CADWALADER

Cabinet News and Views

Informed analysis for the financial services industry

Tis the Season

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In This Issue ...

Welcome to this week's edition of *Cabinet News and Views*, which we're publishing in the wake of a flurry of U.S. agency rule proposals and final updates this month (notwithstanding the three week standstill in Congress), as well as key insights surfacing from climate transition reports across the Atlantic.

My colleagues, Peter Malyshev, Nikita Cotton and Hayden Stark, explore the CFTC's recent proposed amendments to its Regulation 4.7, which provides exemptions to registered commodity pool operators and commodity trading advisors. My colleague, Mercedes Kelly Tunstall, and I report on Tuesday's news of the final rule to amend and update the rules implementing the Community Reinvestment Act. Mercedes also shares her insights into two big announcements over the past week: the FRB's proposed changes to Dodd-Frank's Durbin Amendment, and the CFPB's proposal addressing "personal data financial rights." Rounding out our U.S. reporting, my colleagues, Stephen Fraidin, Richard Brand, Erica Hogan, Adam Tamzoke and Lauren Russo, weigh in on the SEC's adoption of final rules amending beneficial ownership reporting.

Even though it won't be Thanksgiving season here in the U.S. for another month, the federal banking agencies were so busy this week, that we will likely have leftovers that we will cover in next week's edition or other Cadwalader newsletters, such as the Fed's announced proposed changes to Regulation II (Debit Card Interchange Fees and Routing), which is the implementing regulation of the Durbin Amendment to the Dodd-Frank Act, and interagency principles for climate-related financial risk management for large financial institutions.

We also reprint a C&F memo from my colleagues issued earlier this week on the SEC's adoption of final rules to amend the beneficial ownership reporting rules that accelerate the filing deadlines for Schedules 13D and 13G, provide guidance on the formation of a "group" and provide guidance on the treatment of cash-settled derivatives.

In Europe, we have two interesting developments to share. First, my colleague, Duncan Grieve, provides a look into the European Central Bank's second economy-wide stress test and what it means for banks navigating the ongoing climate transition. On a related note, my colleagues, Simon Walsh and Sharon Takhar, summarize key findings from a joint study by the Transition Pathway Initiative and the Grantham Research Institute on Climate Change and the Environment assessing how banks are making progress in managing the same transition.

As always, we welcome your thoughts. Just drop me a note here.

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

CFTC Issues Proposed Rule to Modify Regulation 4.7 Exemptions

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

By **Nikita B. Cotton**
Associate | Financial Regulation

By **Hayden Stark**
Law Clerk

On October 2, 2023, the Commodity Futures Trading Commission (the "Commission" or "CFTC") published a notice of proposed rulemaking (the "Proposed Rule") to amend CFTC Regulation 4.7, which provides exemptions to registered commodity pool operators ("CPOs") and commodity trading advisors ("CTAs") that solely operate or advise (as applicable) private pools from compliance with certain requirements related to disclosure, reporting, and recordkeeping (the "4.7 Exemption"). Specifically, the 4.7 Exemption is available for CPOs and CTAs whose prospective and actual commodity pool participants and/or advisory services are restricted to qualified eligible persons ("QEPs"). The comment period on the Proposed Rule will remain open until December 11, 2023.

The significant features of the Proposed Rule are as follows:

- The Proposed Rule would raise the financial requirements for qualifying as a QEP by increasing the monetary thresholds for the "Portfolio Requirement" of the QEP definition in § 4.7(a)(1)(v) to account for 30 years of inflation. The proposal would double the securities portfolio test to $4,000,000 and the initial margin and premium test to $400,000 – figures which the Commission consulted the CPI index to come up with and is seeking comment as to whether the CPI index or an alternative would be the "most appropriate" measure to assess how to modify the thresholds to account for inflationary effects.

- The Proposed Rule would establish new minimum disclosure requirements, including descriptions of a pool's principal risk factors, investment program, use of proceeds, custodians, fees and expenses, conflicts of interest, and performance.

- The Proposed Rule would codify exemptive relief that has historically been granted to allow CPOs of funds of funds to elect monthly rather than quarterly reporting schedules.

CFTC Commissioner Kristin N. Johnson stated that the amendments in the Proposed Rule are necessary to "address[] regulatory gaps that have arisen due to . . . changing dynamics in the derivatives markets" and to provide "robust customer protections" with respect to the determination of QEPs. Commissioner Summer K. Mersinger, in her dissent, expressed that the Commission has not adequately evaluated whether the Proposed Rule's elimination of certain disclosure exemptions would address the Commission's stated concerns.

Federal Banking Agencies Finalize Community Reinvestment Act Rules

By **Daniel Meade**
Partner | Financial Regulation

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

On Tuesday, the Federal Deposit Insurance Corporation ("FDIC"), the Federal Reserve Board ("FRB") and the Office of the Comptroller of the Currency ("OCC") (together, the "Agencies") issued a final rule to amend and update the rules implementing the Community Reinvestment Act ("CRA"). The proposal was issued in May 2022 and the Agencies reported receiving approximately 1,000 unique comments on the proposal. As we discussed in 2022, the OCC had previously gone its own way in a June 2020 rulemaking, rather than follow the tradition of issuing a joint rulemaking. In 2021, the OCC then rescinded that rule and reverted back to the 1995 interagency version of the rule. Tuesday's action by the Agencies is a culmination of the Agencies work to modernize the CRA on an interagency basis and to "maintain a unified approach."

Though all three Agencies took a unified approach across the Agencies, the view of the final rule was not unanimous across the Agencies. At the FDIC, the two Republican members of the Board of Directors, Vice Chair Travis Hill and Director Jonathan McKernan, voted against the final rule. At the FRB, Governor Michelle Bowman, also a Republican member, voted against the final rule. The three dissenters cited similar concerns regarding the rule's length and complexity, the possible arbitrariness of the retail lending test given its grading on a curve, and other possible Administrative Procedures Act infirmities.

As pointed out in the FRB's press release summarizing the final rule, "it updates the CRA regulations to achieve the following key goals:

- **Encourage banks to expand access to credit, investment, and banking services in LMI communities.** Under the final rule, the agencies will evaluate bank performance across the varied activities they conduct and communities in which they operate so that the CRA continues to be a strong and effective tool to address inequities in access to credit and financial services. It promotes financial inclusion by supporting bank activities with Minority Depository Institutions and Community Development Financial Institutions and in Native Land Areas, rural areas, persistent poverty areas, and other high-need areas.

- **Adapt to changes in the banking industry, including internet and mobile banking**. The final rule will modernize the CRA regulations to evaluate lending outside traditional assessment areas generated by the growth of non-branch delivery systems, such as online and mobile banking, branchless banking, and hybrid models. The revised regulations have been calibrated to recognize the continued importance of bank branches, while establishing a

much-needed framework to evaluate the digital delivery of banking products and services.

- **Provide greater clarity and consistency in the application of the CRA regulations.** The final rule adopts a new metrics-based approach to evaluating bank retail lending and community development financing, using benchmarks based on peer and demographic data. The agencies will develop data tools using reported loan data that give banks and the public additional insight into performance standards. The final rule also clarifies eligible CRA activities, such as affordable housing, that are focused on LMI, underserved, native, and rural communities.

- **Tailor CRA evaluations and data collection to bank size and type**. The final rule recognizes differences in bank size and business models. For example, small banks will continue to be evaluated under the existing framework with the option to be evaluated under the new framework. The rule also exempts small and intermediate banks from new data requirements that apply to banks with assets of at least $2 billion and limits certain new data requirements to large banks with assets greater than $10 billion."

The bulk of the rule's requirements will be applicable on January 1, 2026, but some data reporting requirements will be applicable on January 1, 2027.

The final rule conceptually followed much of what the Agencies proposed in 2022, but the Agencies did note the following eight changes made in the final rule from the proposal:

Key Changes in Final Rule

Based on an analysis of comment letters and further agency review, the final rule includes the following key changes from the proposed rule as stated in the Interagency fact sheet:

1. Reduces complexity and data requirements while providing a consistent and comprehensive approach to evaluating banks under the Retail Lending Test by such changes as reducing the number of major product lines potentially evaluated under the new Retail Lending Test from six to three: (1) closed-end home mortgage loans; (2) small business loans; and (3) small farm loans.
2. Adjusts retail lending performance ranges while maintaining high standards; also increases weighting of Community Development ("CD") financing activities by adjusting the standards to make "Low Satisfactory", "High Satisfactory", and "Outstanding" conclusions under the Retail Lending Test more achievable and gives equal weight to retail activities and CD activities (compared to a proposed 60 percent retail/40 percent CD split).
3. Retains evaluation of banks with significant retail lending outside of branches while increasing tailoring of the retail lending assessment area approach with more tailoring between small, intermediary and large banks, but the approach would still evaluate banks with significant concentrations of retail loans outside facility-based (*e.g.*, branches) assessment areas.
4. Adds metric and impact factor to evaluate bank CD investments under the CD Financing Test by such things as adding and impact factor for Low-Income Housing Tax Credit and New Markets Tax Credit investments.

5. Provides additional flexibility under the strategic plan option while continuing to meet the credit needs of communities for banks with nontraditional business models.
6. Addresses feedback on the need to have additional time for banks to implement the new rule by increasing compliance period.
7. Retains and clarifies the provision on CRA ratings downgrades by maintaining the current standard for "discriminatory or other illegal credit practices" rather than both credit and non-credit practices as proposed.
8. Ensures consideration of certain small business loans under the economic development category of community development in addition to evaluation as a retail loan.

The approximately 1,500-page preamble and rule leaves a great deal of details that we and the banking industry continue to review. As that review continues, stakeholders of all types will likely see that they may have gotten some, but certainly not all, of what that they asked for during the comment period.

Federal Reserve Board Proposes Adjusting Debit Interchange Caps in Accordance with the Durbin Amendment

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

Yesterday, the Federal Reserve Board announced proposed changes to Regulation II (Debit Card Interchange Fees and Routing), which is the implementing regulation of the Durbin Amendment to the Dodd-Frank Act.

The Federal Reserve last touched on Regulation II in 2012, basing the calculation of the interchange fee caps upon numbers from 2009 and 2010, and, in the memo accompanying the proposed rule, the Board observed that the "data show that the costs incurred by covered issuers in connection with debit card transactions have changed significantly over time", with "transaction-processing costs on which the Board based the base component [having] nearly halved, the issuer fraud losses on which the Board based the ad valorem component [having] fallen, and the fraud-prevention costs on which the Board based the fraud prevention adjustment [having] risen." The Federal Register notice that contains the proposed rule and further explains the Board's approach to updating Regulation II is available here. The Cabinet will discuss this proposed rule in more depth in next week's issue.

Comments are due to the Board 90 days following the official publication of the Federal Register notice, which should mean late January or early February 2024.

The CFPB's Personal Data Financial Rights Proposed Rule, Part 1

By Mercedes Kelley Tunstall
Partner | Financial Regulation

On Thursday, October 19, 2023, the Consumer Financial Protection Bureau ("CFPB") released a proposed rule addressing "personal data financial rights", as we reported last week that they would be doing later in October. The proposed rule (comments due December 29, 2023) provides a comprehensive, but newfangled, approach to regulating the collection, use, sharing and maintenance of financial data by a wide variety of participants.

The full text of the Federal Register notice containing the proposed rule is 299 pages and includes a variety of new concepts. Therefore, the Cabinet will provide installments over the next three weeks looking at the different sections of the proposed rule. This week's installment will discuss what the CFPB says about why it is proposing this rule and will give a high-level overview. Next week, we will have two installments, one which will focus on the scope of the rule, in terms of entities that would need to comply with the rule as proposed, as well as the scope of financial data that will be impacted. The other installment that will be published next week will get into the obligations that would be imposed upon the entities and examine some of the technology concepts. And the final week, we will examine how the proposed rule works (or may not work) vis-à-vis existing laws and some of the finer points and concepts.

The CFPB released the proposed rule in conjunction with a press release titled "CFPB Proposes Rule to Jumpstart Competition and Accelerate Shift to Open Banking." Necessarily, it is important to understand what the CFPB means when it refers to "open banking." A footnote explains that, for purposes of the proposed rule, the CFPB "generally uses the term 'open banking' to refer to the network of entities sharing personal financial data with consumer authorization." That network of entities includes the financial institutions that issue payment devices, manage bank accounts and originate credit, but also extends to non-bank financial institutions and technology companies that provide products and services such as digital wallets and personal financial management services, as well as to payment networks and any party that "controls or possesses information concerning a covered financial product or service" offered by that party.

Why does the CFPB care about whether the industry shifts to open banking? As explained in prepared remarks accompanying the proposed rule by CFPB Director Rohit Chopra, the end goal of "open banking" would be to create a "more decentralized market structure [that] will give consumers more control and minimize the ability for companies to take customers for granted" by giving consumers more control over their personal financial data, which in turn will make it easier for them to switch financial service providers. Chopra remarks that because consumers would be empowered to carry their entire personal financial data history with them, should they choose to switch providers, "You won't lose your transaction history, which effectively serves as a life ledger. You won't have to

start over with a new firm that has less history with you and that is less likely to offer you better deals."

Turning back to the text of the proposed rule, however, we can glean additional motives underlying these public relations talking points. Specifically, the CFPB focuses upon new players in the financial markets that are not regulated as financial institutions, but who interact with consumer financial data through authorizations and technologies such as screen-scraping and APIs. The CFPB designates these new, non-bank players as "data aggregators" and points out that these "aggregators currently function as connectors and, as a practical matter, standardize how many third parties receive data. As such, they accrue economic benefits from the system's inability to scale [to] open industry standards." The CFPB then goes on to explain that the dependency many financial institutions, as well as consumers, have developed upon the handful of data aggregators that have emerged allows these aggregators to stifle competition and self-deal. Accordingly, the CFPB envisions this proposed rule as being a crucial step to not only encourage open banking, but also to improve competition among all participants in the consumer payments system, preventing the "entrenching [of] the roles of data providers, intermediaries and third parties."

As mentioned, we will have additional installments looking more closely at various aspects of the proposed rule, but, in sum, the proposed rule seeks to oblige financial institutions and other covered entities to make personal financial data available to consumers such that they may obtain and transfer their entire transactional history, among other personal financial data, to third parties of their choosing. The covered entities would also be required to collect and maintain only that information about consumers that is necessary to carry out the transactions requested by them, and would prohibit the entities from using any information for targeted or behavioral advertising purposes. The proposed rule also seeks to establish a method that would ensure that the personal financial data would be provided in electronic formats that are standardized and that are accessible through an electronic "consumer interface" maintained by each covered entity.

Early industry reactions to the proposed rule have been cautiously supportive of the proposed rule, with the American Bankers Association remarking, "we firmly believe that other entities that are granted access to consumers' data must be held not only to the same high standards but also to the same level of supervision related to data security, privacy, and consumer protection that banks must meet every day," while also pointing out the costs and difficulties in implementing some of the provisions.

SEC Adopts Final Rules to Amend Beneficial Ownership Reporting Rules

On October 10, 2023, the SEC adopted rule amendments related to Section 13 beneficial ownership reporting rules. In brief, the Final Rules accelerate the filing deadlines for Schedules 13D and 13G, provide guidance on the formation of a "group" and provide guidance on the treatment of cash-settled derivatives. The Final Rules adopted by the SEC addressed the concerns raised in many of the comment letters. The final rulemaking is the culmination of a deliberative and thorough process undertaken by Chair Gensler, the other SEC Commissioners, and its staff members. We believe the end result is a final rule that balances the considerations of all market participants and achieves a principal purpose of the SEC, which is to maintain fair, orderly and efficient markets and facilitate capital formation.

Further details of the rule amendments are discussed in our recent Client and Friends Memo here authored by Stephen Fraidin, Richard Brand, Erica Hogan, Adam Tamzoke and Lauren Russo.

ECB Stress Test: Bank's Credit Risk Doubles by 2030 under Slower Climate Transition

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

In September 2023, the European Central Bank ("ECB") published its second economy-wide stress test, shedding light on the credit risks that European banks may face as a result of the ongoing climate transition. The test analyzed the resilience of banks, firms and households to three transition scenarios, which differ in terms of timing and ambition:

- an "accelerated transition," which frontloads green policies and investments, leading to a reduction in emissions while limiting global temperature increases to 1.5°C by 2030 in line with the goals of the Paris Agreement;
- a "late-push transition," which continues on the current path whilst the "real" transition begins around 2026 with a weaker economy but achieves emissions reductions similar to the accelerated scenario; and
- a "delayed transition," which is compatible with a temperature increase of around 2.5°C by the end of the century, but is not sufficiently ambitious to reach the Paris Agreement goals by 2030.

"The results show that – all other things being equal – the earlier the transition happens, the smaller the financial risk, and consequently the less policy support is required to mitigate the costs." The accelerated scenario assumes a significant increase in energy costs in the near term, rising to €2 trillion by 2025, however, the ECB found that the "accelerated" transition scenario resulted in the lowest long-term financial physical risk.

One of the key findings of the stress test indicates that banks' credit risk could increase by more than 100% by 2030 under the late-push scenario. Banks' loan portfolios could become more vulnerable and in response to the heightened credit risk, banks will likely need to reassess their lending practices, which may involve adopting more stringent criteria for evaluating potential borrowers, particularly those operating in high carbon-intensive sectors.

In addition to the difficulty in accessing financing for corporations that are slow to adopt sustainable practices, the stress test results further identified mining, manufacturing, and utility industries as amongst the most severely impacted industries regardless of the scenario given their reliance on brown energy sources. These sectors face higher energy expenses and require substantial investments in carbon mitigation and renewable energy. It was further reported that the reduction in the revenues of brown energy suppliers due to the transition would be substantially larger under the accelerated and late-push transition scenarios.

The ECB's findings underscore the growing calls for corporations to transition to greener business models. Companies are being urged to enhance their risk management and disclosure practices in the transition, while banks are

encouraged to embrace sustainable finance including offering green loans, investing in renewable energy projects, and actively supporting environmentally conscious businesses.

Final Thoughts

The ECB's climate stress test highlights that the choice of transition scenario, timing of the transition, and level of investment could significantly impact long-term economic and financial outcomes. The ECB's research also emphasizes the need for coordinated efforts to mitigate climate risks, support businesses and households during the transition, and ensure the resilience of the financial sector. As financial institutions plan this transition, they will also need to consider how to disclose their transition strategy. As we have previously covered, the ECB has provided guidance on such disclosures in its 2022 assessment of climate-related and environmental risk disclosures of EU-based banks, its joint statement on climate disclosure for structured finance products, and its own climate-related financial disclosures.

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

Assessment of Major Banks Shows Disclosure Gaps in Finance Directed Towards Climate Solutions

By **Simon Walsh**
Special Counsel | Global Litigation

By **Sharon Takhar**
Associate

The Transition Pathway Initiative ("TPI"), in partnership with the Grantham Research Institute on Climate Change and the Environment, conducted a study "[t]racking progress with the TPI Net Zero Banking Assessment Framework." As part of its assessment process, TPI used the Net Zero Baking Assessment Framework to evaluate banks' progress in managing the low-carbon transition and mitigating the impacts of climate change. The Net Zero Banking Assessment Framework comprises ten key areas: net-zero commitments; target analysis; emissions disclosure; emissions performance; decarbonization strategy (including financing conditions and capital allocation, and climate scenario analysis); climate solutions; climate policy engagement; climate governance; just transition; and financial statement disclosure.

Among the report's key findings are:

- "Banks are making progress towards incorporating climate change into their business strategies[;]"
- "[B]anks are not including all on- and off-balance sheet activities nor all high-emission sectors in their targets[,]" meaning that "banks could continue to finance high-emitting activities in the long term[;]"
- "Banks' disclosures remain partial and selective" in that they omit "key topics" like climate related risks; and
- "A lack of external standardi[z]ed methodologies and insufficient data from clients are hindering progress on banks' climate action."

More lenders are disclosing their net zero commitments (20 of the 26 banks assessed have disclosed a net zero commitment). However, of the 26 banks assessed, none disclosed the total share of finance directed towards climate change in the last year; six disclosed a commitment to immediately end all on- and off-balance sheet activities that finance new coal capacity; and three tied financing policies to sectoral targets.

TPI made several recommendations for the future, including: (i) striving to make progress on climate action despite the challenges related to lack of standardized methodologies; (ii) expanding target coverage to include all material financing activities; (iii) formulating comprehensive financing policies for high-emission sectors, covering all on- and off-balance sheet activities; (iv) including climate-related issues and risk analysis in annual reports and financial statements; and (v)

expanding disclosure and governance structure to ensure an in-depth approach to climate action.

Final Thoughts

As we have been reporting for the past few years, financial institutions continue to be viewed as key players in the effort to mitigate risks posed by climate change and transition to a net zero economy. While banks are increasingly incorporating climate change into their business strategies, as the TPI report makes clear, the devil is in the details, and banks are likely going to continue to be subject to scrutiny by prudential regulators, investors and climate-focused NGOs and pressure groups. For example, as we recently discussed, the Hong Kong Monetary Authority called on its banks to ramp up net zero transition planning, and in August, non-profit disclosure organization CDP concluded that financial institutions are not accounting for nature-related risks and opportunities in their financial decision making. The banks assessed in the TPI report include the world's largest banks with global operations and therefore, will likely continue to garner attention from regulators and the private sector for their climate-related strategies.

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