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

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FDIC Proposes Bank Merger Policy Revisions: Our Key Takeaways

By **Andrew Karp**
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On March 21, the Federal Deposit Insurance Corporation published for comment a proposal to revise its Statement of Policy on Bank Merger Transactions. In a recent Client & Friends Memo authored by Andrew Karp and Chris Van Heerden, we focus on how if adopted as proposed, the proposal would modify the Statement of Policy substantially, effectively creating an entirely new policy.

Read more here.

Third Circuit Decides Statutory Trusts Are Covered Persons: What This Means for the Securitization Market

On March 19, 2024, the Third Circuit handed down a decision that statutory trusts used to handle securitizations are considered “covered persons” for purposes of the Consumer Financial Protection Act, in the long-running case involving the Consumer Financial Protection Bureau and the National Collegiate Master Student Loan Trust.

In a recent Client & Friends Memo authored by Mercedes Tunstall, Mike Gambro, Stuart Goldstein, David Gingold, Sophie Cuthbertson, Andrew Karp and Cheryl Barnes we provide background on the underlying litigation, describes the court’s analysis and identifies possible next steps in the litigation. We also discuss the implications of this decision for the securitization industry and practical steps that participants should take under consideration.

Read more here.

Groundbreaking and Informative – CFTC's KuCoin Complaint


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On March 26, 2024, the U.S. Commodity Futures Trading Commission ("CFTC") filed a complaint (the "Complaint") in the U.S. District Court for the Southern District of New York ("SDNY") for injunctive and other relief against several non-U.S. entities (collectively, "KuCoin"). The Complaint is noteworthy for several reasons: first, the CFTC clarifies which "digital assets" would qualify as "commodities"; second, it succinctly summarizes the CFTC's jurisdictional reach in the U.S. and overseas; and third, it provides a comprehensive analysis of KuCoin's operations and contracts traded, while noting which activities the CFTC deems to be instances of specific violations of the Commodity Exchange Act of 1936 ("CEA") and the regulations promulgated by the CFTC thereunder (the "CFTC Regulations")—including the failure to have appropriate customer identification program policies in compliance with anti-money laundering laws, in violation of the CEA's provision that require FCMs to comply with the Bank Secrecy Act ("BSA"). The CFTC's requested relief in the case includes that KuCoin would be permanently banned from conducting any regulated business in the U.S., and pay restitution to consumers and investors as well as significant civil monetary penalties. Notably, on the same date, the Department of Justice (by way of the District Attorney's office of the SDNY) brought additional criminal claims against KuCoin regarding the BSA and for operating as an unlicensed money transmitter business.

Background:

a. Qualification as a "Commodity"

The CEA's definition of "commodity" found in CEA § 1a(9) as well as 17 C.F.R. § 1.3 of the CFTC regulations provides a list of specific assets (*e.g.*, wheat, cotton, rice, *etc.*) as well as a catch-all category for "all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in." However, neither the CEA nor the CFTC Regulations provide a workable definition or a process for determining whether something would qualify as a "commodity" outside of the delineated list, unless it is assumed that everything is a commodity with certain exceptions (the delineated exceptions being onions and motion picture box office receipts). Several courts have attempted to formulate a test analogous to the "Howey Test" for securities that could be used to determine whether something is a commodity, but no such test has gained prevalence to date. Due to the lack of standard protocol, the CFTC has historically simply made declarations that do not carry the weight of law (*e.g.*, in a Chairman's speech or a court filing), putting the market on notice that it considers a certain asset to be a “commodity.” This is exactly what the CFTC did in this case, stating in its Complaint that a “digital asset” is anything that: (i) can be stored, (ii) can be transmitted electronically, and (iii) has associated ownership or use rights; and then the CFTC went on to explain that “virtual currencies” qualify as “digital assets” because they (a) are digital representations of value, (b) function as mediums of exchange, (c) are used as units of account, and (d) are stores of value. Having found that Bitcoin ("BTC"), Ether ("ETH"), and Litecoin ("LTC") and stablecoin projects USD Coin ("USDC") and Tether ("USDT") are “digital assets” and “virtual currencies,” the CFTC states that these instruments are “commodities” traded in interstate commerce and that there are many contracts for future delivery (*i.e.*, futures contracts) on digital assets traded on commodity exchanges (*i.e.*, designated contract markets (“DCMs”)).

Admittedly, when it comes to digital assets and virtual currencies, the U.S. Securities and Exchange Commission (the “SEC”) has also been engaged for some time in “regulation by enforcement” and declared some to be “securities” as defined in U.S. securities laws. Whereas the SEC has undertaken “Howey Test” analyses with respect to individual digital assets in many of its complaints regarding violations of the securities laws, the CFTC has not generally opined specifically and comprehensively on which digital assets are commodities outside of a select few (including BTC, ETH, LTC and USDT), potentially because some digital assets are in the “grey area” between a security and a commodity. Rather, the CFTC has previously asserted that digital assets writ large are commodities, referencing CEA § 1a(9) and stating that “commodities, with limited exceptions, includes all manner of ‘other goods and articles . . . and all services, rights and interests . . . in which contracts for future delivery are presently or in the future dealt in’”, including “non- traditional goods and services”.

b. The CFTC's Jurisdictional Reach

The designation of most digital assets as “commodities” is very significant because it provides the CFTC with (1) non-exclusive enforcement jurisdiction (*i.e.*, authority to prosecute for fraud and manipulation involving any “commodity” traded in the interstate commerce under § 6(c)(1) of the CEA and § 180.1(a) of the CFTC

Regulations), and (2) exclusive regulatory jurisdiction (*i.e.*, the authority to regulate how, when, where and by whom any derivative contract on such “commodity” trades under § 2(a)(1)(A) of the CEA). The latter jurisdiction is exclusive, meaning that no other federal agency—including the SEC—can regulate commodity derivatives (such as futures, options or swaps). The CFTC’s clear assertion of its jurisdiction over specific “digital assets” is significant, as it challenges the SEC’s jurisdictional reach, especially when the SEC has designated most digital assets as “securities”. In a statement, Commissioner Pham challenged the jurisdiction of the CFTC over KuCoin’s proprietary leveraged tokens that allow users to mimic leveraged long positions in a number of virtual currencies, which she asserted could be distinguished as “an investment in a fund, which would typically be a security under the jurisdiction of the SEC.” CFTC Chairman Behnam also urged Congress to act to end the jurisdictional confusion in his recent testimony before the U.S. House Committee on Agriculture.

The Complaint:

a. KuCoin's Specific Violations

After establishing its jurisdiction over KuCoin in the Complaint, the CFTC analyzed the types of contracts KuCoin offered for trading and the manner they were traded in.

The CFTC explained that a "a fungible promise to buy or sell a particular commodity, like BTC, ETH, or LTC, at a fixed date in the future" is a commodity futures contract. All futures must trade on a registered DCM or, if these futures contracts are offered to a U.S. person electronically from overseas, a CFTC-registered foreign board of trade ("FBOT"). Because KuCoin offered trading in futures contracts to U.S. retail participants, KuCoin should therefore have been registered as a FBOT.

Next, the Complaint analyzed "perpetuals" on virtual currencies and concluded that these contracts qualified as "swaps" as defined under § 1a(47) of the CEA, and if offered for trading between multiple participants on a centralized platform, such platform must register as a swap execution facility ("SEF") or a DCM and must only offer these swaps to eligible contract participants ("ECPs"). Additionally, the CFTC explained that KuCoin's proprietary leveraged tokens are "leveraged, margined and financed retail commodity transactions" which must either be offered only to ECPs or executed on a regulated exchange pursuant to § 2(c)(2)(D) of the CEA. KuCoin was not registered in any of these categories.

The CFTC alleged that KuCoin also acted as counterparty to derivative contracts on these virtual currencies, solicited orders and accepted customer assets and margins in some transactions. These activities can only be carried out by registered futures commission merchants ("FCMs") that have implemented certain customer identification procedures (also known as "know -your -customer" or "KYC" procedures) in accordance with the BSA. As KuCoin did not effectively prevent U.S. customers from participating on its platform, was not registered as an FCM, and did not implement KYC procedures, the CFTC concluded that KuCoin was flagrantly disregarding regulatory requirements with respect to U.S. customers.

b. Requested Relief

The Complaint requests permanent injunction of and an effective ban on KuCoin's operations in the U.S. as well as a permanent ban on any future business in commodity transactions and from registering with the CFTC in any regulated category in the future.

The need for this level of sanctions to apply is disheartening because KuCoin could have taken several inexpensive actions to effectively comply with the CEA. First, there is already plenty of authority that some (if not all) digital assets and virtual currencies qualify as "commodities". Anyone familiar with the CFTC's enforcement program should have been able to immediately identify compliance gaps with the CEA. Second, the law is clear that FBOTs, SEFs, DCMs, and FCMs must be registered with the CFTC to offer trading to U.S. customers. The Complaint begs the question of whether if KuCoin had registered as a FBOT, most, if not all violations, could have been avoided. Given that KuCoin's trading volume was $3.6 trillion and daily trading volume was $23 billion, the cost of registration as a FBOT would have been insignificant, especially in light of them now facing a total trading ban and potentially criminal sanctions. Third, had KuCoin registered in an appropriate category, it would have been unnecessary to prevent U.S. participants from trading on an FBOT or a DCM, or even a SEF, if such participants qualified as ECPs. KuCoin would still have to implement the KYC program, but any U.S. participant would have been able to trade, as was also explained in the CFTC's complaint against Binance.

Even though application of the CEA and CFTC Regulations to digital assets is evolving, and the outer reaches of CFTC's jurisdiction are still being tested in courts (and sometimes challenged by the SEC), KuCoin was on notice and this CFTC Complaint was arguably preventable, and at a comparatively low cost to KuCoin.

CRD VI and Its Impact on Lending into Europe


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December 2023 saw the publication by the EU of the near-final version of its 'Banking Package' that makes significant changes to the Capital Requirements Directive known as 'CRD VI'. This article is going to focus on the CRD VI prohibition on the provision of cross-border 'core banking services' into the EU by non-EU institutions; currently, it is up to individual European member states to decide whether and how non-European institutions can provide services to their citizens, and that is going to change and national waivers currently in place will terminate. New and existing 'third country branches' ('TCBs') will be required to apply for (re)authorisation subject to new pan-EU rules including covering capital requirements, unless they operate under one of CRD VI's exemptions.

The core provision requiring the authorisation of TCBs is set out in CRD VI article 21c.

<u>Article 21c CRD VI: SCOPE</u>

<u>WHO</u>: Third-country institutions that carry out:

(a) any of the activities ***referred to in points 2 and 6 of*** Annex I to this Directive by an undertaking established in a third country ***that would qualify as a credit institution or that would fulfil the criteria laid down in points (i)*** through ***(iii) of*** Article 4(1), point (b), of Regulation (EU) **No** 575/2013, ***if it were established in the Union;***

Annex 1 point 2 is '*Lending including, inter alia: consumer credit, credit agreements relating to immovable property, factoring, with or without recourse, financing of commercial transactions (including forfeiting).*'

Annex 1 point 6 covers '*Guarantees and commitments*'

(b) ***the activity referred to in point 1 of Annex I to this Directive*** by an undertaking established in a third country – this is the activity of taking deposits

So, TCBs will be made up of:

1. non-EU banks (that would qualify as banks if they were established in the EU, i.e., entities that both take deposits and make loans);
2. non-EU investment firms that deal on their own account OR underwrite financial instruments AND that have (or belong to a group that has) assets over EUR 30bn or which carry out investment services in amounts over EUR

30bn; and
3. any other deposit takers.

WHAT?

TCBs are providers of 'Core banking services' including deposit-taking, guarantees and lending. While there is a degree of ambiguity around the breadth of the term 'lending', the general assumption is that as it stands, wholesale lending is captured by the prohibition (and in particular, as any one or more such services are covered, lending need not be accompanied by deposit-taking in the EU in order to be covered).

EXEMPTIONS

1. Reverse solicitation – while the CRD VI definition of this is somewhat more generous than the prevailing concept in that it extends the scope to further business that is adjacent to the original business, the definition still requires the approach to be at the European client's 'own exclusive initiative';
2. Interbank – inbound business with an EU-based bank is exempt;
3. Intragroup – inbound business with an EU-based entity in the same group (which could in principle be a non-bank, non-investment firm entity) is exempt;
4. Core banking services ancillary to core MiFID activities/services – these are also exempt, though the scope of the exemption remains unclear (although it seems to be directed at ancillary banking activities such as margin lending by securities dealers).

GRANDFATHERING

'Existing contracts' entered into six months or more before the end of a transitional relief period (Q3/4 2025) can continue without triggering the requirement to establish a branch. It remains unclear whether material amendments to contracts on foot would trigger the branch requirement.

Ambiguities

1. What is providing a service in a European country (there is currently no definition). EU member states have taken different approaches on what constitutes a regulated interaction in their jurisdiction, and local implementation of CRD VI could perpetuate these differences.
2. It remains unclear as to whether a non-EU bank acting for an EU client's non-EU business would be captured by the TCB requirement.
3. The scope of the exemption for services provided that are ancillary to core MiFID services (for example, related deposit-taking, credit/loans provisions) remains undefined.
4. Within 12 months from the date the directive enters into force, the European Banking Authority must review whether any financial sector entities in addition to credit institutions should be exempted from the requirement to establish a branch for the provision of banking services in accordance with 21c. Presumably, this has the potential to expand the universe of exemptions.

Solutions

1. Establish a branch – this is generally an unattractive option, as a branch would be required in each EU jurisdiction where regulated core banking services are provided (and would itself be subject to EU prudential supervision and capital requirements).
2. Establish a subsidiary – this allows cross-border passporting into other relevant EU territories and so would likely be preferable to a branch, but would, except as set out below, also be subject to EU prudential supervision and capital requirements.
3. Conduct European lending business in a non-bank group entity – thus avoiding the core prohibition on credit institutions providing these services and taking advantage of the intra-group exemption.
4. Rely on an exemption – as we have noted, reverse solicitation is generally considered unattractive, but if the business could be reshaped to be interbank or as ancillary to core MiFID services, then there is a clear pathway to exempt lending.

Loan Originating Funds, Liquidity and 'Shadow Banking'

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We spoke with *Law360* about the latest amendments to the Alternative Investment Fund Managers Directive (AIFMD 2.0). We take a look at loan-originating alternative investment funds against a backdrop of growing regulatory focus on shadow banking, liquidity and leverage.

Read more here.