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Cabinet **News and Views**

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Together Again

April 28, 2022 | Issue No. 8

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In This Issue ...

It has been great hearing from our colleagues who this week are attending the first Futures Industry Association Law and Compliance annual conference (FIA L&C) in person in three years in Washington, D.C. While we're hearing that the panels and other programs have been as enlightening and compelling as always, we know that the opportunity to reconnect, face to face, with so many old friends is invaluable.

Today's *Cabinet News and Views* touches on one of the key topics at FIA, but next week's issue will feature a deeper dive into where things stand at the present time and where we think things are going.

What do you think about this week's topics and *Cabinet News and Views* in general? We'd love to hear from you. Just write to us here.

Daniel Meade & **Michael Sholem**
Co-Editors, *Cabinet News and Views*

Live from FIA L&C: Redefining the Scope of a “Trading Facility”

By **Peter Y. Malyshev**
Partner | Financial Services

This week, attendees at the FIA L&C conference are gathered in Washington, D.C., for the first time in three years to discuss several issues with significant potential impact on the markets. One such issue is redefining the concept of the trading facility for securities and derivatives. In 2021 and 2022 the U.S. Commodity Futures Trading Commission ("CFTC") and the U.S. Securities and Exchange Commission ("SEC") have taken several regulatory actions that will have significant implications for commodity traders as well as for the fintech sector.

First, on September 29, 2021, the CFTC issued an advisory where it significantly expanded the contours of what was established as a swap execution facility ("SEF") since 2013. Specifically, the CFTC’s advisory stated that an entity may need to register as a SEF when: (1) facilitating trading or execution of swaps through one-to-many or bilateral communications; (2) facilitating trading or execution of swaps not subject to the trade execution requirement under CFTC rules; (3) providing non-electronic means for the execution of swaps; or (4) currently registered with the CFTC in some other capacity, such as a commodity trading advisor or an introducing broker, if its facility falls within the SEF definition.

Importantly, the advisory implies that platforms that provide purely chat functionalities without the multi-to-multi execution, may nevertheless qualify as SEFs. As a result, many platforms, such as emerging defi facilities or traditional communication platforms may become subject to registration and regulation.

Second, in similar actions, the SEC has proposed Regulation ATS on January 26, 2022, where it proposed that platforms that qualify as communication protocol systems register as exchanges or as broker dealers subject to Regulation ATS requirements. If this regulation becomes law, this rulemaking will significantly expand the definition of “exchange”. Further, on April 6, 2022, the SEC proposed its regulations on Security-Based Swap Execution Facilities ("SB SEFs") where it closely followed the provisions articulated by the CFTC in relation to SEFs in its rules and the advisory.

Further, the European Securities and Markets Authority ("ESMA"), the EU’s securities markets regulator, on January 28 published a consultation paper (CP) on what constitutes a multilateral system also seeking to broaden the scope of regulated trading venues.

These regulatory actions from the CFTC, the SEC and the ESMA indicate that U.S. and global regulators are seeking to bring a larger number of unregulated trading, communication and execution venues that trade derivatives and securities into the regulatory fold. Establishing such broad and flexible parameters for what constitutes a regulated trading platform will particularly affect the fintech sector and the defi platforms and those who trade on them.

FCA Announcement on Synthetic Sterling LIBOR

By **Michael Sholem**
Partner | Financial Regulation

On April 25, 2022, the UK Financial Conduct Authority ("FCA") provided an important update relating to the future of the London Inter-Bank Offered Rate ("LIBOR") benchmark. On its updated Benchmarks Regulation: our powers, policy and decision-making webpage, the FCA has set out the steps it intends to take regarding synthetic sterling LIBOR.

The FCA will, via a public consultation by early Q3 2022, seek views on retiring both 1-month and 6-month synthetic sterling LIBOR at the end of 2022. The FCA will also seek views on when to retire the 3-month rate.

We consider it likely that the 3-month rate will continue, at least in the medium term as it is the most widely used synthetic sterling LIBOR rate. It is interesting, however, to note the proactive approach the FCA appears to be taking to retire the synthetic rates as soon as possible.

CFPB Targets Nonbanks for Supervision

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

The Consumer Financial Protection Bureau ("CFPB") recently announced that it is going to exercise authority described as "dormant" to supervise nonbanks that are not otherwise subject to the CFPB's supervision authority. Since 2011, the CFPB has limited its supervisory activities to banks, so-called "larger participants" in specific industry sectors such as credit reporting, and mortgage and payday lenders. This expanded supervision authority suggests therefore that the CFPB is focused upon gaining supervisory access to fintechs that are not involved in lending and that offer products or services to consumers. Basically, if a company is considered a "covered person" for purposes of the Consumer Financial Protection Act (the "CFPA", also known as Title X of the Dodd-Frank Act), then the CFPB could potentially claim to have supervisory authority over that company.

This supervisory authority is based upon language in the CFPA that gives the CFPB supervisory authority when it "has reasonable cause to determine" that a nonbank "is engaging, or has engaged, in conduct that poses risks to consumers with regard to the offering or provision of consumer financial products or services." 12 U.S.C. 5514(a)(1)(C). In 2013, the CFPB promulgated a procedural rule in 12 CFR Part 1091 that defines how the CFPB can use this authority that has lain dormant to date.

The rule provides that when the CFPB seeks to utilize this authority, it will send a "Notice of Reasonable Cause" that lists consumer complaints or other information the CFPB has obtained that indicate that the nonbank covered person is engaging in conduct that poses risks to consumers. Companies may initially rebuff the attempt at supervision, but the appeal is directed to the CFPB's own Associate Director of the Division of Supervision, Enforcement and Fair Lending and then to the Director of the CFPB, neither of whom is obligated to provide any particular level of impartial review. Further, while supervision is typically cloaked in confidentiality, the CFPB has further amended its procedural rule such that to the extent the CFPB decides that a particular company is rightfully subject to supervision under this authority, the Director of the CFPB may choose to publish information regarding not only that the company is subject to supervision, but also the reasons why that company appears to be posing risks to consumers.

Trade Associations Raise “Significant Concerns” on Re-Proposed Guidelines for Access to Federal Reserve Bank Accounts and Services

By **Daniel Meade**
Partner | Financial Regulation

Last week, six bank trade associations, including the Bank Policy Institute and the American Bankers Association, submitted a joint comment letter on the Federal Reserve’s re-proposed Guidelines for access to Fed accounts and services that we previously wrote about in March.

The re-proposal would establish a three-tier framework for the review process for different types of institutions. Tier 1, the most streamlined, would only be available to insured depository institutions. Tier 2 review would generally be an intermediate level of review that would apply to eligible institutions that are not federally insured but are subject to prudential supervision (by statute or by commitments) by a federal banking agency and/or the Federal Reserve at the holding company level of the organization. Tier 3 review would generally be the strictest level of review applicable to institutions that are not federally insured and not subject to prudential supervision.

The trade associations said that they have “significant concerns” on the re-proposal, noting that the re-proposal does not resolve fundamental issues on possible risks posed by novel charters (*e.g.*, FinTechs and other uninsured bank-like financial services providers). The letter reiterates a recommendation made by some of the trade associations in previous proposals that the Fed expressly assess which novel charters are eligible, as a threshold matter, for Fed accounts and services.

The letter recommends two principles that the trade associations believe the Fed should be guided by in approving applications for Fed accounts and services:

> 1) The Federal Reserve Board of Governors must be involved in (or at least have the opportunity to object to) Tier 2 and Tier 3 applications, as possibly twelve different standards of review by the twelve Federal Reserve Banks could lead to inconsistent results; and
>
> 2) Approved Tier 2 and 3 institutions “should be held to the same supervision and oversight expectations, regardless of the charter type or business model, to preserve the safety and soundness of the financial system and compliance with existing laws and regulations.”

Inherent in the joint trade comment letter seems to be a fairness argument. Most (if not all) of the members of the six trade associations are Tier 1 institutions subject to supervision and regulation by the federal banking agencies. The trade associations are arguing that any institution with similar access to a Fed account ought to have similar supervision.

In Depth: The EBA Publish Final Draft RTS Relating to Risk Retention under the EU Securitisation Regulation

By **Michael Sholem**
Partner | Financial Regulation

By **David Quirolo**
Partner | Capital Markets

On 12 April 2022, the European Banking Authority (the "EBA") announced the publication of its final draft Regulatory Technical Standards ("RTS") specifying the requirements for originators, sponsors and original lenders in relation to risk retention. Regulation (EU) 2017/2402, as amended (the "Securitisation Regulation"), established the requirements concerning the retention of a material net economic interest in securitisations and empowered the EBA to prepare draft RTS in this area. There has been a long wait for these final drafts, given the EBA submitted an initial version to the European Commission in July 2018 (the "2018 RTS") and then consulted on further changes in June 2021.

The Final Draft RTS

The final draft RTS provide detail on the following aspects of the risk retention requirement:

a. requirements on the modalities of retaining risk;

b. the measurement of the level of retention;

c. the prohibition of hedging or selling the retained interest;

d. the conditions for retention on a consolidated basis;

e. the conditions for exempting transactions based on a clear, transparent and accessible index;

f. the modalities of retaining risk in case of traditional securitisations of non-performing exposures; and

g. the impact of fees paid to the retainer on the effective material net economic interest.

Amendments have been made to the 2018 RTS in order to provide greater consistency with the mandate as set out in Article 6 of the Securitisation Regulation. The most pertinent changes are:

1. In order to align the provisions of the final draft RTS more closely with the mandate in the Securitisation Regulation, specific cases of exposure to the credit risk of a securitisation position by credit derivative counterparties and liquidity facility providers under the previous Article 2, and conditions that holdings of securitisation positions by subsidiaries in third countries had to meet under the previous Article 2 to be considered as not in breach of the

due diligence obligations in Article 5 of the Securitisation Regulation, have been deleted.

2. Amendments have been made to the initial disclosure requirements on the level of the commitment to retain a material net economic interest in the securitisation (previously Article 15). Both the Article and the corresponding Recital have been deleted, as there is now overlap with the Delegated Regulation (EU) 2020/1224 on disclosure under Article 7 of the Securitisation Regulation. The obligation on the retainer to make and disclose a commitment to investors to maintain a material net economic interest in the securitisation on an ongoing basis has been retained, as this obligation is not included in the Delegated Regulation.

3. The final draft RTS provide guidance on the ban on originators cherry-picking assets, including criteria for determining comparable assets, and on the focus of the assessment of the relevant national regulator.

New provisions have been included in the final draft RTS to take into account the expanded mandate of the EBA on risk retention under Article 6 of Securitisation Regulation following amendments made as part of the legislative measures in the 2021 Capital Markets Recovery Package. These include addressing the issues of (i) the modalities of risk retention in traditional non-performing exposure (“NPE”) securitisations, (ii) the impact of fees payable to retainers on the risk retention requirement, (iii) the expertise of the servicer in NPE securitisations, (iv) clarification of the synthetic excess spread, (v) retention in re-securitisations, and (vi) own issued debt instruments. The key points include:

1. The final draft RTS set out how to apply the risk retention options on NPE securitisations, referencing the net value of non-performing exposures. The alternative options for retaining a net economic interest (point (a) of Article 6(3) of the Securitisation Regulation) should be included in the application of the net value approach to the securitised exposures qualifying as “non-performing exposures”.

2. The final draft RTS clarify the requirements for the fees payable to the retainer to comply with the risk retention requirements. The requirements are not limited purely to NPE securitisations. The phrase “fees paid to the retainer” refers to the servicer acting as retainer in both NPE securitisations and performing securitisations, insofar as applicable. The definition for “fees” is “any remuneration payable to the retainer where the retainer acts in any additional capacity as service provider to the securitisation”. The term “impact” is defined as “referring to both the amount and structure of the fees payable to the retainer where the amount and/or structure of the fees would undermine the ‘effectiveness’ of the risk retention requirement”. Recital (6) of the final draft RTS establishes that the retained material net economic interest should not be prioritised in terms of cash flows to preferentially benefit from being repaid or amortised. Taking into account the general principle that service providers are usually paid before the holders of the securitisation positions, the fees payable to the retainer in its role as the securitisation’s service provider should not be set at an amount or structured in a way that undermines the retained material net economic interest. The EBA has also set out criteria in the case of fees which are paid on a priority basis. The fees must be set on an arm’s-length basis having

regard to comparable transactions in the market and the fees must be structured as consideration for the relevant service without creating a preferential claim in respect of the cash flows of the securitisation, which results in decreasing the retained interest.

3. The final draft RTS specify standards that the servicer in traditional NPE securitisations should meet to show it has the requisite expertise in the servicing of non-performing exposures. These standards align with the EBA guidelines on STS criteria for non-ABCP securitisation.

4. The final draft RTS recognise synthetic excess spread ("SES") as a form of compliance with the risk retention requirement by the originator of a synthetic securitisation provided it is subject to a capital requirement under the applicable prudential regulation. Article 6(1) of the Securitisation Regulation requires that any form of retention is measured at origination and retained on an ongoing basis thereafter. The exposure value of the SES should be treated as retained net economic interest and therefore the corresponding part of the net economic interest provided through the exposure value of the SES needs to be determined at origination and the commitment of SES has to be maintained on an ongoing basis.

5. As a general rule, re-securitisations are prohibited by the Securitisation Regulation. Competent authorities may, however, authorise these transactions on a case-by-case basis. The final draft RTS give clarity on how the risk retention requirement applies in relation to these transactions and how this risk retention must be met separately for each of the securitisation and re-securitisation transactions. Importantly, the final draft RTS recognise an exception to this requirement. Where the originator acting as the retainer in the first securitisation(s) securitises exposures or positions retained in excess of the minimum net economic interest and no other exposures or positions are added to the pool of the re-securitisation, the retention for the first transaction should be considered sufficient.

6. The final draft RTS do not set out any further risk retention requirements for the securitisation of own liabilities, since the EBA consider the existing requirements and guidance to be sufficient. Sell-side parties of a securitisation are also the debtors of the securitised own liabilities. Therefore a retention of a net economic interest in the securitisation would not add to the sell-side parties' incentive to remain solvent and avoid a default on their liabilities.

In addition, the final RTS include technical changes made to the 2018 RTS. Two of these changes may be of particular interest to market participants:

1. The final draft RTS now provide an exhaustive list of exceptional circumstances under which a change of risk retention holder is permitted (such a change is generally prohibited by Article 6 of the Securitisation Regulation). Accordingly, the prohibition on the transfer of the retained economic interest will not apply: (a) in the event of the insolvency of the retainer; (b) when the retainer is, for legal reasons beyond its control and beyond the control of its shareholders, unable to continue acting in that capacity; or (c) in the case of retention on a consolidated basis in accordance with Article 14 [of the final draft RTS][1].

2. The Securitisation Regulation definition of originator specifies that an entity shall not, for the purposes of risk retention, be considered to be an originator where it has been established or operates for the "sole purpose" of securitising exposures. Article 2(7) of the final RTS has been amended from the 2018 RTS to modify the factors that should be should be taken into account when assessing whether such an entity meets the sole purpose test.

Next Steps

If endorsed by the European Commission, the final draft RTS will be subject to scrutiny by the European Parliament and Council before the finalised text can be published in the Official Journal of the EU and enter into force on the twentieth day thereafter. It may be subject to further amendment before it is finalised and enters into force, although this is thought to be unlikely given the extended drafting process.

The UK Position

Following its exit from the EU and the end of the Brexit transition period at the end of 2020, the UK has applied the "onshored" version of the Securitisation Regulation, which includes the same mandate in Article 6 for the development of technical standards on the risk retention requirement. The UK has previously announced that it will put forward its own technical standards in this area, in accordance with that mandate in the UK Securitisation Regulation. It is unclear when these standards will be announced, and the degree to which there will be divergence between the UK standards and the RTS developed in the EU.

1 This refers to a scenario where a retention interest was held within a consolidated group and the retention interest is to be transferred to an affiliate to ensure that the retention is retained within that group.

Welcoming Peter Malyshev and Mercedes Kelley Tunstall

Cadwalader welcomes the arrival of CFTC Regulatory Partner Peter Y. Malyshev and Fintech and Consumer Financial Services Partner Mercedes Kelley Tunstall, who join Cadwalader's Financial Services Group in Washington, D.C.

Peter focuses his practice on regulatory, compliance and transactional matters relating to commodities, derivatives and securities products regulated by the CFTC and the SEC. For over 25 years, Peter has assisted clients in the United States and overseas on numerous transactions involving over-the-counter and exchange-traded derivatives products in almost every asset class and market, such as: banking, financial institutions and insurance; agriculture, energy, mining and emissions; transportation and infrastructure; interest rates and credit default swaps; foreign exchange, digital assets and fintech; precious metals; and securities.

Mercedes regularly counsels banks, lenders, payments companies, digital asset companies and fintechs regarding federal banking regulators and compliance with laws and industry standards. She also defends clients against enforcement actions taken by these regulators, including the CFPB. As a former FTC lawyer and bank in-house counsel, she also draws on her experience to work with companies in a wide variety of industries, including the burgeoning Web3 and metaverse spaces, on advertising law, privacy and cybersecurity issues, as well as to represent clients in FTC and National Advertising Division defense.

Read more about Peter here and Mercedes here.