In This Issue ...

Welcome back to *Cabinet News and Views*! We trust you enjoyed a rejuvenating holiday season, and we're thrilled to rejoin you in the exciting year ahead.

In our first issue for 2024, we are diving into what we think promises to be a busy year for the industry and regulators alike.

As always, your comments and questions are valued. Feel free to reach out to us anytime by dropping a note here.

Mercedes Tunstall and Alix Prentice
Partners and Co-Editors, *Cabinet News and Views*

Trends in 2024: Consumer Financial Services Edition

By Mercedes Kelley Tunstall
Partner | Financial Regulation

Earlier this week, the Consumer Financial Services Law Subcommittee of the American Bar Association's Business Law Section met in Santa Barbara for its winter meeting. This conference brings together practitioners in consumer financial services law from all sectors – private practice, in-house and government.

The following summary provides highlights and trends that came from the many substantive sections of the meeting and begin to answer the question as to what topics will be most important for anyone working in consumer financial services in 2024.

1. **Expect Continued Fair Lending Enforcement.** Throughout several sessions at the conference, speakers emphasized again and again (including the head of the Office of Fair Lending at the Consumer Financial Protection Bureau ("CFPB"), Patrice Ficklin) that focus on fair lending concerns was important to the CFPB in 2024. In particular, financial institutions were encouraged to look beyond the standard controls for identifying fair lending problems. Standard controls often include employing a variety of algorithmic and other automatic methods to attempt to identify burgeoning fair lending problems early and to correct course as quickly as possible, conducting training of all consumer-facing employees and maintaining strict lending criteria, with minimal opportunities for any individual to waive a consumer from requirements or to adjust interest rates. Controls that are not as standard today and that were mentioned by the speakers as being effective means for improving fair lending compliance include screening emails sent between consumer-facing employees for discussions involving any of the prohibited bases, as well as evaluating policies that may be in place regarding consumers who report income received from public assistance or who have formerly been incarcerated. For supervised financial institutions, to get a better sense of the CFPB's activity regarding fair lending in the supervision context, review the Supervisory Highlights published in Summer 2023.
2. **Publication of the Personal Financial Data Rights Rule (Section 1033).** As readers may recall, we published a four-part series covering the substantive aspects of the Personal Financial Data Rights rule ("PFDR Rule") and there was much discussion at the conference regarding the implications of the PFDR Rule. Comments were due December 29, 2023 regarding the proposed PFDR Rule and the intel from the conference was that the CFPB's Director, Rohit Chopra, is very anxious to finalize the rule as soon as possible, maybe even as early as April 2024. Such an early finalization of the PFDR Rule portends that we will likely not see many changes from the proposed rule. In reviewing the comment letters the CFPB received (just under 11,000), there was actually not as much uniformity among those submitted by the financial services industry (i.e., the data providers under the rule), as we would typically expect. Nevertheless, the primary points of pain raised in the letters, most of which were mentioned at the conference, include the

following:

- ***Timeframe for initial compliance should be extended***. The proposed rule required the largest financial institutions to comply with the rule as early as six (6) months after finalization of the rule. Most commenters requested somewhere between at least 18 and 24 months for any financial institution to commence compliance. The primary reasons for the requested delay were all based on technology concerns, not the least of which is that the required dashboards through which consumers and authorized third parties are intended to request information are supposed to be built in accordance with technical specifications established by standard-setting organizations and that have been evaluated and approved by the CFPB. To date, there are no specifications from such organizations to even be evaluated or approved.

- ***Data providers should be allowed to charge fees***. The proposed rule imposed a ban on data providers being able to charge fees for access to the information, but authorized third parties and data aggregators that will primarily be requesting the data on the consumer's behalf can charge any fees they like. Meanwhile the data providers must invest substantial amounts of time and money to build and maintain the required interfaces that will facilitate the sharing of the information. Accordingly, many data provider comment letters have requested that the PFDR Rule establish that data providers may charge a reasonable fee for access to the information, generally charged to the authorized third party. The authorized third parties could then pass along the fees to the data aggregators. Consumers asking directly for their information from the data provider would not be charged a fee.

- ***Screen-scraping should be explicitly prohibited***. A major reason that the PFDR Rule specifies that data providers should build interfaces for the exchange of data is because of concerns related to the practice of effectuating the sharing of data by means of "screen-scraping." Today, due to the lack of alternatives, the companies that would be authorized third parties under the PFDR Rule often will obtain the data on a consumer's behalf, by requesting the consumer's online banking credentials and using those credentials to access and "scrape" the data directly from the online banking portal. This process of accessing data is fraught with security concerns, and often technically violates the online banking agreements consumers have with their financial institutions. The PFDR Rule as proposed should minimize the amount of "screen-scraping" that occurs, but the commenters noted that without a ban on screen-scraping would-be authorized third parties could effectively duck out of the consumer protections imposed on them by the PFDR Rule by continuing to screen-scrape, instead of accessing the information through the required interfaces. As the Bank Policy Institute and the Clearinghouse said in their letter, "the CFPB should explicitly prohibit screen scraping and credential-based access by all third parties and data aggregators, not just authorized third parties and data aggregators used by those entities, with respect to data that a data provider has made available via a developer interface. This prohibition should extend to all data made available via the interface and not be limited to "covered data."

- ***Obligations and Liability Under the PFDR Rule, Generally***. As written, the proposed rule leaves questions of liability for non-compliance with security, privacy and consumer protection standards to private contracts between and among parties, except that only data providers have the obligations to protect consumers. We discussed this point in our own coverage of the PFDR Rule, but, once again here is the rationale on this concern from the comment letter sent by the Bank Policy Institute and The Clearinghouse, "Data providers also would bear responsibility for ensuring that third parties become authorized third parties, abide by the relevant obligations to obtain such status, and access covered data via developer interfaces and do not use consumer credentials to access consumer interfaces. This puts a substantial oversight burden on data providers, individually and collectively, to monitor compliance by thousands of prospective data recipients. While data providers, particularly those that are regulated financial institutions, conduct appropriate due diligence on third parties and aggregators consistent with their third-party risk management obligations, it is not appropriate or feasible for data providers to bear responsibility for ensuring third party compliance with all relevant obligations."

- ***Obligations and Liability for Transactions Under Regulations E and Z***. One of the categories of "covered data" that is required to be shared by data providers under the proposed rule with authorized third parties and aggregators includes information necessary such that the authorized third party or data aggregator may institute a transaction on a consumer's card (credit, debit, prepaid or otherwise) themselves. However, should an unauthorized transaction occur while that information is in the hands of said authorized third party or data aggregator, then the data provider ends up liable for that transaction, per the provisions of Regulations E and Z, and under those regulations the data provider has the further burden of conducting an investigation into whether the transaction was truly unauthorized. Accordingly, many data provider comment letters requested that the CFPB extend those Regulation E and Z obligations for investigation, data security and liability to the authorized third parties and data aggregators under whose watch the unauthorized transaction occurred.

- ***Permit Consumers to Opt-In to Secondary Use of Their Data***. The PFDR Rule severely restricts the ability for data providers, authorized third parties and data aggregators to use covered data for any purpose other than the primary use. Although this restriction is not to be unexpected from a consumer protection regulator, it is curious that the CFPB would choose to recommend such a strong control for an industry that already has more severe restrictions on secondary use thanks to existing laws that are decades old, including the Gramm-Leach-Bliley Act and the FCRA. The comment letter from the Mortgage Banking Association provided the following detail and commentary, "Consumers should also be allowed to opt-in to targeted advertising, cross-selling, and the sale of their data by third parties. These secondary uses are allowed under the Gramm-Leach-Bliley Act with consumer consent. Allowing consumers to choose to receive advertisements and information about other products offered by third parties would promote competition between third parties and data providers. Third parties would not need to rely on data providers for consumer information before offering products and could compete on an even playing field."

While these six areas were the most frequent comments provided to the CFPB, as mentioned, there were a wide variety of additional areas that data providers, authorized third parties and data aggregators alike addressed. For example, some commenters requested that the PFDR Rule should clarify that participants are not consumer reporting agencies for purposes of the Fair Credit Reporting Act, including a comment letter from a data provider that explained, "mandatory participation in the consumer-authorized data sharing ecosystem should not result in a bank falling within the expanded definition of a 'CRA' or a 'furnisher'", referencing the greatly expanded definition of a consumer reporting agency in the CFPB's concurrent FCRA rulemaking process. Other commenters focused upon the reporting requirements related to the interfaces that the PFDR Rule imposed upon data providers, observing that such reporting has little benefit as it does not provide protection to consumers and may betray security and trade secret information. Still others were concerned that the prong of the data provider definition that included companies that were engaged in the facilitation of payments from the covered products was too broad. As one comment letter explained, "[I]t appears that any person that 'controls or possesses' information on the 'facilitation' of payments from a Regulation E account or Regulation Z credit card would be treated as a Data Provider and subject to the full panoply of information-sharing requirements under the Proposed Rule. The Proposed Rule suggests that 'payment facilitation products and services . . . would generally already be covered as Regulation E financial institutions,' but the rule nowhere defines or analyzes 'facilitation' and, in the absence of clarity, the Proposed Rule would likely sweep in entities the CFPB does not address in the Proposed Rule and did not intend to cover." Finally, it bears mentioning that a majority of the comments received were variations on a form letter prepared by a consumer group requesting that the CFPB include EBT cards as a covered product in the PFDR Rule. The CFPB did mention in the Federal Register commentary to the proposed rule that they envisioned incorporating additional products into the PFDR Rule coverage at a later time.

3. **Considering When Discouragement Occurs**. Separate and apart from the general focus on fair lending concerns already mentioned, many panels at the conference referenced the increased marketing activity that drives who applies for what credit products, and when. While redlining has long been recognized as an unfair practice that denies credit or provides credit at higher interest rates to populations in the redlined areas, targeted marketing to specific groups may effectively render the same kind of result. Often called "reverse redlining", the problem occurs when targeted populations are primarily or exclusively marketed to by certain lenders that may only offer high-cost loans. As a result, these populations may have a much higher incidence of receiving loans with higher APRs than they would have received from a lender that offers a wider variety of loan types. Likewise, if the primary marketed material received by individuals shows only high interest rates, then those individuals may be discouraged from even submitting an application. A corollary concern arises when consumers reach lenders primarily through lead generation. Due to varying levels of interest and drive, higher cost lenders may respond leads much more consistently than other lenders, leading to consumers being discouraged from submitting applications for credit. Accordingly, creditors are encouraged to evaluate whether their marketing efforts and use of lead generation effectively results in discouraging applications in this manner.

4. ***Bonus Topic: Buy Now, Pay Later Legislation***. Although not much discussed during the substantive panels of the meeting (the topics for which were settled months ago), participants buzzed about legislation that Governor Hochul of New York is promoting to regulate "buy now, pay later" ("BNPL") companies. The push for this legislation appears to have commenced in conjunction with the Office of the Comptroller of the Currency issuing guidance to financial institutions called "Risk Management of 'Buy Now, Pay Later' Lending" in early December 2023. The guidance, consistent with other guidance related to risk management of relationships between banks and fintechs, identifies both general risks and specific risks related to BNPL transactions, including that "[b]orrowers could overextend themselves or may not fully understand BNPL loan repayment obligations" and "Merchandise returns and merchant disputes can be problematic for BNPL borrowers and banks because the issue may not be resolved during the brief term of the loan." The proposed legislation would seek to normalize disclosures and consumer rights and protections in the BNPL space and would clearly provide the New York Department of Financial Services with enforcement authority.

While these topics were much discussed and debated at the conference, these are just a few topics percolating in the consumer financial services space. Keep watch here for updates throughout the year on other hot areas.

Hot Topics for 2024

By **Alix Prentice**
Partner | Financial Regulation

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

By **Grace Ncube**
Associate

Here are some of our key focus items across Europe and the UK as we enter a New Year. There are, of course, others, but these represent the most important themes – a regulatory focus on the non-bank credit market, risk management and prudential provisioning, a developing post-Brexit legislative landscape, the treatment of consumers and the customer journey and diversity and inclusion in financial services.

EUROPE

1. AIFMD II: Publication of the agreed version of AIFMD II finally arrived on 6 November 2023 (see here for our note on its new requirements for loan origination funds) with publication in the Official Journal of the European Commission ("EC") due in Q1 of 2024. Given the obligation on the European Securities and Markets Authority ("ESMA") to produce draft regulatory technical standards, including on liquidity management, within a year of AIFMD II's entry into force, 2024 will be the year to look out for technical detail on the actual implementation of AIFMD II's novel features.

2. SFDR: 2023 has seen a lot of discussion and consultation on the EU's Sustainable Finance Disclosure Regulation ("SFDR"). Specifically, the EC launched their targeted consultation focused on four main sections: (i) SFDR current requirements; (ii) how SFDR interacts with other EU legislation; (ii) potential changes to disclosure requirements for financial market participants; and (iv) the proposal of a categorisation system for financial products. It is anticipated that in 2024, the EC will provide an update following the end of their targeted consultation on 15 December 2023 and it remains to be seen whether this will lead to a new product categorisation system similar to the labelling system under the UK's Sustainability Disclosure Requirements. Our previous notes on SFDR can be found here and here.

UK

1. Basel 3.1: The UK's banking regulator, the Prudential Regulation Authority ("PRA") has published its near-final policy statement on the implementation of seven aspects of the final elements of Basel III standards on the measurements of risk-weighted assets ("Basel 3.1") (see here for our note on this policy statement). Q1 of 2024 will bring the publication of a companion near-final policy statement on the remaining elements of Basel 3.1 from the PRA, including new provisions on credit risk and the "output floor", both carrying significant implications for the

calculation of risk across a comprehensive range of bank transactions and instruments.

2. SDR: The UK Financial Conduct Authority ("FCA") issued a consultation on Sustainability Disclosure Requirements ("SDR") and investment labels in October 2022. Following input from numerous stakeholders, on 28 November 2023 the FCA published its long-awaited final rules and guidance (see here for the full policy statement). This new disclosure regime has a number of important impacts on FCA authorised firms, including significant new "anti-greenwashing" rules which come into effect during the course of 2024.

Some key 2024 milestones to note are:

- the anti-greenwashing rule for FCA authorised firms which comes into force on 31 May 2024;
- the four specific sustainability labels which firms can begin to use from 31 July 2024;
- the new naming and marketing rules to come into force on 2 December 2024; and
- the new rules relating to distributors of sustainability products to come into force on 2 December 2024.

3. FSMA 2023: The Financial Services and Markets Act 2023 ("FSMA 2023"), which received Royal Assent in June 2023, implements and furthers the Government's post-Brexit aim to tailor EU legacy legislation to a revised and renewed domestic regime. 2024 will see further progress in the areas of ringfencing and resolution regimes, investment research as well as public offers and admissions to trading on equity markets. Following on from 2023 consultation exercises, finalised legislation on securitisations in the form of new securitisation regulations, along with a new Securitisation Sourcebook "SECN" from the Financial Conduct Authority ("FCA") are also scheduled to come on stream in 2024 (see here for our note on developments for the UK Securitisation Regulation).

4. Consumer Duty: The FCA's Consumer Duty rules came into effect on July 31, 2023 (see here for our note on this topic). 2024 will see firms under considerable scrutiny as the FCA begins evaluating their interactions with retail customers through the Consumer Duty lens, emphasizing compliance with higher standards of care and protection. July 2024 will also see the Duty start to apply to closed products and services, and the FCA has indicated that it will use its full range of powers when faced with serious breaches of the Duty's obligations, including fines, removing permissions and requiring consumer redress, with senior managers and boards being held to account for delivering the required outcomes.

5. Diversity and Inclusion: 2023's annual reports have been the first to include the mandatory diversity disclosures required under the UK's Listing Rules, applicable to reporting periods beginning on or after 1 April 2022. Together with the recent FCA consultation on diversity and inclusion ("D&I") in financial services (see here for our note on this), as well as the Parker Review report and the 2024 Glass Lewis report on Proxy Voting Guidelines, we expect to see heightened scrutiny of public companies' commitment to D&I and regulator intervention around related non-financial misconduct in 2024. Responses to the FCA's Consultation have recently

been published, with most organisations broadly supportive of the FCA's proposed approach in setting minimum standards by embedding rules around D&I into fitness and propriety requirements, the code of conduct and threshold conditions for doing business. A final FCA Policy Statement is due in 2024, with rules to be in force 12 months after publication.

Insider Trading in Physical Commodities

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

By **Kenneth Breen**
Partner | White Collar Defense and Investigations

On December 14, 2023, the Commodity Futures Trading Commission ("CFTC") and Department of Justice ("DOJ") Fraud Section announced the settlement of insider trading fraud charges and Foreign Corrupt Practices Act ("FCPA") charges, respectively, against Freepoint Commodities LLC ("Freepoint"). This note focuses on the CFTC charges which involved trading on material non-public information ("MNPI") improperly obtained from a foreign state-owned enterprise ("SOE") in connection with physically deliverable fuel oil trades. As a result of this fraudulent scheme, the CFTC alleges that Freeport was able to generate approximately $30 million over a period of 6 years. The CFTC order requires Freeport to pay more than $91 million in civil and monetary penalties and disgorgement.

This CFTC case is noteworthy because it is one of the very few where the CFTC asserts its anti-fraud jurisdiction not with respect to swaps, options and futures contracts (*i.e.*, "commodity interests" or derivatives), but with respect to purchases and sales of physically-delivered commodities, such as fuel oil.

According to CFTC's order, Freepoint, a large commodity trader based in Connecticut, had hired an overseas consultant who was able to obtain MNPI from certain foreign SOE's employees for bribes and other compensation that gave a significant commercial advantage to Freepoint over its competitors. Freepoint employees knew that the information was improperly obtained and took steps to conceal that they were in possession of this MNPI.

To establish its fraud claim under § 6(c)(1) of the CEA and § 180.1 of CFTC Regulations, the CFTC order found that Freepoint's traders: (1) attempted or engaged in prohibited fraudulent or manipulative conduct (*i.e.*, engaged in fraud, such as giving bribes and other corrupt payments); (2) with scienter (*i.e.*, acted knowingly and attempted to conceal their knowledge); and (3) in connection with any swap, futures contract, or contract of sale of any commodity in interstate commerce (*i.e.*, the sale and purchase of physical fuel oil which is a commodity).

The CFTC's order signifies its ambition to expand its anti-fraud and anti-manipulation jurisdiction with fraud claims alleging misappropriation of MNPI (*i.e.*, insider trading claims) involving only physical commodities without the use of derivatives.

In the parallel DOJ matter, DOJ announced the entry of a deferred prosecution agreement (DPA) with Freeport, deferring criminal prosecution on a charge of conspiracy to violate the FCPA.

Lessons to Be Learned From 2023's Bank Failures

By **Alix Prentice**
Partner | Financial Regulation

By **Juliette Mills**
Associate | Financial Services

In scale and scope, 2023 saw the most significant systemwide banking stress since the 2008 global financial crisis. The collapse of four regional and global banks coupled with significant rises in interest rates, inflation and seismic geopolitical instability have raised questions around the adequacy of prudential and regulatory frameworks.

This article, featured in *Law360*, looks at the major themes emanating from the consequent period of self-reflection by regulators across the world. It will examine the U.K. perspective while drawing on the universal themes that have, understandably, been reiterated across the major global economies.

Background

On March 8, Silvergate Capital, a fintech and cryptocurrency uninsured, nondepository bank in California, announced it would be winding down its operations and liquidating its bank.

Two days later, following a bank run, Silicon Valley Bank, one of the most prominent lenders in the start-up world, failed.

On the heels of Silicon Valley Bank's collapse, the contagion caused Signature Bank, another prominent regional bank, to be taken into receivership by the Federal Deposit Insurance Corp. on March 12.

The rapid collapse of these three banks was caused by classic bank runs precipitated by rising interest rates and apparent poor interest rate risk management, according to Vice Chairman Travis Hill of the Federal Deposit Insurance Corp.[1]

Meanwhile, in Europe, on March 15, in the wake of the failures in the U.S., Credit Suisse, a global systemically important bank, was on the verge of collapse, having been severely affected by issues including capital sufficiency and investor confidence, and subsequently entered into a rescue merger deal with UBS AG.

Risk and Governance

The banking turmoil highlighted a number of weaknesses in the way risks are being managed and the need for more robust governance, supervision and risk culture.

The report on the 2023 banking turmoil from the Basel Committee on Banking Supervision identified shortcomings in basic risk management and a lack of

appreciation of how buildups of different risks are interrelated and have a compounding contagion effect.

Business models were found to remain overly focused on growth and short-term profitability, which became unsustainable, and were compounded by poor risk culture and insufficient oversight.

Following the 2008 global financial crisis, there was a concerted effort to improve banks' financial resources, most importantly the levels of capital available to allow losses to be absorbed before a bank becomes insolvent.

One of the key reforms following this period was the introduction of central bank stress testing. This remains a vital part of how the Bank of England and other global regulators promote financial soundness.

Stress testing assesses the ability of banks to withstand severe but plausible stress by looking at capital adequacy and measuring the resilience of banks by identifying their vulnerabilities. The purpose of stress testing is to establish that banks, insurers and their counterparties have the strength to withstand another financial crisis.

On an annual basis, stress testing is carried out by the Bank of England on the largest U.K. banks and building societies. Firms that are not captured within this scope will be given a hypothetical adverse scenario to test themselves against, via computer simulation, to see whether they can withstand extreme economic scenarios.

Every other year, the Bank of England will probe the resilience of the banking system by testing it against an exploratory scenario that is not directly linked to the financial cycle.

Recent events, however, have led the Bank of England to carry out systemwide stress testing across banks, insurers, pension schemes and clearing houses to explore how they would collectively cope under severe — but plausible — market stress.

Not only is the Bank of England testing to observe how market players cope with huge demands on liquidity, but it will also be looking at more severe, wide-ranging, and persistent conditions than the so-called dash-for-cash in March.

As well as stress testing, regulators will be relying on the implementation of the Basel III reforms — the Basel 3.1 Standards — to ensure they have the ability to adapt and react quickly and appropriately to external factors, including environmental, economic and market, to avoid risks and maintain financial stability across the board.

Liquidity and Risk-Weighted Assets

One of the main causes of the 2008 global financial crisis was a failure by banks to adequately monitor and control liquidity risk.

In response, regulators around the world designed and implemented extensive reforms, notably those implemented by the Basel committee to address a number of shortcomings within the pre-global financial crisis regulatory framework.

The Basel committee is in the process of implementing the final limb of the Basel 3.1 Standards, with the goal of creating a resilient banking system where market participants remain adequately capitalized and have sufficient liquidity to absorb any risks in times of challenge.

Basel 3.1 Standards introduced a number of risk management measures including liquidity coverage ratio and risk-weighted assets to improve resilience against short-term liquidity shocks.

Liquidity coverage ratio dictates the proportion of highly liquid assets that must be held by financial institutions, designed to ensure that financial institutions possess suitable capital preservation to meet short-term obligations in a period of significant liquidity stress — 30 calendar days — and is calculated by way of a generic stress test.

Risk-weighted assets calculations are used in the risk-adjusted capital ratio, which determines a bank's ability to continue operating under stress and seeks to strengthen bank capital requirements by assessing levels of liquidity and leverage depending on the level of risk a bank has, and ensuring it has enough capital to outweigh such risk.

These changes will improve the comparability and credibility of the risk-based capital ratios of firms and their products.

Unsurprisingly, the report published by the Financial Stability Board in October on the events of 2023,[1] focuses on resolution mechanisms for banks in crisis, but it is worth noting the board's emphasis on the need for credible liquidity backstops in an environment where liquidity can come under rapid and intense stress.

In the U.K., in a speech published on Oct. 16,[2] Deputy Governor for Prudential Regulation and CEO of the Prudential Regulation Authority Sam Woods discussed the year's banking failures, the lessons learned therefrom and priorities going forward in the work that needs to be done to "improve and refine the regulatory regime for banks."

While dismissing the idea of a zero-failure regime, the speech does examine the efficacy of tools to accommodate the Prudential Regulation Authority's "zero appetite for systemic financial crises."

These tools include measuring risk correctly: Woods points to the variability of risk-weights across firms and jurisdictions as being a drain on confidence in the banking system that upcoming Basel 3.1 refinements are intended to address.

Supervision

One of the Bank of England's aims is to be at the forefront of identifying new and emerging risks in order to be prepared to supervise the financial system of the future — this is, of course, true of other globally focused regulators.

In light of recent events, banks will need to enhance their standards around how they manage and identify risks in order to achieve such goals.

Additionally, banks will need to apply a level of supervision and maintain financial stability, which will require supervision and cooperation at both a local and global level.

The Basel committee report highlights a number of important points to be examined further in order to achieve effective implementation of the international resolution framework. These include:

- 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; and
- Robust regulatory standards: Including those addressed to ensure robust corporate governance and internal risk management and controls. The need for tools that can drive real change and for concrete action is also stressed.

From the information gathered in the aftermath of the bank collapses earlier this year, it was clear that clients had been withdrawing their funds and assets for some time prior to the runs on the banks in question, suggesting that the risk indicators being used were no longer suitable to identify such a crisis of confidence in a timely manner.

Market signals as well as regulatory metrics should be used by banking supervisors and regulators in their evaluation of a bank's viability. Regulatory indicators alone do not provide a complete assessment of the levels of capital and liquidity available in banks.

Market Sentiment

Although recent episodes of banking system stress can be blamed on the culmination of risk build-ups over years, it is important to note that any institution engaged in liquidity and maturity transformation can be subject to a run.

Due to the unprecedented speed and scale of deposit runs, it is clear that market sentiment will need to be monitored more closely.

Capital and liquidity are clearly both fundamental to banks; however, the size and pace of outflows earlier this year would suggest they are not the only elements required for banks to survive, and that market sentiment plays a much more pivotal role that translates into hard numbers.

On the surface, each bank's offering is essentially the same as that of another, i.e. liquidity, safekeeping and low interest, which means that if a bank's soundness comes into question, most depositors will have little conceptual difficulty in changing to a bank they perceive as being more trustworthy.

Now more than ever, in a world of 24/7 mobile banking and social media, most customers can easily communicate with one another and what can start off as a hint of uncertainty can quickly lead to a rush of withdrawals, causing runs of extraordinary speed and widespread financial disruption.

There is a strong correlation between credibility and profitability for depositor and investor sentiment. Again, in light of recent events, the importance of nonfinancial regulation and supervision of issues that can affect credibility and profitability like risk culture and governance needs to be reasserted, and supervisors should be asking whether business models are viable and sustainable.

Summary

Following the collapse of three regional banks in the U.S. and the near collapse of a global systemically important bank in Europe, the economic turbulence unraveling across the globe was a startling display of the speed at which perceived weaknesses can be exposed in the current environment and highlighted issues around financial stability.
While it may not always be possible to control reactions to external factors, regulators and banks have learned that they need to make sure they have the adequate tools to respond appropriately.

Being able to adapt in a timely manner and ensure they can be resilient to the wide range of risks they could face at an operational level are essential to this.

While markets and their participants are clearly keen to move on from the banking failures of 2023, it is likely there will be a ripple effect from these events that will roll well beyond the new year.

However, there is room for optimism about developments in the form of agile, yet robust, risk frameworks created by regulators, which will have the ability to evolve in tandem with an ever-evolving global market.

Clearly, there exists an intention to prepare the global economy and banking sector to manage any future adverse events and protect it from another financial crisis.

[1] https://www.fdic.gov/news/speeches/2023/spapr1223.html.

[1] https://www.fsb.org/2023/10/2023-bank-failures-preliminary-lessons-learnt-for-resolution/.

[2] https://www.bankofengland.co.uk/speech/2023/october/sam-woods-speech-at-the-city-banquet-mansion-house.

ISDA Publishes Tokenized Collateral Model Provisions for ISDA 2016 Credit Support Annexes for Variation Margin

By **Michael Ena**
Counsel | Financial Services

By **Ivan Loncar**
Partner | Financial Services

On December 20, ISDA published the tokenized collateral model provisions for inclusion in ISDA 2016 Credit Support Annexes for Variation Margin (VM) (the "Model Provisions"). The Model Provisions comprise two sets of provisions, one for the English Law ISDA 2016 Credit Support Annexes for Variation Margin (VM) (the "English Law VM CSA") and the other for the New York Law ISDA 2016 Credit Support Annexes for Variation Margin (VM) (the "New York Law VM CSA").

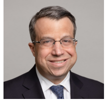
The intended scope of use of the Model Provisions is limited to the situations where the parties to an English Law VM CSA or a New York Law VM CSA (each, a "VM CSA") wish to use tokenized securities or stablecoins transferrable using the distributed ledger technology as collateral under their VM CSA. The Model Provisions allow the parties to a VM CSA to designate certain tokenized digital assets as "DLT Cash" or "DLT Securities" and amend the transfer provisions and the definition of "Local Business Day" in their VM CSA to cover transfers of DLT Cash and DLT Securities, taking into account that blockchain networks used to effect those transfers typically operate on a 24/7 basis. In addition, the Model Provisions include amendments to the definitions of "Distributions" in the VM CSAs to cover issuer airdrops relating to DLT Securities.

The use of the Model Provisions with other ISDA credit support documents would require certain revisions, while their use for other types of digital assets based on the distributed ledger technology would also require analysis of the relevant legal issues specific to those types of digital assets.

See the recent Client & Friends Memo here authored by Michael Ena and Ivan Loncar.

CFTCs Increased Reach Over Environmental Commodities

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



By **Jason M. Halper**
Partner | Global Litigation

By **Jeffrey Nagle**
Partner | Corporate Finance

During 2023 the Commodity Futures Trading Commission (CFTC) engaged in several regulatory actions aimed at further clarifying its jurisdictional reach over environmental commodity markets generally and the voluntary carbon credit (VCC) markets in particular. First, on June 20, 2023, the CFTC issued an alert seeking whistleblower tips relating to carbon market misconduct. CFTC noted that many VCCs serve as the underlying commodity for futures contracts that are listed on CFTC designated contract markets (DCMs) over which the CFTC has full enforcement authority as well as the regulatory oversight. Importantly, the CFTC also noted that it has anti-fraud and anti-manipulation enforcement authority over the related spot markets for VCCs as well as carbon allowances and other environmental commodities products that are linked to futures contracts.

Second, on July 19, 2023 the CFTC held its second convening where several market participants expressed the view that reliability, integrity and resilience of VCCs will be significantly improved with greater regulatory involvement.

Third, in response to a growing demand to become more actively involved in environmental commodity markets on December 4, 2023, the CFTC issued proposed Guidance Regarding the Listing of Voluntary Carbon Credits Derivatives and Request for Comment (VCC Guidance). The VCC Guidance "outlines factors for a DCM to consider in connection with product design and listing [of futures contracts on VCCs] to advance the standardization of such products in a manner that promotes transparency and liquidity.

Further details are discussed in our recent Client & Friends Memo here authored by Peter Malyshev, Jason Halper and Jeffrey Nagle.