

Cabinet News and Views

Informed analysis for the financial services industry



Regulatory Resonance

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In This Issue ...

As Thanksgiving week approaches in the U.S. and many prepare for the holiday break (there will be no Cabinet issue next week, but we'll be back on November 30th), the pace of news out of the U.S. regulatory agencies hasn't slowed.

I delve into the recent testimonies offered by key regulatory leaders—FRB, FDIC, OCC, and NCUA—during Congressional hearings.

Meanwhile, my colleague Mercedes Kelley Tunstall provides an analysis of the freshly updated consumer credit and leasing thresholds for 2023.

Michael Ena highlights the release of the updated General Disclosure Statement for Transactions by the International Swaps and Derivatives Association, emphasizing the document's significance in providing disclosures of risks associated with transactions, as it continues its evolution from its inception in 2013.

UK colleagues Michael Newell and Alix Prentice dive into the novel requirements of AIFMD II, examining the implications for credit funds following the Council of the European Union's latest amendments on loan origination activities by alternative investment funds.

Additionally, Alix shares significant observations from the UK's FCA on "market soundings," while Sukhvir Basran presents the challenges outlined in ISS's latest report concerning the interoperability of sustainability disclosure standards.

We're always here for comments and questions. Just drop me a note [here](#).

Daniel Meade

Partner and Editor, *Cabinet News and Views*

FRB, FDIC, OCC and NCUA Testify at Congressional Oversight Hearings



By **Daniel Meade**
Partner | Financial Regulation

This week, the [Senate Banking Committee](#) and the [House Financial Services Committee](#) held oversight hearings with leaders of the Federal Deposit Insurance Corporation (“FDIC”), Federal Reserve Board (“FRB”), the National Credit Union Administration (“NCUA”) and the Office of the Comptroller of the Currency (“OCC”).

Testimony from the four leaders were substantially similar before both of the committees. The four witnesses were [Michael Barr](#), Vice Chair for Supervision, FRB; [Martin Gruenberg](#), Chair, FDIC; [Todd Harper](#), Chair, NCUA; [Michael Hsu](#), Acting Comptroller, OCC.

The four prudential leaders reported that their respective depository institutions are generally sound. Vice Chair Barr pointed to the FRB’s [Supervision and Regulation Report](#) issued earlier in the week, and his testimony reflected much of what was in the report. Notwithstanding the strength and resilience of the system generally, the four regulators noted the risks they continue to see since the collection of regional bank failures this spring such as lowering net interest margin, unrealized losses in securities holdings, and continuing risks in the commercial real estate sector.

In general, Republican members of the respective committees were critical of recent actions by the three banking agencies, such as the [Basel III Endgame Proposal](#), and the issuance of a final rule updating the [Community Reinvestment Act regulations](#). Senate Republicans actually called for the withdrawal of the proposal in a [November 12 letter](#). While Democratic members were generally more supportive of the agencies, there was a good deal of criticism of the Basel III Endgame Proposal from Democrats, noting that the proposal could negatively impact efforts to help low-and-moderate-income homebuyers and beneficiaries of certain tax credit programs.

In addition to the expected Q&A on banking policy, FDIC Chair Gruenberg faced numerous questions about the culture and protection of employees at the FDIC, following a [Wall Street Journal article](#) reporting on instances of reported sexual harassment and a possible toxic work environment amongst its bank examiners on Monday. Chair Gruenberg stated that he was deeply troubled by the report and was engaging an independent law firm to conduct a review. FDIC Vice Chair Travis Hill and FDIC Director Jonathan McKernan released a [joint statement](#) that “the independent review initiated by the Chairman be effectively overseen by the Board and have the latitude and time needed to conduct a thorough, holistic review.”

Consumer Credit and Leasing Thresholds Updated for 2023



By **Mercedes Kelley Tunstall**
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For purposes of general applicability of the Truth in Lending Act and Regulation Z to credit transactions and the Consumer Leasing Act and Regulation M for lease transactions, the Consumer Financial Protection Bureau ("CFPB") and the Federal Reserve must annually adjust the maximum dollar amounts that require full compliance with these laws and regulations.

When a transaction has a dollar amount above these maximums, then many of the disclosures and consumer protections required by these laws and regulations fall away. The percentage change in the dollar amount correlates directly to the percentage change in the Consumer Price Index for Urban Wage Earners and Clerical Workers ("CPI-W") per statute.

To this end, [credit transactions not involving real estate that are \\$69,500 or less](#) are required to fully comply, and [lease transactions not involving real estate that are \\$69,500 or less](#) are also required to fully comply. Just three years ago these dollar amounts were more than \$10,000 less, at \$58,300 for 2021.

ISDA Publishes Updated General Disclosure Statement for Transactions



By **Michael Ena**
Counsel | Financial Services

In 2013, the International Swaps and Derivatives Association (“ISDA”) started publishing the General Disclosure Statement for Transactions document (“General Disclosure”) with annexes containing disclosures of risks that are specific to certain classes of reference assets, such as interest rates, foreign exchange rates and currencies, credit instruments, asset-backed instruments, equities, and commodities. The General Disclosure, together with asset-specific annexes, is intended to help swap dealers and major swap participants comply with the external business conduct rule disclosure requirements (17 CFR 23.431, 17 CFR 23.450(g) and 17 CFR 23.605(e)) enacted by the Commodity Futures Trading Commission (“CFTC”) under Dodd-Frank Wall Street Reform and Consumer Protection Act.

At least biannually, the Disclosure Package is reviewed and updated to reflect changes in relevant transaction disclosure requirements.

On November 14, ISDA published an updated General Disclosure. The updates include:

- a disclaimer of liability for hedging transactions failing to have the desired effect;
- a warning that a failure of the custodian holding collateral posted by a party under a transaction may result in default that party defaulting under the transaction documentation;
- warning that certain actions of the collateral custodian may result in additional costs;
- a new Section V.G that addresses risks associated with pre-hedging activity; and
- certain technical clarifications.

The most noteworthy update is the addition of Section V.G, which is intended to provide a more robust pre-hedging disclosure as a response to recent CFTC enforcement actions where CFTC raised issues of inadequate disclosure of pre-hedging activities and frontrunning (see [Enhancing Disclosure Requirements for Derivatives](#) for a more detailed discussion of these CFTC enforcement actions). Swap dealers and major swap participants should use the updated General Disclosure to alleviate the risk of becoming subject to regulatory scrutiny in connection with their pre-hedging activities.

AIFMD II and Loan Origination Funds



By **Michael Newell**
Partner | Financial Services



By **Alix Prentice**
Partner | Financial Regulation

On 6 November 2023, the Council of the European Union published its long anticipated final compromise text '*as regards delegation arrangements, liquidity risk management, supervisory reporting, provision of depositary and custody services and loan origination by alternative investment funds*' amending AIFMD and UCITS directives.

This note considers what are entirely novel requirements attaching to loan origination activities by alternative investment funds and their implications for credit funds once AIFMD II is fully in force, though it is worth pointing out at this stage that little has changed since the publication of the “final” compromised text on 1 June 2022 beyond some movement to increase flexibility, particularly in relation to the leverage limit for closed-ended funds.

Further details are discussed in our recent Client & Friends Memo [here](#) authored by Michael Newell and Alix Prentice.

The UK's FCA Shares Observations on 'Market Soundings'



By **Alix Prentice**
Partner | Financial Regulation

The UK's Financial Conduct Authority ("FCA") has devoted [issue 75 of Market Watch](#) (a newsletter on market conduct and transaction reporting issues) to share observations on practices around 'market soundings'.

Market soundings are communications between issuers and potential investors that take place prior to transactions and that are undertaken to gauge interest and help set price, size and structure. Because of the involvement of inside information in such interactions, there are regulations and procedural requirements that must be in place in order to manage the risk of the inappropriate use of this information, largely driven by the UK's onshored version of the EU Market Abuse Regulation ("UK MAR"). One of the functions of UK MAR is to ensure that no potentially sensitive information is unnecessarily disclosed, as well as ensuring that Market Sounding Recipients ("MSRs") do not trade or attempt to trade on the basis of any inside information they receive from Disclosing Market Participants ("DMPs").

Market Watch 75 is concerned with cases the FCA has observed when MSRs have traded a financial instrument during the period after a DMP has made initial contact with them or asked for their consent to receive a sounding and thereby receive inside information. MSRs are required to make their own independent assessment of whether or not they are in possession of inside information, and this assessment must include not just any preliminary information they have received from a DMP, but also other information the MSR may possess that may enable the MSR to identify the issuer. Market Watch 75 sets out the FCA's concerns that there have been a number of instances when MSRs have traded during this intervening period after an initial communication from a DMP but before the DMP has disclosed inside information including the identity of the issuer involved. In those cases, the FCA has identified that the MSRs were in possession of other information that would enable them to ascertain inside information.

The FCA uses Market Watch 75 to alert DMPs to the need to take care when undertaking soundings that involve a limited pool of potential market participants, and to assess the possibility that they are disclosing inside information at all stages of the sounding, including the initial communications with MSRs seeking their consent to receive soundings and thereby receive inside information. This could involve reviewing scripts used during soundings, tailoring information depending on the nature of the transaction, minimising the time between initial communications and requesting MSR consent to receive the sounding, and putting in place 'gatekeeper' arrangements whereby specific teams in compliance functions act as the first point of contact for DMPs.

ISS: Challenges Remain in Interoperability of Sustainability Disclosure Standards



By **Sukhvir Basran**
Partner | Financial Services

In its annual [Global Regulatory Update](#) (the 2023 Update Report), Institutional Shareholder Services (ISS) determined that the application of different ESG disclosure and reporting frameworks presents significant challenges for companies. The 2023 Update Report delves into several recent regulatory developments and analyzes the state of ESG regulations internationally, describing these disparate regulatory initiatives as a collective “work-in-progress” that has created “a labyrinthine landscape for financial market participants to navigate.”

The 2023 Update Report addresses the comparability of the International Sustainability Standards Board’s (ISSB) Sustainability Disclosure Standards and the European Commission’s European Sustainability Reporting Standards (ESRS). The report describes the level of interoperability between the ISSB and ESRS as “an open question.” The two frameworks share the overall approach adopted by recommendations issued by the Taskforce on Climate-Related Financial Disclosure (whose work has not been taken over by ISSB), [but they diverge](#) on the definition of materiality, flexibility in companies’ application of materiality assessments, and time provided to implement certain disclosure requirements.

The 2023 Update Report cites regulatory fragmentation across the globe as a major concern for issuers of investment products and major fund managers that operate across jurisdictions. ISS flagged one example with respect to fund classification: the UK’s Financial Conduct Authority, the Hong Kong Securities and Futures Commission, and the Monetary Authority of Singapore have all referred to the European Union’s Sustainable Finance Disclosures Regulation (SFDR) in connection with their disclosure regimes, yet in both Hong Kong and Singapore, funds may ultimately be required to provide additional disclosures to be marketed to retail investors as ESG funds. Fund naming rules vary widely across jurisdictions: Hong Kong, for instance, requires that 70% of the fund’s net asset value (NAV) be aligned with the ESG strategy reflected in the fund name, Singapore requires that two-thirds of the product’s NAV be aligned with its ESG strategy, and in the U.S. the SEC’s recently promulgated “[Names Rule](#)” requires 80% alignment.

Another area that the report explores, using the EU, U.S., and Japan as case studies, is the evolution of due diligence obligations in corporate supply chains. Japan has already introduced human rights due diligence guidelines, the first in Asia. As we discuss [here](#) and [here](#) the EU Corporate Sustainability Due Diligence Directive (CSDDD) and the EU Corporate Sustainability Reporting Directive (on which the CSDDD builds), could impact significantly corporate supply chain standards in Europe. If the CSDDD comes into force by 2024 as planned, EU member states will then transpose it into domestic legislation.

Final Thoughts

Overall the 2023 Update Report's findings are not surprising or unexpected. [As we have discussed](#), different jurisdictions' evolving ESG regulatory regime poses challenges. Standardized regimes across jurisdictions would ease the disclosure burden. We report on this trend [here](#) with respect to specifics in the EU, [here](#) in terms of Asia's developments, and [here](#) with regard to Canada.

(This article originally appeared in [Cadwalader Climate](#), a weekly newsletter on the ESG market.)
