In This Issue …

As we are heading to press, the House Financial Services Committee, Subcommittee on Financial Institutions and Monetary Policy is holding a hearing on the Basel III Endgame proposal from the federal banking agencies. We will have more on that next week.

This week, my colleagues, Peter Malyshev and Mercedes Tunstall delve into the latest actions taken by the Commodity Futures Trading Commission in the decentralized finance arena, detailing the CFTC's growing influence over this space.

My colleague Lary Stromfeld explores the potential discontinuation of the Bloomberg Short-Term Bank Yield Index, as proposed by Bloomberg Information Services Limited, and the implications for financial markets.

Mercedes Tunstall has another piece discussing an announcement this week by The Consumer Financial Protection Bureau, wherein it, along with 41 states and the District of Columbia, reached a resolution in a multistate investigation concerning the leasing activities engaged in by a specialty consumer finance company.

I review the post-mortem report issued by the Federal Deposit Insurance Corporation last week on the FDIC's supervision of First Republic Bank.

Lastly, but certainly not least, we cover issues from the UK. My colleague Alix Prentice dives into recent regulatory developments from the UK's Financial Conduct Authority regarding residential mortgages. Sukhvier Basran and Sharon Takhar discuss the unveiling of the European Commission's annual Strategic Foresight Report.

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

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

CFTC Enforcement Focus on DeFi

By Peter Y. Malyshev
Partner | Financial Regulation

By Mercedes Kelley Tunstall
Partner | Financial Regulation

The CFTC has announced three enforcement actions this month that further cement the CFTC's jurisdiction over the decentralized finance space ("DeFi"). Back in 2022, the CFTC filed its first DeFi cases, including the Polymarket enforcement action and the Ooki DAO enforcement action where the CFTC alleged for the first time that DeFi platforms as well as decentralized autonomous organizations ("DAOs") could be deemed a "person" under the Commodity Exchange Act of 1936 ("CEA") and would therefore be subject to CFTC's regulations.

This month's three enforcement actions, involved operators of DeFi platforms, specifically Opyn, Inc., ZeroEx, Inc., and Deridex, Inc. each of which the CFTC has alleged to be engaged in offering illegal digital asset derivatives trading. With respect to these actions, Director of Enforcement, Ian McGinley remarked, "Somewhere along the way, DeFi operators got the idea that unlawful transactions become lawful when facilitated by smart contracts. They do not. The DeFi space may be novel, complex and evolving, but [we] will continue to evolve with it and aggressively pursue those who operate unregistered platforms that allow U.S. persons to trade digital asset derivatives."

McGinley later provided comments at the Practicing Law Institute's White Collar Crime conference on (September 11, 2023) summarizing the enforcement actions and explaining that "[e]ach of these three platforms was offering and confirming off-exchange leveraged or margined retail commodity transactions ... [and] we will do everything in our power to ensure that digital asset commodity transactions that should be conducted on regulated derivatives exchanges are in fact conducted on those exchanges."

Digging into the three enforcement actions, each of the orders identifies the following activities as being violations of the CEA:

- The DeFi platforms offered, or made available for trading, contracts that were based on various cryptocurrencies and digital assets, such as Ether. These contracts qualify as "commodities" under the CEA. The CFTC has enforcement jurisdiction over interstate transactions involving "commodities".

- Some of the contracts offered on these platforms, no matter how sophisticated and novel they were (*e.g.*, using smart contracts to effectuate the trades on the blockchain) qualified as "swaps", as defined in § 1a(47) of the CEA (*e.g.*, "perpetual" contracts without the delivery of a commodity), which gives the CFTC exclusive regulatory jurisdiction over their activities.

- Some of these commodity contracts were offered on leveraged basis, without actual delivery of a commodity within 28 days, to traders that did not qualify as "eligible commercial entities" or "eligible contract participants" as defined in § 1a(17) and (18), respectively of the CEA, and therefore these commodity contracts qualified as "retail commodity" contracts that are deemed to be "futures."

- The platforms facilitated the trading of swaps on a platform that offered matching between multiple participants, which means such platform must be registered as a "swap execution facility" ("SEF"), and none of the three platforms were registered as such.

- The platforms also facilitated the trading of retail commodity contracts, which, again, are deemed to be futures contacts, and which must be traded only on a "designated contract market" ("DCM"), *i.e.*, a registered commodity exchange. None of the three DeFi platforms were registered as DCMs.

- When any entity that acts as a broker or solicits for deposit assets (including digital assets) in connection with margined or leveraged retail commodity transactions, that entity must be registered as a futures commission merchant ("FCM").

- None of the platforms had appropriate anti-money laundering controls in place, as required by the Bank Secrecy Act, and in the alternative, nor did the platforms have effective systems to prevent U.S. persons from trading on the platforms.

Director of Enforcement McGinley later provided comments at the Practicing Law Institute's White Collar Crime conference on (September 11, 2023) summarizing the enforcement actions and explaining that "[e]ach of these three platforms was offering and confirming off-exchange leveraged or margined retail commodity transactions … [and] we will do everything in our power to ensure that digital asset commodity transactions that should be conducted on regulated derivatives exchanges are in fact conducted on those exchanges.

Bye-bye BSBY?

By **Lary Stromfeld**
Partner | Financial Regulation

Earlier this week, Bloomberg Information Services Limited ("BISL") announced that it is seeking feedback on a proposal to cease the publication of the Bloomberg Short-Term Bank Yield Index ("BSBY") "following a review of commercial opportunities for BSBY." BSBY was originally developed by BISL as an alternative to the secured overnight financing rate ("SOFR"), the rate widely endorsed as the replacement for USD LIBOR. Unlike SOFR, BSBY was designed as an index of credit sensitive reference rates that reflects bank credit spreads and a forward term structure.

BISL's announcement follows a statement issued on July 3, 2023 by the International Organization of Securities Commissions ("IOSCO") that certain credit sensitive rates exhibit "some of the same inherent … weaknesses as LIBOR" that, absent modification, "may threaten market integrity and financial stability."

In the announcement, BISL stated that "BSBY's usage within financial products is limited and unlikely to see significant growth, resulting in insufficient usage of the benchmark." BISL was clear that the consultation itself is not intended to trigger typical contract provisions regarding the use of alternative, fallback rates.

Feedback on the proposal is due by October 13, 2023.

Multistate and CFPB Enforcement Actions Against Lease Finance Company Tempoe

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

The Consumer Financial Protection Bureau ("CFPB") announced on Monday that it and 41 states and the District of Columbia had resolved a multistate investigation in the leasing activities engaged in by specialty consumer finance company Tempoe. According to the press releases of the CFPB and several of the states involved (See, *e.g.*, North Carolina and Connecticut), Tempoe will cancel all existing leases, to the tune of $33MM, and will then pay a $2MM penalty to the CFPB and $1MM total to all 41 states and the District of Columbia. The CFPB and the states allege that Tempoe engaged in unfair or deceptive acts or practices in violation of their various consumer protection laws, and also violated Regulation M, 12 CFR 1013, the implementing regulation for the federal Consumer Leasing Act.

Leases have come to be a favorite financing vehicle for subprime consumers who are not otherwise able to qualify for financing when they are attempting to finance the purchase of items like furniture or equipment from retailers. While consumers are used to the concept of leasing in terms of real property or motor vehicles, consumers do not typically associate leases with items like mattresses or auto parts because they are not sold as "used" to subsequent purchasers when the lease ends.

In the Tempoe case, consumers were indeed attempting to finance items such as mattresses and auto parts. With respect to the Tempoe leases in question, "[t]ypically, consumers were offered [the Tempoe lease] after applying and being rejected for financing through the retailer. The in-store application process was designed so that a consumer's approval [for the lease] was nearly instant and contemporaneous with the financing rejection."

When the consumer agreed to the leasing option, Tempoe then purchased the item(s) directly from the retailer, and the retailer was no longer involved in the transaction. The consumer made an initial payment at the retailer and then made payments to Tempoe for an initial term of five months. After those first five months, during which time consumers had paid as much as 90% of the cash price of the item, the consumer could choose to keep making periodic payments (for as long as three years), to purchase the item outright for an additional fee, or to return the property to Tempoe (not the retailer). Many consumers never received a copy of their initial lease agreement and those who continued making periodic payments because they either did not choose to purchase the item outright or did not (or could not) return the item to Tempoe, never received subsequent required disclosures. It was not unusual for these consumers to discover at the end of the initial term "that they did not own their items and were required to pay more to buy the items."

While the 41 states and the District of Columbia entered into an "Assurance of Voluntary Compliance/Discontinuance" with Tempoe that included permanently banning Tempoe from engaging in future leasing activities, the CFPB decided to handle its action administratively, and obtained a negotiated consent order from Tempoe, as well as a "Stipulation and Consent to the Issuance of a Consent Order".

FDIC Issues Bank Failure Post Mortem Report

By **Daniel Meade**
Partner | Financial Regulation

Last week, the Federal Deposit Insurance Corporation ("FDIC") issued a report from its Chief Risk Officer entitled FDIC's Supervision of First Republic Bank. The FDIC was First Republic Bank's primary federal banking agency, as First Republic was a state-nonmember bank. The report is basically a post-mortem of the FDIC's supervision of First Republic leading up until its failure in May.

The FDIC's report stated that the "primary cause of First Republic's failure was a loss of market and depositor confidence, resulting in a bank run following the failure of Silicon Valley Bank (SVB) and Signature Bank on March 10 and 12, 2023, respectively." As we noted in May, a unique feature of these post-mortem reports is that they include a great deal of supervisory material that is usually not public and closely guarded as confidential supervisory information. The FDIC's report went on to state that until April of 2023, First Republic had been well-rated with the highest two ratings for all components in its CAMELS exam reports. The FDIC went on to state that notwithstanding the generally well run nature of First Republic, "there were attributes of First Republic's business model and management strategies that made it more vulnerable to interest rate changes and the contagion that ensued following the failure of SVB." The FDIC noted three factors: (1) rapid growth and loan and funding concentrations; (2) overreliance on uninsured deposits and depositor loyalty; and (3) failure to sufficiently mitigate interest rate risk.

The FDIC's report concluded, even with the benefit of hindsight, it's unclear whether earlier supervisory action to criticize First Republic's interest rate or liquidity risk management would have prevented the failure given the speed of withdrawals following SVB's failure. However, it noted "meaningful action to mitigate interest rate risk and address funding concentrations would have made the bank more resilient and less vulnerable to the March 2023 contagion event."

The UK Introduces Repayment Concessions for Residential Mortgages


By **Alix Prentice**
Partner | Financial Regulation

In June of this year, the UK's Financial Conduct Authority ("FCA") introduced rules to allow mortgage lenders to more easily vary contracts in order to allow borrowers to make reduced capital payments or switch to an interest-only loan for a period of up to six months. With 1.7 million fixed rate deals expiring over the next 12 months, and to enable lenders to meet their commitments under the Government's Mortgage Charter (to help customers in financial distress due to rising interest rates, including with tailored support such as temporary payment deferrals, part interest-part repayment options and a switch to interest-only payments), changes to the FCA's Mortgages and Home Finance: Conduct of Business ("MCOB") sourcebook have been made as exemptions from responsible lending requirements. As the exemptions facilitate switching to interest-only mortgages as well as extensions of the term of the loan, these measures have an obvious potential effect on the risk profile of securitised asset pools, as well as prompt reviews of impacts on any eligibility criteria and concentration limits of certain types of mortgage within securitised portfolios.

The New Rules

Effective immediately:

1. Authorised mortgage lenders may now allow borrowers to extend their mortgage term up to retirement without undertaking the affordability assessment usually required by MCOB rules provided that the borrower decides to reverse the extension within six months of it having taken effect; and
2. Lenders may also offer the option of making interest-only payments for up to six months, provided that full capital repayments are resumed which include catching up with the reduced payments over the remaining term.

These measures do not supersede or replace existing forbearance options for borrowers in financial difficulty in MCOB, and lenders will still be expected to consider these. In addition, the new Consumer Duty will apply, including requirements to empower borrowers to make informed decisions by explaining benefits, risks and costs and enabling understanding.

Implementation and Next Steps

Due to the urgent requirement for consumer protection measures, these new rules came into force on publication on 24 July. The FCA has also recently concluded a consultation on making their COVID Tailored Support Guidance ("TSG") permanent. The TSG was introduced during the pandemic and sets out expectations from lenders when dealing with customers who need "tailored support," including forbearance, when dealing with mortgage, overdraft and consumer credit debt. Again, the embedding of this support for consumers may require the review of affected securitised asset pools.

EU Commission Releases 2023 Strategic Foresight Report Focusing on Environmental and Social Well-Being Objectives


By **Sukhvir Basran**
Partner | Financial Services


By **Sharon Takhar**
Associate

n July 2023, the European Commission published its annual Strategic Foresight Report (the Report), focusing on how sustainability and people's wellbeing can help to achieve President von der Leyen's six priorities for the European Union, referred to as the "Open Strategic Autonomy." The Open Strategic Autonomy is characterized by: a European Green Deal, a Europe fit for the digital age, an economy that works for people, a stronger Europe in the world, promoting the European way of life and a new push for European democracy. The Report identifies six critical social and economic challenges to its sustainability transition and ten ways to overcome those challenges.

The six challenges identified by the report are:

1. **The rise of geopolitics**, in particular a changing geopolitical landscape marked by the Russian war against Ukraine, China's changing economic and global focus, and the focus of the U.S. on its domestic and foreign policies, that will challenge international cooperation on global issues, including climate change and the transition away from fossil fuels and toward green energy.
2. **The need to transform the current economic model** to ensure its sustainability and the wellbeing of Europeans, detach economic growth from the use of natural resources (currently up to 75% of Eurozone businesses are highly dependent on natural resources) and transition to more sustainable production and consumption.
3. **The need for sufficient investment from the private sector**, in addition to public funding from Member States, to drive the transition toward sustainability.
4. **The growing demand for workers** with the necessary skills and technical training to help navigate both the green and digital transitions in the face of workforce shortages and competency gaps (an estimated 85% of EU firms today lack staff with the required competencies).
5. **Eroding social cohesion**, including growing income inequality and the disproportionate impact of climate change on the most vulnerable populations, as well as intergenerational tensions that threaten trust in governments and the viability of a green transition.
6. **Threats to democracy** resulting from the erosion of public trust in government and other public institutions in dealing with growing socio-economic issues, coupled with the rise of extremist, autocratic or populist movements.

The ten action steps to address the six challenges are:

1. Ensure a new social contract appropriate for a sustainable European economy, including encouraging Member States to develop "inclusive, high-quality social services" and renewed welfare policies.
2. Strengthen the EU "single market" framework to drive a resilient net-zero economy and achieve "open strategic autonomy" and Eurozone economic security.
3. Enhance the EU's offer globally, including by focusing on the connection between internal and external policies, and strengthening key global partnerships.
4. Support shifts in production and consumption to support sustainability, in particular by "decarbonizing and depolluting" the economy, including streamlining regulation to impact the production side, and encouraging sustainable and balanced lifestyles on the consumption side.
5. Foster a "Europe of Investment"—ensuring that the EU is and remains attractive for investments in the net-zero and sustainable economy—including by developing "an agile, fast and responsive framework" for boosting private investments and "ensuring a positive business environment."
6. Make public budgets "fit for sustainability" by, among other efforts, adapting fiscal and tax policies.
7. Revamp policy and economic indicators to reflect sustainable and inclusive wellbeing, including developing and incorporating "beyond-GDP" metrics into EU policymaking to measure environmental and social impacts.
8. Make sustained efforts to increase labor market participation for all segments of the population, in particular underrepresented populations, with a focus on both education (including technical, sustainability, digital and entrepreneurial skills) and adapting workplaces and working conditions.
9. Strengthen the EU's ability to defend democracy and promote citizen agency, including by developing mechanisms to counter dis- and misinformation, making social media platforms more accountable and supporting independent media.
10. Complement civil protection with "civil prevention," which includes developing "strategic foresight and monitoring capacities" to ensure that the EU is able to anticipate potentially disastrous events, such as the COVID-19 pandemic and Russia's war against Ukraine, and prepare for their impacts.

The Report is expected to inform the agenda at the upcoming European Council, which will be hosted by Spain in October 2023, and also contribute to the agenda at the Commission and EU Parliament's co-organized European Strategy and Political Analysis System conference in November 2023.

Final Thoughts

European Commission President Ursula von der Leyen has long been a vocal advocate for EU leadership in the green transition. The Report, which addresses a host of non-climate sustainability issues in addition to climate concerns, acknowledges the significant geopolitical and economic challenges inherent in the EU's transition agenda.

As the Report reflects, the EU is considering its dependence on, and place among, dominant global economic players, including the U.S. (which the Report acknowledges is a strategic partner) and China. It is also contemplating its wider impact on decarbonization and green energy, both in the Eurozone and on emerging and developing nations, in particular on countries in Africa, Latin America and Asia that have strong economic ties to China. Point two of the ten action points focuses on economic security with an inward focus on Member State economic cooperation, while action point 3 focuses on the EU as an appealing alternative to the U.S. and China for outside partners, and action points 5 and 6 speak to making the EU attractive for private sector green investment, in particular because of the concern over the high cost of the sustainability transition. The Commission proposes increased funding from both the public and private sectors to facilitate the transition.

Of particular note is the proposed adoption of more expansive “beyond-GDP” metrics that factor in environmental and health concerns to enable the measurement of progress toward sustainability. Action point 7 makes that suggestion explicit and the report provides an in-depth look at some options for these metrics, including a well-being-adjusted, “enhanced GDP” measurement that would include different quality-of-life factors (health, education and recreation), work-related factors (unpaid care and domestic work), socio-economic inequalities, costs of environmental damage (such as pollution and greenhouse gas ("GHG") emissions) and natural resource exhaustion.

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