbon budgets and net-zero goals. While the CCC acknowledges the increased transparency as a result of the CBDP, it expresses reservations about the pace of implementation, citing concerns about the nation's ability to meet medium-term targets, especially 2030 goals.

Key Concerns Raised by the CCC

The CCC's report outlines specific areas of concern where immediate action is required to enhance the UK's climate performance. These concerns include:

- *Fossil Fuel Support:* The CCC highlights that despite climate commitments, the government continues to endorse new oil and gas projects and airport expansions. This raises questions, according to the report's authors, about the nation's dedication to transitioning to a low-carbon economy.

- *Decarbonized Steel Production:* A lack of clear policy for decarbonizing steel production is identified as a significant gap in the UK's efforts to reduce emissions in industrial sectors. This omission could hamper progress in achieving comprehensive decarbonization targets.

- *Infrastructure Upgrades:* The CCC emphasizes the necessity of rapid reforms in planning regarding and upgrades to the country's electricity infrastructure. Such actions are crucial to facilitate a transition to cleaner energy sources and sustainable land use practices.

- *Hydrogen Integration:* The report raises concerns about the delayed strategic decision regarding the role of hydrogen in heating systems. The CCC suggests that postponing this decision until 2026 could impede progress towards decarbonizing heating systems efficiently.

- *Priority Recommendations:* The CCC notes that key government departments have not met the priority recommendations outlined in the 2022 report. The report includes 27 priority recommendations for both the government and individual departments, highlighting the need for a more synchronized approach to policy implementation.

Final Thoughts

The CCC's 2023 progress report highlights the challenges associated with meeting government climate-related commitments. In that sense, the UK's struggles mirror those faced by countries globally, where progress toward net zero goals and increasing transparency may not happen quickly enough to achieve commitments on previously announced timelines, as we have discussed with respect to, among others, Australia, Switzerland, the EU, and countries in the Association of Southeast Asian Nations region. While the UK has a wealth of research and expertise, the 2023 progress report serves as a call for immediate and coordinated action for funding improvements and a swifter transition to low-carbon technologies.

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

France and UK Announce Roadmap to Boost Biodiversity Credit Market

By **Sukhvir Basran**
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In June 2023, the UK and France announced a joint plan to launch a new biodiversity credits scheme. Through the Global Biodiversity Credits Roadmap, the two countries have pledged to support private sector biodiversity efforts and mobilize financing towards preventing biodiversity loss and conserving nature. The initiative was launched at the Summit for a New Financial Pact held in Paris. The Roadmap supports the COP15 Global Biodiversity Framework (GBF), which, among other things, aims to protect 30% of the world's land and oceans and restore 30% of degraded ecosystems by 2030.

The Roadmap details a plan to scale up global efforts to support companies in buying biodiversity credits—broadly, vehicles for investment in environmental projects that strengthen biodiversity or restore nature in a variety of contexts, including rainforests, oceans and wetlands. It is also designed to centralize expertise on biodiversity credits, establishing working groups and advisory panels to examine best practices on issues ranging from credit funding governance mechanisms to monitoring frameworks. The Roadmap will also consider how to distribute income from biodiversity credits across communities fairly. The Roadmap aims to make progress consistent with international milestone events such as the next United Nations Biodiversity Conference, or COP16, which will be held next year in Turkey. COP15's landmark Kunming-Montreal Global Biodiversity Framework (GBF) is often described as the Paris Agreement of Nature, and the 2024 convention will put individual parties' progress towards their national goals and targets in the spotlight.

In 2020, the World Economic Forum (WEF) estimated that more than half of the world's GDP, or $44 trillion, is moderately or highly dependent on nature, yet the funding gap for biodiversity restoration remains significant. In the same year, the Paulson Institute estimated that current spending on biodiversity conservation (measured against the total estimated biodiversity protection need) leaves a current biodiversity financing shortfall of between $598 billion and $824 billion per year. The UK and France have reached the conclusion that government initiatives alone cannot cover funding that size biodiversity gap.

Final Thoughts

Within the EU and elsewhere, biodiversity preservation increasingly has become a priority, as we have discussed. However, securing the necessary investment remains a significant hurdle, and promoting public and private sector funding is a consistent focus of biodiversity efforts, whether in the context of the development of a sustainability taxonomy, the formation of a 35-member bank-led working group to promote nature- and biodiversity-related target setting that is aligned with the GBF, or enhancing biodiversity-related governance and disclosure as part of the Corporate Sustainability Due Diligence Directive.

As for France in particular, at COP27, President Emmanuel Macron announced an initiative to protect the planet's essential carbon and biodiversity reserves. Central to this initiative are Positive Conservation Partnerships (PCPs), which would function through a biodiversity credit market and ultimately serve as a way to facilitate biodiversity investment. On its end, the Roadmap helps the UK build on its Ten Point Plan for a green industrial revolution and more recent initiatives emphasizing the UK's approach to biodiversity.

As we have previously observed, a related area of focus in terms of spurring climate-related investment concerns carbon credit markets as nations and companies look to offset their emissions and achieve net zero and other climate related goals. At the same time, such schemes are attracting increasing scrutiny and criticism, as we have noted, due to concerns around the transparency and quality of the credits. At least in part due to these concerns, in the fall of 2022, the International Organization of Securities Commissions launched an investigation (see our commentary on that here) into both voluntary and compliance carbon credit markets.

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