In This Issue ...

Welcome to the latest edition of Cabinet News and Views, as we get ready to turn the calendar to December and enter the home stretch of 2023.

We do so with some greater clarity on the state of the banking industry and of corporate governance issues. I offer a top-line summary of the FDIC's quarterly banking profile for the third quarter of 2023 which, as Chairman Martin Gruenberg notes, reflects continued resilience in the industry.

This week's issue also offers key insights into UK and EU regulatory reports. My colleague, Jack Andrew Kelly, provides an update on the 2024 proxy voting guidelines for UK-listed companies, recently published by Glass Lewis. The guidelines contain equal measures of key updates and existing policy clarifications. My colleague, Alix Prentice, details the UK Financial Conduct Authority's final report on the implementation of the Investment Firms Prudential Regime, which will impact over 3,500 investment firms. Finally, in a nod to the classic Shakespearean question of what's in a name, my colleague, Duncan Grieve, discusses the findings of an EU report indicating that the proportion of Europe investment funds using ESG-related terms in their fund names has grown by 400% over the past decade.

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

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

FDIC Issues Q3 Quarterly Banking Profile

By **Daniel Meade**
Partner | Financial Regulation

Earlier this week the Federal Deposit Insurance Corporation ("FDIC") issued the latest Quarterly Banking Profile ("QBP") for the third quarter of 2023.

The headline results of the QBP were:

- Net Income ($68.4 billion) decreased from the prior quarter, Driven By Lower Noninterest Income and Higher Realized Losses on Securities
- The Net Interest Margin Declined Quarter Over Quarter to 3.30%
- Unrealized Losses on Securities Increased From the Prior Quarter
- Loan Balances increased From Last Quarter and One Year Ago
- Total Deposits Declined For a Sixth Consecutive Quarter
- Asset Quality Metrics Remained Favorable Despite Modest Deterioration
- Community Banks Reported Lower Net Income From the Prior Quarter
- The Reserve Ratio for the Deposit Insurance Fund Rose to 1.13%

FDIC Chairman Martin Gruenberg, commenting on the QBP, stated "[t]he banking industry continued to show resilience in the third quarter. Net income remained high, overall asset quality metrics remained favorable, and the industry remained well capitalized. Despite a modest improvement in the industry's net interest margin, funding pressures continued to challenge the industry." He noted further that "[t]hough the U.S. economy has remained strong in 2023, the banking industry still faces significant downside risks from the continued effects of inflation, rising market interest rates, and geopolitical uncertainty. These issues could cause credit quality, earnings, and liquidity challenges for the industry." He concluded by noting that the downside risks mentioned above, together with a focus on commercial real estate deterioration, and other funding and earning pressures would warrant further supervisory attention.

Glass Lewis Releases Its 2024 Proxy Voting Guidelines for UK Listed Companies

By **Jack Andrew Kelly**
Special Counsel | Financial Regulation

On 16 November 2023, Glass Lewis, a global provider of corporate governance and proxy voting services, published its 2024 Benchmark Policy Guidelines which sets out its updated framework for evaluating the governance policies and practices of UK listed companies and its approach in respect of proxy voting recommendations ("the 2024 Proxy Voting Guidelines"). The 2024 Proxy Voting Guidelines cover a range of topics including directors' appointment, attendance, remuneration and risk management oversight.

Glass Lewis' proxy research papers will report against the 2024 Proxy Voting Guidelines in respect of meetings of UK listed companies from 1 January 2024.

Key Updates contained in the 2024 Proxy Voting Guidelines

Glass Lewis reviews its proxy voting guidelines on an annual basis to ensure that they remain current with market practice, regulation, governance codes and the evolving standards of best practices for UK corporate governance. The 2024 Proxy Voting Guidelines contains the following key updates:

- **Director Attendance:** Glass Lewis has clarified that it will generally recommend voting against the re-election of directors who fail to attend either (i) at least 75% of board meetings or (ii) an aggregate of 75% of board and applicable committee meetings. Exceptions may be granted to directors in their first year of service on a board or when the company discloses mitigating circumstances for a director's poor attendance record.

- **Interlocking Directorships:** Glass Lewis has expanded its policy to cover interlocking directorships between both public and private companies. Other types of interlocking relationships will be evaluated on a case-by-case basis, and multiple board interlocks among non-insiders will be reviewed for evidence of a pattern of poor oversight.

- **Director Accountability for Climate-Related Issues:** While the policy for disclosure regarding climate risks and holding responsible directors accountable was applied to the largest, most significant emitters in 2023, beginning in 2024 Glass Lewis will apply the policy to FTSE 100 companies operating in industries where the Sustainability Accounting Standards Board has determined that companies' greenhouse gas emissions represent a financially material risk.

- **Cyber Risk Oversight:** Glass Lewis has expanded its policy on cyber risk oversight to emphasize the expectation that where a company has been materially impacted by a cyber-attack, such company shall provide periodic updates to shareholders on its progress towards resolving and remediating the impact of the attack. Where a company has been materially impacted by

a cyber-attack, Glass Lewis may recommend against appropriate directors should it find the board's oversight, response or disclosure concerning cybersecurity-related issues to be insufficient or not provided to shareholders.

Clarifications contained in the 2024 Proxy Voting Guidelines

The 2024 Proxy Voting Guidelines also clarifies existing policies relating to:

- **Accounts and Reports:** Glass Lewis may recommend, on a case-by-case basis, that shareholders vote against proposals to approve or acknowledge a company's accounts and reports where the auditor did not provide an unqualified opinion on the financial statements while assessing the reasoning provided by the statutory auditor and any relevant disclosure from the company.

- **Executive Remuneration Voting Considerations:** Certain structural elements that Glass Lewis considers to be best practice and specific circumstances which may lead it to recommend against the company's remuneration policy and/or reports that have been clarified.

- **Executive Shareholding Requirements:** Glass Lewis has outlined its belief that companies generally should adopt minimum executive share ownership requirements that should apply for the duration of an executive's tenure, and for a period of time post-employment (typically two years).

- **Remuneration Relative to Ownership Structure:** Glass Lewis has expanded its guidelines to outline a number of company practices that may serve to mitigate concerns when a significant equity award is made to an executive who is also a major shareholder. These include the inclusion of challenging targets attached to a diverse set of performance metrics, meaningful disclosure on the company's engagement with free-floating shareholders on the topic, or a policy that the shareholder executive will not participate in voting on the award.

- **Remuneration Relative to Peers:** Glass Lewis has outlined its expectations surrounding setting remuneration levels relative to peers and clarified that it welcomes companies to disclose the peer group utilised, including the criteria used in the selection process, for pay benchmarking – particularly in cases where companies consider US-based peers.

- **Standard Listed Companies:** Glass Lewis has clarified that, for companies listed on the standard segment of the main market of the London Stock Exchange, it generally will apply its policies as they pertain to companies traded on the Alternative Investment Market (AIM). However, in light of the varied market capitalisation and complexity of standard listed companies, Glass Lewis will approach this on a case-by-case basis.

Glass Lewis will be hosting a webinar to provide a detailed overview of the key updates to its 2024 Proxy Voting Guidelines on 12 December 2023 at 2 pm GMT / 3 pm CET. To register for the webinar, please visit here.

The UK’s FCA Reports on a Multi-firm Review of Investment Firms Internal Capital Adequacy Assessment Processes

By **Alix Prentice**
Partner | Financial Regulation

The UK’s Financial Conduct Authority (“FCA“) has published its final report on the implementation of the Investment Firms Prudential Regime (“IFPR”) “*IFPR implementation observations: quantifying threshold requirements and managing financial resources – concluding report.*”

The report is the conclusion of a review of the implementation of IFPR for 3,500 MiFID investment firms that are prudentially regulated by the FCA, and while it concludes that firms have generally engaged well with IFPR requirements, there are areas where improvement is needed:

1. Liquid Asset Assessments

The FCA has observed that firms are not assessing liquid asset requirements to cover periods of liquidity stress. As part of the internal capital adequacy and risk assessment (“ICARA”) process, MiFID investment firms must process, assess and monitor the adequacy of their liquid assets and capital and liquidity planning to make sure that they can withstand severe but plausible stresses while minimising harm. The FCA is concerned that the firm's plans for liquidity coverage during such times of stress are “*insufficiently time-granular*” to identify mismatches between cash requirements and cash flows, particularly when winding down. Firms are also failing to distinguish between own funds and liquid assets needs, further jeopardising orderly wind-downs.

2. Early Warning Indicators, Triggers, and Interventions

Being able to spot early warnings and triggers allows firms to identify when they should intervene. The FCA observed that firms are generally identifying two main internal intervention points at times of stress: (1) the activation of the recovery plan; and (2) the activation of the wind-down plan, and is concerned that firms are not actually identifying the right time to intervene and the right amount of resources needed above and beyond threshold requirements. The FCA wants to see more effective use of stress testing to better understand appropriate intervention points and resources buffers.

3. Wind-down Plans

Here, the FCA calls for greater consideration of the role of group governance and group risk appetite statements when formulating wind-down plans for individual group entities. This is important in order to be able to assess group-wide impacts, which may include the wind-down of other group entities, as well as the dependencies that exist intra-group which will be affected.

4. Operational Risk Capital Assessments

The FCA has identified poor practices in assessing operational risk capital, including the inappropriate use of group models and poor governance and oversight over modelling. These poor practices lead to an incomplete assessment of risk, with consequent failures of resourcing when those risks crystallise.

Next Steps

While none of the FCA's observations involve policy change, the FCA's expectation is that firms will review their own practices to make sure they are meeting rules and requirements already in place. The final report also includes a comprehensive list of good and poor practices the FCA review found, and firms can cross-check these against their own.

EU Market Regulator Finds 400% Increase in Use of ESG Language in Fund Names

By **Duncan Grieve**
Special Counsel | White Collar Defense and Investigations

On October 2, 2023, the EU markets regulator, the European Securities and Markets Authority (ESMA), published a study indicating that the proportion of investment funds in Europe using ESG-related terms in their fund names has grown by 400% over the past ten years.

Funds with ESG-related language in their names have grown to represent 14% of assets under management in the EU in 2023, reaching €974 billion out of a total €6.8 trillion AUM. The use of the terminology gained momentum after the 2015 Paris Agreement was signed and escalated from 2018 to 2022, although the pace of new ESG investment product development slowed in 2023. The report highlights the increasing demand for funds with ESG-related terms in their names, surpassing demand for other funds consistently over the past six years. Global sustainable fund assets have tripled to over €2.1 trillion in the last three years.

The study also notes a preference among fund providers for more generic ESG terms, potentially posing challenges for investors in verifying whether fund investments align with the ESG claims in their names. This trend has implications for both retail and institutional investors. ESMA's natural language processing techniques reveal that funds sold to retail investors are associated with more ESG claims in standardized documents compared to funds sold to institutional investors. ESMA emphasizes the importance of monitoring such communication channels for investor protection.

Final Thoughts

It is notable that ESMA continues to be highly focused on the use of ESG-related terms in fund names and investor and marketing communications. This is consistent with two of its strategic priorities: (i) strengthening the supervision of EU financial markets, and (ii) enhancing the protection of retail investors. The findings of ESMA's study and the significant increase in the use of ESG language in fund names bring into further focus ESMA's delayed fund names rules. These were initially proposed in November 2022 for a Q3 2023 publication but are still awaited.

As we covered earlier this year, another significant recent issue that highlights the difficulties around ESG fund names, classifications and sustainability descriptions is the controversy around the classification of funds under Article 8 and Article 9 of the EU's Sustainable Finance Disclosure Regulation (SFDR), and the use of the disclosure categories as de facto labels. The resulting mass downgrades by asset managers of funds previously classified as Article 9-compliant – i.e., those that have specific sustainable goals as their objective – to less restrictive Article 8-compliant funds prompted the European Commission to launch a review of the SFDR in September 2023.

One of the primary concerns around the use (and potential misuse) of ESG-related terms in fund names is greenwashing. In February 2023, ESMA announced the launch of a common supervisory action (CSA) to cover the application of MiFID II (Markets in Financial Instruments Directive) disclosure rules to marketing communications for financial products across the EU. One of the objectives of the CSA was to ensure that such communications are fair, clear and not misleading. ESMA, the European Banking Authority, and the European Insurance Occupational Pensions Authority agreed on a common, high-level definition of greenwashing and outlined greenwashing risks, impacts, proposed mitigation efforts and challenges for their respective industries, providing much sought clarity for EU operators. ESMA then issued a public statement outlining its expectations for sustainability-related disclosures to be incorporated into prospectuses. In September this year, it was announced that EU institutions are to vote to ban misleading advertisements and enhance product information provided to consumers. The so-called Green Claims Directive will prohibit companies from making statements such as “carbon neutral” or “environmentally friendly” unless they can substantiate those claims.

ESMA’s focus on potentially misleading practices in marketing materials for ESG-linked financial products across the EU is consistent with a global trend and echoes similar initiatives by other financial regulatory authorities. As we previously reported, the SEC adopted amendments to the Investment Company Act of 1940, most notably to the “Names Rule” governing the names of funds to ensure that they do not mislead investors regarding the fund’s risks and investment characteristics. The SEC commented that the updates are designed to “address materially deceptive and misleading use of ESG terminology in fund names.” In the UK, the Financial Conduct Authority announced its intention to publish rules around the use of ESG terms in investment product sustainability labels and how these can be used.

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