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Cabinet News and Views

Informed analysis for the financial services industry

Be Resilient

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Welcome to this week's edition of *Cabinet News and Views* covering topics ranging from regulatory insights on bank failures and the benefits of having adequate capital to remain resilient to market shocks, to calls for reform in agricultural subsidies, and advancements in sustainable investments and ESG initiatives.

My colleague Peter Malyshev, joined by Maurine Bartlett and Nikita Cotton, explore the recent clarifications made on September 19, 2023, regarding the jurisdictional boundaries between the Commodity Futures Trading Commission and Securities and Exchange Commission in the regulation of swaps and security-based swaps. They dissect the impact of these regulatory delineations on the financial industry.

I summarize the recent remarks by Michael Barr, the Federal Reserve Board's Vice Chair for Supervision, regarding his view on the costs and benefits of the Basel III Endgame Proposal.

Alix Prentice offers insights into the recent publications by the Basel Committee on Banking Supervision and the Financial Stability Board concerning lessons learned from bank failures in 2023. Alix's analysis sheds light on the potential implications of these reports on regulatory frameworks and the banking industry.

Sukhvir Basran, joined by Timbre Shriver, detail the proactive steps taken by the Farm Animal Investment Risk & Return Initiative in calling upon G20 Finance Ministers to reform agricultural subsidies regimes. In addition, Sukhvir and Ludovica Veltri provide an in-depth examination of the sustainable finance landscape with the launch of new ESG tools and initiatives by Euronext.

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

Daniel Meade
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Jurisdictional Boundaries Between CFTC Swaps and SEC Security-Based Swaps Clarified


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On September 19, 2023, the jurisdictional boundaries between the regulation of swaps by the Commodity Futures Trading Commission (the "CFTC") and the regulation of security-based swaps ("SBSs") by the Securities and Exchange Commission (the "SEC") were clarified for the first time in a decision by the United States District Court for the Southern District of New York (the "SDNY").

In *CFTC v. Archegos Capital Management LP*, the SDNY held that the CFTC does not have jurisdiction over either (a) total return swaps ("TRSs") based on exchange-traded funds ("ETFs") or (b) custom baskets of securities that can be rebalanced on a discretionary basis. We discussed the grey area of swap and SBS regulation between the CFTC and the SEC in prior coverage last year. This holding eliminated some of this grey area when it confirmed the SEC's assertion that such TRSs qualify as SBSs that fall within the SEC's exclusive jurisdiction.

This decision follows (and aligns with) the reasoning given in the SEC's June 9, 2022 advisory that clarified the SEC's position on TRSs based on ETFs, and also enshrines in case law the guidance given in the joint CFTC and SEC rulemaking from 2012 on custom baskets of securities managed on a discretionary basis.

The two components to the SDNY's decision are as follows:

1. A TRS based on an ETF that is in turn based on a broad-based security index ("BBSI") (such as the S&P 500) is not itself based on a BBSI—for clarity, a TRS based on a BBSI would be within CFTC's exclusive jurisdiction—but instead is based on a single security (*i.e.*, the ETF). In other words, there is no look-through from the ETF to the underlying BBSI. The court also rejected the CFTC's assertion that such a TRS may qualify as a "mixed" swap that would be subject to shared CFTC and SEC jurisdiction, providing the rationale that a "mixed" swap is a narrow category and does not fit within the description in the Joint Release.

2. Whether a TRS based on a custom basket of securities is a SEC-regulated swap or a CFTC-regulated swap turns on the classification of any such basket as a narrow-based security index ("NBSI") (which is within the SEC's jurisdiction) or a BBSI (which would be within the CFTC's jurisdiction). The court found that the custom basket of securities at issue was subject to "direct or indirect discretionary authority" and, therefore, was not determined by the "predetermined criteria or predetermined self-executing formula." Thus, in accordance with the Joint Release,

the court concluded that the index qualified as an NBSI, making the TRS an SBS subject to the SEC's jurisdiction.

Although this decision has better elucidated the boundary between CFTC-regulated swaps and SEC-regulated SBSs, there still remain certain other jurisdictional issues to be clarified between the agencies relating to other products, such as digital assets.

Vice Chair Barr Speaks on Capital Endgame Proposal

By **Daniel Meade**
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On Monday, Michael Barr, the Federal Reserve Board's ("FRB") Vice Chair for Supervision, delivered remarks to the American Bankers Association Annual Convention entitled Capital Supports Lending regarding the Basel III Endgame Proposal (which we discussed this summer here) issued jointly by the FRB, Office of the Comptroller of the Currency, and his views on why the benefits of the proposal outweigh the costs.

In his remarks, Vice Chair Barr noted "[m]ost of the banks represented in this room today—and the vast majority of banks in the country—would not be subject to the Board's recent 'endgame' proposal on bank capital. The proposal affects only the very largest banks." Vice Chair Barr also noted that the proposal remains open for comment until the end of November, and since the FRB "has just begun to receive comments on the proposed rules, I cannot say how those rules will evolve, but I can try to provide more background on why I believe the benefits of the proposal would outweigh the costs."

He invited commenters to provide more data on the costs and benefits of the rule, but proffered that the proposal's increase in capital for lending activities is "limited," and stated it "might be expected to increase the cost to banks for funding the average lending portfolio by up to 3 basis points—0.03 percentage points." The Bank Policy Institute at its stopbaselendgame.com website disagrees and asserts that the increased costs of lending in the proposal would be higher.

Vice Chair Barr went on in his remarks to state that notwithstanding a "small" increase in capital costs is outweighed by the costs of a financial crisis. He stated that "[r]esearch suggests the costs of a financial crisis are sizable ... [as] the cumulative loss in economic activity is consistently estimated to lie above 20 percent of annual GDP—and in some estimates up to 100 percent of GDP."

Vice Chair Barr concluded his remarks for another call for comments and additional data, noting "[w]e have already heard concerns that the proposed risk-based capital treatment for mortgage lending, tax credit investments, trading activities, and activities that generate fee-based income might overestimate the risk of these activities. We welcome all comments that provide the agencies with additional data and perspectives to help ensure the rules accurately reflect risk."

The Basel Committee and the Financial Stability Board Publish Reports on Lessons Learned From Recent Bank Failures

By **Alix Prentice**
Partner | Financial Regulation

The Financial Stability Board ("FSB") has published its report on *2023 Bank Failures: Preliminary lessons learnt for resolution* which follows on from the report from the Basel Committee on Banking Supervision ("BCBS") on the *2023 banking turmoil*. The reports differ in subject matter, with the FSB examining preliminary lessons learnt for the key attributes framework for resolving global systemically-important banks ("G-SIBs") and other systemically important banks, and the BCBS looking at prudential regulation and supervision. The main points include:

FSB Report

This report looks at the Key Attributes of Effective Resolution Regimes for Financial Institutions ("Key Attributes") and how these held up during recent crises. Adopted in October 2011 and subsequently endorsed by the G20, the Key Attributes are 12 essential features that should be part of all resolution regimes, being:

- scope;
- resolution authority;
- resolution powers;
- set-off, netting, collateralisation, segregation of client assets;
- safeguards;
- funding of firms in resolution;
- legal framework conditions for cross-border cooperation;
- crisis management groups;
- institution-specific cross-border cooperation agreements;
- resolvability assessments;
- recovery and resolution planning; and
- access to information and information sharing.

The report highlights a number of important issues for effective implementation of the international resolution framework to examine further, including the need for an '*effective public sector liquidity backstop and operational readiness of banks to access it as a last resort*'. Other important workstreams for G-SIB resolution include:

- using resolution planning to address legal issues identified around cross-border bail-ins;
- looking at the operation of a range of resolution options, including transfer and sale, both alone and in combination with bail-in; and
- understanding the market impacts of bail-ins and the need for credible liquidity backstops and other frameworks that are visible to and easily understood by market participants and depositors.

When looking at non-G-SIB resolution, the FSB raises the need to explore:

- whether the scope of resolution planning and associated loss-absorbing capacity requirements need expansion;
- how authorities can be better prepared to deal with the increased speed of bank runs; and
- implications of recent events for the role of deposit insurance in bank resolutions.

BCBS Report

The BCBS report is an assessment of the regulatory and supervisory responses to 2023's issues, and not an indication of any planned revisions to the Basel Framework. As such, it focuses on:

1. *Governance and risk management:* the BCBS has identified shortcomings in basic risk management and a lack of appreciation of how build-ups of different risks are interrelated and have a compounding contagion effect. Business models were found to still be overly focused on growth and short term profitability, leading to unsustainable business models and compounded by poor risk culture and insufficient oversight.
2. *Strong and effective supervision:* the analysis of banks' business models, and the identification of outliers, remains core to supervisory efforts, including the assessment of the viability/sustainability of those models.
3. *Robust regulatory standards:* including those addressed at ensuring robust corporate governance and internal risk management and controls. The need for tools that can drive real change and concrete action is also stressed.

Other initial lessons learnt and takeaways for regulation include:

- questions to be asked about the design and calibration of the Basel III liquidity standards;
- questions to be asked about the current regulatory treatment of IRRBB in the Basel Framework;
- the treatment of held-to-maturity assets and the role of Additional Tier 1 capital instruments in the capital framework; and
- the scope of application of the Basel Framework to internationally active banks on a fully consolidated basis.

Other Takeaways

While differing in focus areas, both reports stress the need to look at how toolkits should change in the light of the increased speed of liquidity outflows, and for the BCBS, of course, this leads to a discussion of whether liquidity supervision may also need to evolve. Unsurprisingly, both reports discuss the need for cross-border supervisory cooperation, involving significant information sharing and collaboration.

Investor Group FAIRR Calls on G20 Finance Ministers to Reform Agricultural Subsidies Regimes


By **Sukhvir Basran**
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Ahead of September 2023's G20 summit in Delhi, the Farm Animal Investment Risk & Return ("FAIRR") Initiative called on G20 Finance Ministers to reform agricultural subsidies to enable countries to meet their net zero greenhouse gas emissions commitments by 2050 along with their commitments to global biodiversity and nature goals. At the COP15 biodiversity conference in December 2022, governments agreed pursuant to the Kunming-Montreal Global Biodiversity Framework to "identify by 2025, and eliminate, phase out or reform subsidies harmful to biodiversity…starting with the most harmful incentives." According to FAIRR, "'[h]armful' subsidies are incentivizing the over-production and over-consumption of certain high-carbon agricultural products," such as red meat and dairy, and as the UN reported in September 2021, damage caused to nature by subsidy regimes is estimated at $4-$6 trillion each year. The alliance made four recommendations to the G20:

1. Link financial support to environmental performance-related conditions (*e.g.*, GHG reduction or biodiversity protection);
2. Incentivize sustainable agricultural practices over those that harm the environment, *e.g.*, financing a transition towards regenerative practices;
3. Stop supporting carbon-intensive commodities such as red meat and dairy; and
4. Increase available just transition funding to support affected stakeholders who are impacted by reforms.

Final Thoughts:

The spotlight on nature and biodiversity continues to shine. As we reported in discussing a recent CDP report on financial institutions attempting to address nature-related risks, a significant proportion of the world's total GDP is moderately or highly dependent on nature. In September 2023, the UK government announced a sweeping inquiry into the role of private finance in nature recovery, and how it might redirect capital towards that end. In the EU, the European Parliament adopted amendments to the Corporate Sustainability Due Diligence Directive so that large EU companies would be required to, among other things, conduct due diligence to identify and mitigate negative impacts on the environment, including related to biodiversity loss and environmental degradation. Under the amendments, large companies operating in the EU would be required to conduct due diligence to identify, prevent, mitigate or end negative impacts on human rights and the environment, including in particular pollution, biodiversity loss and environmental degradation, as well as labor exploitation, slavery and child labor.

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

Euronext Launches New Sustainable Investment Tools and ESG Initiatives


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In September 2023, pan-European stock exchange and market infrastructure provider Euronext announced the imminent launch of a range of ESG tools and initiatives focused on sustainable finance, including its intention to publish the non-financial data of issuers on its website. It is intended that the tools and initiatives will support and implement Euronext's "Fit for 1.5°" commitment, under which it will develop products and services to assist companies and organizations to mitigate temperature increases. The new initiatives will also support the "Growth for Impact 2024" strategy, *i.e.*, the ambition to build the leading market infrastructure in Europe.

One of the tools launched by Euronext is the "My ESG Profile," a digital tool that will enable issuers to display their sustainability efforts and also provide investors a way to access and evaluate ESG data. Euronext will reportedly be the first stock exchange to make the non-financial data of issuers available to investors. It is envisaged that the tool will classify nearly 1,900 companies' profiles on its website, including information regarding, among other things, GHG emissions and the percentage of women employed.

Another tool announced by Euronext, and developed in partnership with Iceberg Data Law, is the Euronext Biodiversity Enablers Index, which takes into account the effect that companies and organizations can have on biodiversity. The index will rely on two new metrics: (i) a Dependency Exposure Score, which will identify companies that have a significant revenue dependency linked to biodiversity ecosystems; and (ii) a Biodiversity Avoided Impact, which will serve to identify companies that carry out innovative and efficient practices in biodiversity ecosystems.

Euronext also revealed the launch of "Euronext Foundation," which will promote and support local sustainable communities and projects across Europe in a number of areas, including financial literacy and diversity and inclusion.

Final Thoughts:

Euronext's "My ESG Profile" is a significant step towards closing the information gap between companies and investors. One caveat, however, is that the source of information is the issuer itself and as such is subject to the issuer's data assessment and reporting choices. The data is not subject to external verification and is unaudited. There also does not appear to be any indication as to whether the information will be analyzed in any way in order to make the data comparable from company to company.

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