CADWALADER

Questions of Funding

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In This Issue ...

Since last Thursday's edition of *Cabinet News and Views*, we've experienced quite a week for financial regulation on both sides of the Atlantic.

The U.S. Supreme Court began its term this week, and among the first cases it heard oral argument in was *CFPB v. Community Financial Services Association of America* to decide whether the CFPB's funding structure violates the Constitution's Appropriations Clause. My colleagues, Rachel Rodman, Ken Bergman and Keith Gerver, note that the arguments have yielded some interesting takeaways, most notably a sense of skepticism among certain justices.

The UK's Prudential Regulation Authority published a consultation paper on the "Capitalisation of foreign exchange positions for market risk" that my colleague Alix Prentice discusses. The paper proposed changes to implement upcoming Basel 3.1 requirements for the maintenance of capital against position exposed to FX risks covering several key areas, including the treatment of items held at historical FX rates, structural FX, and Pillar 1 FX risk calculations and SFX mitigation.

My colleague Jed Miller and I discuss the Federal Reserve Board's posting of three new FAQs to its website regarding Regulation Q (Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks). The FAQ guidance provides additional clarity on the use of credit-linked notes to transfer credit risk. Such transactions can go by various names, such as capital relief trades, credit risk transfers, or just CRTs, but whatever you call it, the written guidance from the Fed offers U.S. banks another tool to manage their capital adequacy.

We're covering these latest developments and more this week, including two recent CFTC developments impacting event contracts for political events and the Commission's position regarding certain large trader reporting obligations for futures, options and swaps; the European Commission's recent announcement on sustainability-related disclosures in the financial services sector; and the European Securities and Markets Authority's decision to include climate risk for the first time in its framework for stress test exercises for central counterparties.

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

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CFPB Funding Challenge: Supreme Court Appears Skeptical

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On October 3, 2023, the U.S. Supreme Court heard oral argument in *CFPB v. Community Financial Services Association of America* to decide whether the CFPB's funding structure violates the Constitution's Appropriations Clause.

The Appropriations Clause states, in part, that "no money shall be drawn from the Treasury, but in consequence of appropriations made by law." Instead of appropriating a specific dollar amount to the CFPB from the Treasury, Congress authorized the CFPB to request a capped amount of funds from the Federal Reserve each year. Solicitor General Elizabeth Prelogar defended the CFPB's funding scheme, arguing that it comports with the text of the Appropriations Clause and Congress's historical practices when appropriating funds to the executive branch. On behalf of Community Financial Services Association of America ("CFSA"), former Solicitor General Noel Francisco argued that the CFPB's funding structure is unconstitutional. According to Francisco, Congress "has not determined the amount [the CFPB] should be spending." Rather, Congress "delegated to the Director the authority to pick his own appropriation, subject only to an upper limit that's so high it's rarely meaningful."

Over the course of the hearing, the Court grappled with fundamental questions about the text of the Appropriations Clause. For example, much of the questioning focused on whether the Appropriations Clause restricts the amount of funds that Congress can appropriate to an executive agency, prohibits or limits the duration of standing appropriations, or requires Congress to allocate specific dollar amounts to an executive agency instead of authorizing an agency to spend up to a certain amount. Justice Alito appeared sympathetic to CFSA's argument that Congress improperly delegated its appropriations authority to the CFPB when it created a capped standing appropriation to the CFPB, without setting a specific amount or expiration date for the appropriation. Others, including Justices Jackson and Coney-Barret, were concerned that no language in the Appropriations Clause itself constrains the amount, duration, or specificity of an appropriation by Congress. They highlighted the practical difficulties that the Court faces in establishing rules for appropriations to executive agencies (*e.g.*, How much is too much for an appropriation? How long is too long for a standing appropriation?), and whether it is proper for the Court to make these rules in the first place.

The Court's questioning also focused on whether and to what extent the CFPB's funding structure is unique, and whether any distinctions between the CFPB and other agencies are constitutionally significant. Justice Sotomayor, for example,

seemed to agree with the Solicitor General that Congress used well-accepted methods to fund the CFPB, even if the combination of methods used to fund the CFPB was unique. Similarly, Justice Jackson did not believe that CFSA could prove its case merely by showing that the CFPB's funding structure was novel. By contrast, Justice Alito was troubled by the fact that there is no perfect historical analogue for the CFPB's funding mechanism. In one of his few statements of the day, Justice Roberts also indicated that he saw no historical analogue for the CFPB.

Oral argument suggested that CFSA will not be able to secure the five votes necessary to uphold the Fifth Circuit's ruling. Justices Kagan, Jackson, and Sotomayor were vocal critics of CFSA's position. Justice Sotomayor, for example, stated that she was "at a total loss" in trying to understand Mr. Francisco's argument. Justice Coney-Barrett seemed unconvinced by Mr. Francisco's effort to ground CFSA's theory in the text of the Appropriations Clause, and troubled by the practical difficulties in crafting rules for Congress to follow when appropriating funds to agencies. Justice Kavanaugh appeared to disagree with CFSA's argument that the CFPB is improperly insulated from Congressional control because, as Mr. Francisco conceded, Congress could discontinue the CFPB's funding even if doing so would be practically or politically difficult. Justice Alito appeared to accept CFSA's views of the Appropriations Clause issue, while Justice Thomas's position was somewhat ambiguous. Early in the hearing, Justice Thomas appeared skeptical of what he called the "skeletal" restrictions on Congress's appropriation authority proposed by the CFPB. But later in the hearing, he appeared dissatisfied with Mr. Francisco's theory as to why the CFPB's funding violates the Appropriations Clause, and prompted Mr. Francisco to "complete this sentence: Funding of the CFPB violates the appropriations clause because…" Justice Gorsuch and Chief Justice Roberts were relatively quiet during oral argument and revealed little about their views.

The Court is expected to issue its decision by June 2024.

Fed Issues FAQs Clarifying That Credit-Linked Notes Can Serve as Valid Capital Relief Tools for U.S. Banks

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On September 28, the Federal Reserve Board ("FRB") posted three new FAQs to its website regarding Regulation Q (Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks). The FAQ guidance provides additional clarity on the use of credit-linked notes ("CLNs") to transfer credit risk and offer capital relief to U.S. banks. While in some respects the FAQs merely confirm positions that the FRB has already taken in regard to individual CLN transactions, these FAQs are nevertheless important inasmuch as they publicly memorialize the FRB's view of these products as valid capital management tools.

The FAQs speak to two different formats of CLNs: those issued by special purpose vehicles ("SPV CLNs") and those issued directly by banks ("Bank CLNs"). The FRB's view of SPV CLNs is relatively straightforward: per the FAQs, the FRB recognizes that properly structured SPV CLNs constitute "synthetic securitizations" for purposes of Regulation Q and that the collateral for such SPV CLNs can serve as a credit risk mitigant that banks can use to reduce the risk-weighting of the relevant assets.

The FRB's posture toward Bank CLNs, however, is more nuanced. According to the FRB, unlike SPV CLNs, Bank CLNs do not technically satisfy all of the definitional elements and operational criteria applicable to "synthetic securitizations" under Regulation Q, such that banks that issue Bank CLNs would not be able to *automatically* recognize the capital benefits of such transactions (as would be the case with properly structured SPV CLNs). The reasons for this are twofold: first, Bank CLNs are not executed under standard industry credit derivative documentation; and second, the issuance proceeds from Bank CLNs generally are owned outright by the issuing bank (rather than held as collateral in which the issuing bank has a security interest). Nevertheless, the FRB recognized that Bank CLNs can effectively transfer credit risk; as such, the FRB is willing to exercise its "reservation of authority" to grant capital relief on a case-by-case basis for Bank CLNs where the only two features of the Bank CLNs that depart from the strictures of Regulation Q are those described above. In other words, Bank CLNs can offer capital relief, but only if the issuing bank specifically requests such relief from the FRB and the FRB decides to grant such relief under its reservation of authority powers.

In his statement dissenting on the issuance of the U.S. Basel III endgame proposed rules—our discussion of which is available here—Federal Deposit Insurance Corporation ("FDIC") Director Jonathan McKernan argued for increased clarity on the FRB's position with respect to CLNs in order to provide U.S. banks with better parity in relation to their European counterparts (which routinely issue CLNs in

different formats). While these FAQs may not fully address FDIC Director McKernan's concerns, they do begin to provide some clarity concerning the effective use by banks of CLNs as capital management tools.

Fight Over Political Event Futures Contracts Remains Contentious

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On September 22, the U.S. Commodity Futures Trading Commission (the "CFTC" or the "Commission") issued an order disapproving the listing and trading of congressional control event contracts by KalshiEX, LLC (the "Kalshi Order"), a designated contract market ("DCM"). The disapproval, which follows the Commission's withdrawal of its no-action position regarding PredictIt—an online prediction market that allows participants to trade swaps and futures contracts on political election outcomes—represents another blow to event contracts based upon political events. (We previously covered the Commission's PredictIt no-action letter withdrawal (the "Withdrawal") and review of Kalshi's congressional control event contracts (the "Kalshi Contracts") here.) However, the procedural circumstances of both actions mean that the fight is far from over.

As we noted in our prior coverage, PredictIt brought a challenge to the CFTC's decision in the U.S. District Court for the Western District of Texas on September 9, 2022, requesting a preliminary injunction preventing the Withdrawal from going into effect. Over a year later, on September 12, the Fifth Circuit Court of Appeals issued a mandate remanding the case to the District Court with instructions to enter a preliminary injunction in favor of PredictIt. The Court of Appeals' ruling is based upon its determination that the Withdrawal constituted a final agency action —making the Fifth Circuit the only court ever to issue such a holding.

According to the Kalshi Order, the Kalshi Contracts would be offered as cash-settled, binary contracts based on the question: "Will be controlled by for?" The settlement values would be determined by the party affiliation of the leader of the identified chamber of Congress upon every two-year term. Certain individuals and entities would be prohibited from trading the contracts—including Congress, candidates for federal and statewide public office, Congressional staffers and employees of party organizations, polling organizations, and PACs.

Following the Commission's public comment period and review, it determined that the Kalshi Contracts violate CFTC Regulation 40.11(a) and Section 5c(c)(5)(C)(i)-(ii) of the Commodity Exchange Act ("CEA"), which prevent registered entities (*e.g.*, DCMs) from listing or making available for clearing or trading contracts that involve gaming and activity that are unlawful under State law, or that are contrary to the public interest.

Some highlights of the Commission's reasoning from the Kalshi Order are below:

1. The Commission determined that the definition of "gaming" includes "the act of staking something of value on the outcome of a contest of others", and that an election is a contest between electoral candidates. The Commission averred that "futures contracts traditionally have not been

premised on the outcomes of a contest of others" but have "served hedging and risk management functions."

2. The Commission rejected Kalshi's argument that state statutes and common law that prohibit betting or wagering on elections are pre-empted by the Commission's jurisdiction over futures and swaps pursuant to the CEA.
3. The Commission determined that the Kalshi Contracts do not serve a public interest (in particular, with respect to hedging and price basing) in that the economic impacts of Congressional elections are "too diffuse and unpredictable to serve the hedging and risk management functions." For example:
   - The Kalshi Contracts "have no underlying cash market with bona fide economic transactions to provide directly correlated price forming information" and their price forming information "is driven in large measure by polling, voter surveys" and other "opaque" and "unregulated" processes; and
   - Their binary payout and frequency of settlement "further limit[] their utility as a vehicle for hedging any eventual economic effects resulting from which party controls a chamber of Congress."
4. The Commission determined, in concert with over 600 commenters (which included members of Congress themselves), that the Kalshi Contracts threaten the public good in that they could (or be perceived to) impact election integrity, which could, by extension, "require the Commission to assume a role in overseeing the electoral process." The Commission reasoned that the lack of regulation of the price-forming information for the Kalshi Contracts could increase the risk of manipulative activity, and the trading prohibitions set forth would not exclude all individuals who could be motivated to engage in such manipulation.
   - To this end, Chair Behnam, in his statement, noted that, "It makes sense for the CFTC to have authority to combat fraud, manipulation, and false reporting in underlying commodity markets. But it is impractical for the CFTC to combat them in the underlying market here—a political contest. The implications of such authority are vast, and could extend in a multitude of directions beyond the election itself, political fundraising and polling, to name just two."

The ongoing battle in the PredictIt case, combined with the Kalshi Order, is likely to force the Commission's hand further in making a definitive finding whether political events contracts are gaming and contrary to the public interest under CEA 5c(c)(5)(C). Commissioner Caroline D. Pham abstained from the vote on the Kalshi Order, averring that any decision from the Commission with respect to the Kalshi Contracts may violate the Fifth Circuit's May 1 injunction in the PredictIt case against the Commission from "otherwise 'prohibiting or deterring the trading' of contracts listed on the PredictIt Market." Additionally, in her dissent, Commissioner Summer K. Mersinger expressed her support for a notice-and-comment rulemaking on event contracts, and disagreed with the Commission's findings in nearly every aspect of the Kalshi Order, noting, in particular, that "an economic purpose test …" is not mentioned in the CEA and was not designed for these types of contracts."

CFTC Extends OCR Final Rule Relief

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On September 22, 2023, the Commodity Futures Trading Commission's (the "CFTC" or the "Commission") Division of Market Oversight extended its no-action position regarding certain large trader reporting ("LTR") obligations for futures, options and swaps under parts 17, 18 and 20 of the CFTC's final rule on Ownership and Control Reports (*see* 78 Federal Register 69178; hereinafter, the "OCR Final Rule"). The no-action position granted in CFTC Letter No. 23-14 is an extension of relief from compliance with certain requirements under the OCR Final Rule that has been granted by the DMO since 2014, and will remain in effect until the earlier of a Commission action addressing the reporting obligations or September 30, 2024. This relief applies to electronic submission of trader identification and market participant data on several forms: Form 40, Form 71 and Form 102 (including Forms 102A, 102B and 102S) (collectively, the "OCR Forms").

Since the adoption of the OCR Final Rule in November 2013, reporting entities (*i.e.*, futures commissions merchants, clearing members and foreign brokers) have struggled with identifying and providing the data in many of the fields in the OCR Forms. Recognizing the complexity of the filing requirements of the OCR Forms, in 2016, the CFTC published the OCR Technical Guidance. However, as the series of CFTC no-action letters indicate, market participants remain unable to comply with many of the requirements.

The no-action relief extends the date for required compliance to, among other things, (i) report information relating to (a) certain account owners, originators and controllers and (b) reportable account volume levels associated with designated contract markets and swap execution facilities and (ii) file change updates. Relief provided in this no-action letter is very fact-specific and conditional upon compliance with other provisions of the OCR Final Rule and does not relieve reporting entities from the filing of OCR Forms.

In their request for an extension of the no-action relief, three industry groups (namely, the Futures Industry Association ("FIA"), Commodity Markets Council ("CMC") and International Swaps and Derivatives Association ("ISDA")) expressed the inability of reporting entities to achieve full compliance with several of the OCR Forms "due to some of [the OCR Final Rule's] problematic requirements." FIA and CMC had previously submitted a petition to the Commission requesting, among other things, the codification of certain no-action positions taken with respect to the OCR Final Rule, the streamlining and "right-siz[ing]" of the reportable data and a withdrawal of Part 20 in its entirety. In connection with September's extension of the no-action relief, CFTC Commissioner Summer K. Mersinger expressed support for "a rulemaking that could address these OCR issues on a permanent basis," which is included in the Commission's 2023 agenda.

European Commission Consultation on SFDR

By **Michael Newell**
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On 14 September 2023, the European Commission published a targeted consultation and a public consultation on the implementation of Regulation ("EU") 2019/2088 on sustainability-related disclosures in the financial services sector ("SFDR"), which focus on potential shortcomings of SFDR, including legal certainty, the usability of the legislation and its ability to stop greenwashing. Of particular interest is the Commission's acknowledgment that the SFDR is being used as a labelling scheme (when it was designed as a disclosure regime). There is currently no EU regulatory definition of, or label for, an environmental, social and governance ("ESG") investment product, although several industry and national fund labels exist and the Commission has observed that Articles 8 and 9 of SFDR are being used as product "labels." Accordingly, the Commission is seeking views on the merits of developing a more precise EU-level product categorisation system based on defined criteria as well as views on the use of ESG terminology in fund names and whether further rules on the use of terminology in fund names and marketing communications are required.

Four proposed criteria are being consulted on:

1. Products investing in assets that specifically strive to offer targeted, measurable solutions to sustainability-related problems that affect people and/or the planet; *e.g.*, investments in firms generating and distributing renewable energy, or in companies building social housing or regenerating urban areas.

2. Products aiming to meet credible sustainability standards or adhering to a specific sustainability-related theme; *e.g.*, investments in companies with evidence of solid waste and water management, or strong representation of women in decision-making.

3. Products that exclude activities and/or investees involved in activities with negative effects on people and/or the planet.

4. Products with a transition focus aiming to bring measurable improvements to the sustainability profile of the assets in which they invest; *e.g.*, investments in economic activities becoming taxonomy-aligned or in transitional economic activities that are taxonomy-aligned, investments in companies, economic activities or portfolios with credible targets and/or plans to decarbonise, improve workers' rights or reduce environmental impacts.

The two consultations both close to comments on 15 December 2023. The Commission intends to adopt a report on the SFDR in the second quarter of 2024.

ESMA report on sustainable fund names and claims

On 2 October 2023, the European Securities and Markets Authority ("ESMA") published a study on ESG names and claims in the EU funds industry (ESMA50-524821-2931), complementing the Commission's current consultation on SFDR and EU regulators' drives to continue to monitor ESG-related disclosures and to scale up the monitoring and supervision of greenwashing.

ESMA has created a comprehensive list of ESG words and phrases, which has allowed it to apply natural language processing ("NLP") techniques to several large text and numerical datasets, including one containing the historical names of over 36,000 unique EU-domiciled investment funds. Key findings from the study that include:

- An increasing number of funds include ESG terms in their names and ESMA has found evidence of high investor appetite for funds with an ESG-related term in their name. For example, the share of EU UCITS investment funds with ESG words in their name has increased from less than 3% in 2013 to 14% in 2023.

- Managers prefer to include generic ESG terms (such as "sustainable") rather than more specific terms, which can make it more difficult for investors to verify that the fund portfolio is in line with the name.

- Funds with ESG-related language in their names, and funds disclosing under Article 9 of SFDR, provide more extensive ESG disclosures in their investment strategies and documentation than other funds.

The UK Consults on Clarification of the Requirements for Capitalisation of FX positions

By **Alix Prentice**
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The UK's Prudential Regulation Authority ("PRA") has published a consultation paper on the 'Capitalisation of foreign exchange positions for market risk' (**CP17/23**). CP17/23 proposes changes to implement upcoming Basel 3.1 requirements for the maintenance of capital against position exposed to FX risks covering:

1. **The treatment of items held at historical FX rates***:* In order to reflect the fact that assets, liabilities or capital currencies held on the balance sheet and using the exchange rate at the time of acquisition are exposed to contingent FX risk and not to daily FX risk, the PRA is proposing to clarify that positions held at historical rates should not be included in the net risk position in Pillar 1 and should be taken account of, and if necessary capitalised as part of the Internal Capital Adequacy Assessment Process Pillar 2 calculations.
2. **Structural FX** ("SFX")*:* SFX risk arises when firms hold assets, liability and capital denominated in a currency other than their reporting currency, usually due to having overseas operations. These positions lead to capital ratio volatility as exchange rates move and firms need to translate their risk weighted assets and capital resources into the reporting currency. SFX risk is managed by matching movements in values of foreign currency risk weighted assets to movements in the value of risk positions to achieve broad correlation. Firms are already permitted to apply for permission from the PRA to exempt risk positions that stabilise capital adequacy ratios and the PRA proposes to maintain this SFX Permission but clarify it and make clearer what firms are required to demonstrate in order to exclude positions meant to hedge capital adequacy ratios. Firms will also now be required to segregate SFX positions from trading activities (this is currently an expectation in Supervisory Statement 13/13).
3. **Pillar 1 FX risk calculations and SFX mitigations***:* The PRA is proposing further clarification and specifications for Pillar 1 calculations, including clarification of the expectation that firms should apply to exclude the SFX position at the consolidation level for which the position hedges the ratios in order to adequately capitalise the FX risk at entity level.

Responses to CP17/23 are due by 31 January 2024.

ESMA Launches Fifth Stress Test Exercise for Central Counterparties That Includes Climate-Related Risks

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On May 31, 2023, the European Securities and Markets Authority ("ESMA") published a final report on the framework for the 5th ESMA Stress Test Exercise for Central Counterparties ("CCPs"). For the first time, climate risk has been included among the components of the test. In part, the inclusion of climate risk in the Stress Test evidences the regulator's interest in evaluating the impact that the energy crisis and market disruption following the COVID-19 pandemic have had on CCPs, and how CCPs have responded to such events.

ESMA has been running such Stress Tests since 2016, and they represent part of its strategy to assess and evaluate the resilience of CCPs, which form a core element of the financial system in the EU, providing stability and mitigating financial risks. ESMA describes the Stress Tests as a key tool to strengthen the flexibility and resilience of the CCPs, in order to enhance and ensure the stability and effectiveness of the EU capital markets.

ESMA's goal is to obtain an overview on how prepared CCPs are to tackle climate risks. For the 2023 Stress Test, fourteen CCPs authorized in the EU and two authorized in the UK are included in the exercise. The main components of the Stress Test are: (i) credit stress; (ii) concentration risk; (iii) liquidity stress; (iv) reverse stress; and (v) climate risk.

In order to assess CCPs' response to climate risks challenges, the scenario presented in the Stress Test features, among other things, the transition to a carbon-neutral economy and the consequences of such transition. The study of the CCPs' business models and their reaction to such changes will be carried out taking into account the long-term pillars of climate risk: (i) business model risk, *i.e.*, the risk to the profitability and stability of a CCPs' business model; (ii) physical risk, *i.e.*, the risk that an extreme weather event could have on the CCPs and its ecosystem, with consequences such as operational disruptions and market instability; and (iii) collateral replacement risk, *i.e.*, the risk that market participants might eventually need to replace assets provided as collateral following a negative evaluation of the eligibility of such assets.

Final Thoughts:

The decision by ESMA to include climate risk among the components of the Stress Test evidences how EU regulators are adapting their approach to the evaluation of resilience of CCPs to increasing climate challenges. In doing so, as also remarked by Verena Ross, Chair of ESMA, in an interview, the additional innovative approach adopted by ESMA was that of assessing how climate risk can impact CCPs as a

whole, rather than analyzing them individually, and to show how the various CCPs are interconnected.

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