

## Cabinet News and Views

Informed analysis for the financial services industry



## More of the Same

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## In This Issue ...

While March Madness, in the form of the NCAA men's and women's basketball tournaments, and the Academy Awards left us with the week's "did you see that?" moments, the SEC's proposed climate-related rule remained a top-of-mind topic in the financial services industry. Add to that an important new pronouncement from the FDIC, covered in this week's issue as a "Take Five" commentary item by our Global Litigation colleagues Jason Halper, Sara Bussiere and Timbre Shriver, and you can see why we think there will be continued focus and debate on climate in the weeks and months to come.

Unfortunately, the situation in Ukraine remains dire, and so we are revisiting sanctions and other related developments this week. In addition, lost in the news shuffle a bit was important FDIC guidance on bank mergers. That's certainly worth a read as well.

As always, we welcome your comments and questions. Just write to us [here](#).

**Daniel Meade & Michael Sholem**

Co-Editors, *Cabinet News and Views*

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## FDIC Requests Comment on Proposed Framework for Managing Climate-Related Risk



By **Jason M. Halper**  
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By **Timbre Shriver**  
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On March 30, 2022, the Federal Deposit Insurance Corporation (“FDIC”) requested comment on [draft principles](#) “that would provide a high-level framework for the safe and sound management of exposures to climate-related financial risks.” These draft principles, which are “targeted at the largest financial institutions” (*i.e.*, over \$100 billion in total consolidated assets), “are intended to support efforts by financial institutions to focus on the key aspects of climate risk management.” The principles reflect the FDIC’s view that the “effects of climate change and the transition to a low carbon economy present emerging economic and financial risks that threaten the safety and soundness of financial institutions and the stability of the financial system.”

In order to address these risks, which the FDIC recognizes comprise both physical risk (*i.e.*, harm to people and property from acute climate events or chronic climate changes) and transition risk (*i.e.*, challenges or opportunities associated with the transition to a low carbon economy), the FDIC seeks comment on principles (certain of which are set forth below) in the following broad areas:

- **Governance:** “A financial institution’s board and management should demonstrate an appropriate understanding of climate-related financial risk exposures and their impact on risk appetite to facilitate oversight.” The release emphasizes the board’s need to have adequate understanding and knowledge to assess and address the potential impact of climate-related risks.
- **Policies, Procedures and Limits:** “Management should incorporate climate-related risks into policies, procedures and limits to provide detailed guidance on the institution’s approach to these risks, in line with the strategy and risk appetite set by the board.”
- **Strategic Planning:** “The board and management should consider material climate-related financial risk exposures when setting the institution’s overall strategy, risk appetite and financial, capital and operational plans.” Among others, the board and management should consider potential climate-related impacts on low to moderate income and other disadvantaged households and communities, stakeholders’ expectations, and the institution’s reputation.
- **Risk Management:** “Management should oversee the development and implementation of processes to identify, measure, monitor and control climate-related financial risk exposures.” These could include heat maps, climate risk dashboards and scenario analysis.

- **Data, Risk Measurement and Reporting:** The release observes that “effective risk data aggregation and reporting capabilities” are important in order for boards and management to assess and address climate-related risk, and that this area “continue[s] to evolve at a rapid pace.”
- **Scenario Analysis:** The release recognizes the importance of scenario analysis (*i.e.*, forward-looking assessments of the potential impacts of climate-related risks under various sets of assumptions and time horizons) for “identifying, measuring and managing climate-related risks.” The release cautions that climate-related scenario analysis “should be subject to oversight, validation, and quality control standards that would be commensurate to their risk.”

The FDIC stated that it “plans to elaborate” on these principles in subsequent guidance that “would distinguish roles and responsibilities of boards of directors (boards) and management” and incorporate “feedback received on the draft principles.”

The FDIC is just the latest financial regulator to weigh in on the obligations of regulated entities in terms of addressing climate change. Other significant statements include the Securities and Exchange Commission’s [Proposed Rules to Enhance and Standardize Climate-Related Disclosures for Investors](#); the Financial Stability Oversight Council’s [Report and Recommendations on Climate-Related Financial Risk](#); the Commodity Futures Trading Commission’s [Managing Climate Risk in the U.S. Financial System](#); and the Office of the Comptroller of the Currency’s [Principles for Climate-Related Financial Risk Management for Large Banks](#).

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## The Biden Budget: Funding Sanctions and AML Initiatives



By **James A. Treanor**

Special Counsel | White Collar Defense and Investigations

Increased defense spending and assistance to the Ukrainian government in Kyiv grabbed many of the headlines regarding President Biden's fiscal year 2023 budget. However, **funding** requests for key functions within the Department of the Treasury highlight the critical role of economic sanctions and anti-money laundering tools for responding to the crisis in Ukraine.

First, the budget reflects a nearly 20% increase for three main components of Treasury's Office of Terrorism and Financial Intelligence ("TFI"). These components – among them the Office of Foreign Assets Control ("OFAC"), which has primary responsibility for administering and enforcing economic sanctions – would see their total budget increase from an estimated \$186 million in 2022 to \$223 million in 2023. Headcount for these components also would expand significantly under the new budget, from an estimated 561 full-time equivalents in 2022 to 624 in 2023.

This budget increase follows the release last year of Treasury's **Sanctions Review**, which called for investments in technology, workforce, and infrastructure to ensure that sanctions remain an effective policy tool. In particular, the Sanctions Review called attention to the increased use of digital currencies – and the potential of such technologies to erode the efficacy of U.S. sanctions. Accordingly, Treasury can be expected to direct significant new funding towards building the right teams, systems, and processes within OFAC and other offices, in order to more effectively identify and address digital currency-related threats. Such efforts directly align with the Biden administration's focus on stamping out the use of digital currencies as a means for sanctioned Russian companies and oligarchs to evade recent sanctions (see our coverage [here](#)).

The Financial Crimes Enforcement Network ("FinCEN") – Treasury's money laundering regulator – is another important component of TFI, and under the 2023 budget its resources would expand even more significantly than TFI as a whole. In particular, the Biden administration has requested \$220 million for FinCEN in fiscal year 2023, up from an estimated \$171 million in 2022 – an increase of \$49 million, or nearly 30%. Meanwhile, FinCEN's workforce could grow by nearly 50%, up to a total of 420 full-time equivalents.

Certainly, a surge in resources for FinCEN was planned long before Russia's invasion of Ukraine – among other things, the agency is responsible for adopting and implementing significant new beneficial ownership regulations under the Corporate Transparency Act. Nonetheless, the White House has **identified** FinCEN's portfolio as "critical to the development, implementation, and enforcement of targeted financial measures in response to Russia's aggression against Ukraine," and the increased funding will support the agency's anti-money laundering mission vis-à-vis Russia and related actors.

A centerpiece of the Biden administration's response to the crisis in Ukraine has been its emphasis on implementing and enforcing tough economic sanctions, and also prohibiting sanctioned Russian individuals and companies from surreptitiously moving assets through the U.S. financial system. It should come as no surprise, then, that the resources required to implement these measures are reflected in the 2023 budget for key offices at Treasury. What remains to be seen is whether, and to what extent, Congress will fund them.

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## Meeting of Congressional Aides Signals Interest in Comprehensive Federal Privacy Legislation



By **Howard Wizenfeld**  
Special Counsel | Intellectual Property

Recently, the offices of various Members of Congress announced that their Members would be meeting to discuss comprehensive federal privacy legislation. [1] This meeting among the aides could represent a sign of growing recognition that an absence of uniform, national privacy protection poses a vacuum with respect to federal regulation directed to personal data.

In contrast to the United States, the European Union and China have passed comprehensive privacy legislation, leading proponents of uniform federal legislation to argue that the United States is falling behind. In the absence of any comprehensive nationwide privacy legislation, it has been left to the states to pass their own state-wide privacy legislation. This risks allowing individual states with the strictest privacy laws to become the standard-bearer for the rest of the country because national companies must typically comply, at the very least, with the privacy requirements of the strictest state. Indeed, many companies have already begun allocating significant resources towards compliance with California's privacy law. Federal legislation could ameliorate this problem by setting a single standard that many states would likely adopt, and which, in any event, could pre-empt state law. And a federal law could help slow, or stop, big technology companies from ingesting large amounts of personal data without restriction. As Rep. Jan Schakowsky (D-IL) noted just this week, "We have to protect the privacy of consumer data which feeds into AI algorithms." [2]

[1] John D. McKinnon, *The Wall Street Journal*, "[Congress to Take Another Swing at Privacy Legislation](#)," Mar. 25, 2022.

[2] POLITICO, "[Could Congress Fix AI Bias with Privacy Rules?](#)" Mar. 29, 2022.

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## FDIC Issues Request for Information and Comment on Bank Mergers



By **Daniel Meade**  
Partner | Financial Regulation

Last week the FDIC [announced](#) it will publish in the *Federal Register* a Request for Information and Comment (“RFI”) on the regulatory framework regarding mergers involving one or more insured depository institutions (*i.e.*, bank mergers). This is the RFI that resulted in [competing statements](#) from the FDIC and CFPB in December and appeared to prompt the [resignation](#) of the then-Chair of the FDIC.

The preamble to the RFI notes four reasons for the request for information: (1) several decades of changes to the banking industry since the last major review; (2) the FDIC’s responsibilities to review bank mergers and resolve failing depository institutions; (3) Section 604 of the Dodd-Frank Act’s amendment to the Bank Merger Act that added a financial stability factor; and (4) the recent [Executive Order](#) to federal agencies on competition.

The RFI asks 10 questions in order to assist the FDIC on whether the existing framework is effective or whether it should make any changes to its regulatory framework related to bank mergers.

The RFI is likely to elicit comments from the industry and community advocates. Most interested parties will likely be in agreement that the bank merger regulatory framework is ripe for updating. That is likely where the agreement will end. Community advocates will likely echo calls like those made by some [Congressional Democrats](#) to impose increased scrutiny on mergers where the resulting institution would have more than \$100 billion in assets. The industry is likely to raise issues with whether the use of local markets is still the right measure in light of technological advances, and point out the multiple non-bank competitors and fintechs that compete with banks but are not included in the competitive analysis conducted by the banking agencies or the Department of Justice.

Comments on the proposal are due 60 days after publication in the *Federal Register*.

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# Supervisory Statement on the Application of the EU Sustainable Finance Disclosure Regulation and the EU Taxonomy Regulation



By **Michael Sholem**  
Partner | Financial Services

On March 25, 2022, the three European supervisory authorities – the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority (collectively the “ESAs”) – published an [updated joint statement](#) on the application of [Regulation \(EU\) 2019/2088](#) on sustainability-related disclosures in the financial services sector (“SFDR”). This updated statement replaces the prior joint statement released in February 2021 in relation to the SFDR, and provides new guidance on the application of [Regulation \(EU\) 2020/852](#) on the establishment of a framework to facilitate sustainable investment (the “Taxonomy Regulation”).

This statement provides further guidance to firms on SFDR compliance in the absence of finalised detailed disclosure requirements under EU secondary legislation (known as Regulatory Technical Standards, or “RTS”). Although the entity and product disclosure level requirements in SFDR have been applicable since March 10, 2021, the RTS have been repeatedly delayed, and the date set for their entry into force is now January 1, 2023. Similarly, the sustainability disclosures required under the Taxonomy Regulation will apply from January 1, 2022 for climate change objectives, but the RTS under the Taxonomy Regulation will not apply until January 1, 2023, in tandem with the RTS under the SFDR.

The Statement is intended to alleviate the risk of inconsistent application and national supervision of the SFDR and the Taxonomy Regulation disclosures during this interim period until 2023. The key guidance in the statement includes:

- a timeline setting out the application dates and summary guidance for each element of the SFDR and Taxonomy Regulation regime;
- draft versions of the RTS to be used as a reference for applying the disclosure obligations set in SFDR and the Taxonomy Regulation. It is important to note, however, that these measures may be subject to further change. The ESAs recommend that national authorities should encourage market participants to “use the interim period until 1 January 2023 to prepare for the application of the RTS”;
- clarification that any financial product that falls within the detailed disclosure obligations in the Taxonomy Regulation should include an “explicit quantification” of the extent to which the product can be considered taxonomy-aligned by using a “numeric disclosure as a percentage of the extent to which investments underlying the financial product are taxonomy-aligned”; and
- estimates should not be used when calculating taxonomy-alignment of in-scope financial products under the Taxonomy Regulation. However, the ESAs suggest that “where information [on sustainability] is not readily available

from public disclosures by investee companies, financial market participants may rely on equivalent information on taxonomy alignment obtained directly from the investee companies or from third party providers.”

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## In Depth: The Rise and Rise of Public Pensions in Private Equity



By **Christopher Montgomery**  
Special Counsel | Fund Finance

Two recent news items got me thinking about public pensions, their continued rise in private equity and their sovereign status. The first news item, already widely covered in the media, is the announcement by the Securities and Exchange Commission (“SEC”) of new rules requiring (among other things) enhanced periodic disclosure for fees, expenses and performance (including, possibly, reporting performance with and without the use of fund financing) (see, e.g., “[The SEC’s Private Market Takeover](#)” in *The Wall Street Journal*). *The Wall Street Journal*, in its unfavorable write-up, described the SEC as dancing “to the public pension tune,” and *The Washington Post*, taking a more favorable view, noted that part of the motivation for the SEC is that “many retirees depend on the pensions that are invested in” private markets. (For *The Washington Post*’s write-up, see “[SEC proposes basic rules for private equity, hedge funds](#).”) What’s notable is that both the media supporters and the media detractors have focused on public pensions. The media coverage therefore seems to imply that public pensions are partly driving this regulatory change.

I am not so sure, since that would be in conflict with the second news item, which is the increasing deployment of public pension money in private equity as a long-term secular trend. According to Prequin, the average public pension allocation has increased from just above 6% in 2010 to close to 9% in 2021. In percentage terms, that’s a huge increase and a vote of confidence in private markets.

(See “[Retirement Funds Bet Bigger on Private Equity](#)” in *The Wall Street Journal*.)

It’s also worth remembering that these percentages are of massive holdings. Some of the biggest players have allocated an even larger exposure: the California Public Employees’ Retirement System voted to increase its private equity allocation to 13% over the next four years, which equals roughly \$25 billion dollars of additional demand from a single investor. With the increased demand from public pensions for private equity products, we have seen a greater internal focus on questions of sovereign immunity and its associated waivers at banks and sponsors. (I would also forecast an ever-increasing number of SMA facilities with public pensions, especially in the latter half of this year.)

What we can say for certain is that public pension money has confidence in private equity returns (now more than ever), but at least some voices in the media think that the current push for greater regulation and disclosure comes from those same investors. It’s possible that both of these statements are true, but it seems more likely that we need to be skeptical of the claim that public pensions are the source of the SEC’s recently proposed rules. It is just as probable that the SEC was going to focus on private markets anyway, regardless of the actions or concerns of public pensions. Nonetheless, the greater exposure to sovereign-status public pensions and the greater focus on private market regulation are at least correlated. Both of these trends have been major stories of the past year, and each trend features sovereign-status public pensions as key actors.

In any case, there is some concern that increased public pension money may expose sponsors and funds to greater sovereign immunity risk and also that increased public pension participation in these markets may lead to greater regulation. The first concern, sovereign immunity, can be addressed succinctly: the exceptions and waivers to sovereign immunity that we see from many states and their agencies (*i.e.*, their public pensions) remain robust. The second concern, which is that the increased participation of public pensions in private equity is causing greater regulation, is likely unfounded based on the facts we can observe.

### **Two Sides of the Sovereign Coin**

The current British sovereign gold coin features the face of Elizabeth II on the obverse (front) and St. George slaying his dragon on the reverse. It's the perfect embodiment of these two ideas: Elizabeth as sovereign looks serenely into the distance, but there is also the myth on the back: real or imagined dragons need slaying. (Certainly the proposed SEC rules are the sword, but I will let the reader decide who is St. George and who is the dragon.)

#### ***Side One: The Queen Can Do No Wrong***

Cadwalader's *Fund Finance Friday* newsletter has covered sovereign immunity before in detail. (See "[Immunity Unlikely](#)" by Wes Misson, which offers an excellent overview of the issue and the sponsor/lender protections available via various waivers.) The short version is that public pensions enjoy sovereign status under the Eleventh Amendment of the United States Constitution (though they are only one category of investors that may enjoy sovereign status, as foreign governments (or their agencies), supra-national organizations and Native American tribes may have sovereign rights in federal or state courts as well). However, the sovereign immunity of state public pensions is often waived when the state agency is entering into a commercial contract. This waiver may take the form of statutory or constitutional waivers (37 such states as of 2021) or common law waivers (12 such states as of 2021). In addition, we often see a public pension investor reserve its Eleventh Amendment status in a side letter, but will also have what lawyers call "mitigating language," which essentially states that the reservation of sovereign immunity does not in any way limit the investor's obligations to fund capital calls. Sovereign immunity is therefore often mitigated, and counsel perform careful due diligence to identify the risk and assess the mitigations available given the jurisdiction in question and the language in the side letter and limited partnership agreement. When such mitigants exist, the sovereign has a serene gaze indeed.

#### ***Side Two: St. George vs. the Dragon***

Then there's the dragon, real or imagined. This is the media narrative that increased regulation of private markets is coming and that it's in part driven by public pension investors. It's easy for some in the media to make that connection – according to *The Wall Street Journal* article, public pensions account for 35% of all private equity capital, so it is tempting to connect the correlation of increased public pension money with increased regulation and to infer a causation. I would be skeptical of that claim. Pension funds have been and continue to be extraordinary partners with their private equity sponsors. The largest pension funds are not just investors, but co-investors or joint-venturers, and some are even exploring the option of becoming liquidity providers to select sponsors.

## Conclusion

We have often heard or read that “private markets are the new public markets.” A cynic could now say “private regulations are the new public regulations.” While the current composition of the SEC certainly suggests a greater role for regulation in private markets, it is not at all clear that these actions are a result of greater public pension participation. We should not blame public pensions for the political decisions of a select few in Washington. In fact, the increased allocations toward private equity suggest that the partnership between public pension investors and private equity sponsors is stronger than ever (for my part, my father’s public pension is tied up in many of the deals I work on, even though I typically represent the lenders). In addition, while many bankers/sponsors may receive increased internal scrutiny on sovereign immunity exposure to such investors, reputational risk and legal waivers mitigate this exposure into a manageable commercial risk (with some exceptions for certain problematic jurisdictions). Despite the proposed regulations, it’s not an exaggeration to say that the relationship between public money and private equity is now a cornerstone of the American economy. It’s a bit like a certain motto written on another English coin: *honi soit qui mal y pense*, or “shamed be whoever thinks ill of it.”

(This article was originally published in Cadwalader's [Fund Finance Friday](#).)

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