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SPA Structured Products Association

2021 STRUCTURED PRODUCTS LEGAL, REGULATORY AND MARKET BRIEFING

SUPPLEMENTAL MATERIALS | MAY 13, 2021

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VOLUME 04, ISSUE 02 | March 29, 2021

REVERSE inquiries

Structured and market-linked product news for inquiring minds.

FDIC Proposes to Rescind 1996 Statement of Policy on the Use of Offering Circulars and Replace It with a New Rule of Narrower Scope

In This Issue

The disclosure requirements for offerings of securities by state non-member banks have long been governed by the Federal Deposit Insurance Corporation's ("FDIC") 1996 Statement of Policy on the Use of Offering Circulars in Connection with Public Distribution of Bank Securities (the "1996 Statement").[1] The 1996 Statement focuses on disclosure, requires that specific legends be included in offering circulars used by state non-member banks issuing securities and has no filing requirement. The 1996 Statement also refers to the disclosure requirements of the former Office of Thrift Supervision.

On January 19, 2021, the FDIC proposed, among other items, rescinding the 1996 Statement and replacing it with a new regulation to be codified in Subpart A of 12 C.F.R. Part 335, as "Securities of State Nonmember Banks and State Savings Associations" (the "Proposed Rule").[2] The Proposed Rule is limited in its scope, as opposed to the 1996 Statement, which applies to all state nonmember banks. Comments on the Proposed Rule must be submitted to the FDIC by April 5, 2021.

The Proposed Rule applies to offerings of bank securities in the following circumstances:

- FDIC-supervised institutions (*i.e.*, state nonmember banks and state savings associations) in organization;
- FDIC-supervised institutions subject to an enforcement order or capital restoration plan that intend to issue securities;
- FDIC-supervised institutions converting from a mutual to stock form of ownership; and
- Subsidiaries of state savings associations in any of the three situations above.[3]

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[1] 61 Fed. Reg. 46,807 (Sept. 5, 1996).

[2] FDIC FIL-6-2021 is available at: https://bit.ly/3cwA0c0. The Proposed Rule is available at: https://bit.ly/3sz7wUt. The Proposed Rule also would rescind the rules for securities offerings by state savings associations, which the FDIC inherited from the Office of Thrift Supervision in 2011.

[3] See Proposed Rule at 335.1(b). The offers and sales of the securities of state savings associations in connection with a mutual-to-stock conversion also are subject to the rules set forth by the Office of the Comptroller of the Currency at 12 C.F.R. pt. 192.

Unlike under the 1996 Statement, an insured state nonmember bank issuing debt securities outside of the first three bullet points above would not be subject to the Proposed Rule. However, the Proposed Rule is instructive as to the type of disclosure to include in an offering circular for an offering of bank securities by a state nonmember bank, and the FDIC indicates that in its experience, many state nonmember banks comply with federal securities offering rules even if they are not legally required to do so.

State nonmember banks and state savings associations subject to the Proposed Rule would be required to file a registration statement, including a prospectus, with the appropriate regional FDIC office, notwithstanding the availability of the exemption from the registration requirements of Section 5 of the Securities Act of 1933 ("Securities Act") provided by Section 3(a)(2) thereunder.[4] The registration statement and prospectus would need to conform to Regulation C under the Securities Act, unless provided otherwise in the Proposed Rule.[5] With respect to disclosure, the documents would need to conform to the requirements of Regulations S-K and S-X under the Securities Act.[6]

The Proposed Rule would exempt the following types of offerings from the registration statement and prospectus requirements of Regulation C (*i.e.*, an offering document would still need to be filed with the FDIC, but no particular form would be required):

- Regulation A under the Securities Act;
- Regulation D under the Securities Act;
- Rule 701 under the Securities Act;
- Rules 144 and 144A under the Securities Act; and
- Other reorganization and dissolution events.[7]

Registration statements, prospectuses and any offering circular used in connection with any of the exempt offerings listed above would need to be filed with the FDIC prior to the commencement of an offering. Once the FDIC confirms in writing that no additional changes or information to the offering circular are required, the offering could commence.[8]

As in the 1996 Statement, the standard legends (*i.e.*, the securities are not deposits, not FDIC insured, no approval by the FDIC is implied and debt securities are subordinated to deposits) would need to be included in the offering circular in bold capital letters.[9]

Because all offerings of securities, including those by state nonmember banks, are subject to the anti-fraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, offering circulars of state nonmember banks tend to include the full scope of disclosure included in registration statements and prospectuses for offerings registered under the Securities Act. Consequently, it is unlikely that the disclosure in

[4] See Proposed Rule at 335.3(a).

[5] See Proposed Rule at 335.3(b).

[6] See Proposed Rule at 335.3(c), (d).

[7] See Proposed Rule at 335.4(a). The Proposed Rule does not explain the meaning of the reference to Rule 144 beyond a statement that it and Rule 144A "provide guidance for persons who are not deemed to be engaged in a distribution and therefore are not underwriters, and for private resales of securities to institutions."

[8] Proposed Rule at 335.7.

[9] Proposed Rule at 335.6.

offering circulars for offerings of securities by state nonmember banks will change at all if the Proposed Rule is finalized.

2021 Report on FINRA's Examination and Risk Monitoring Program

This February, the Financial Industry Regulatory Authority, Inc. ("FINRA") released its Report on FINRA's Examination and Risk Monitoring program (the "Report").[10] The Report replaces FINRA's former Report on FINRA Examination Findings and Observations, and its Risk Monitoring and Examination Priorities Letter. The Report, in its new format, will be released annually.

The Report covers a broad spectrum of issues. This article focuses on areas of interest to the structured products industry.

REGULATION BEST INTEREST

This part of the Report generally asks firms whether they have policies, procedures and controls in place to implement all aspects of Regulation Best Interest, including relating to recommendations, record keeping, disclosures and training. There are also inquiries relating to the use of Form CRS. FINRA Rule 2111 (Suitability) is still relevant, as the Report asks whether a member firm's "policies, procedures and controls continue to address compliance with FINRA Rule 2111 (Suitability), which still applies to recommendations made to non-retail investors …."[11]

COMMUNICATIONS WITH THE PUBLIC (FINRA RULE 2210)

FINRA reminds firms that all communications must be fair, balanced and not misleading, noting that if a communication promotes the benefits of a high-risk or illiquid security, it should also explain the associated risks. In particular, the Report asks "[d]o your firm's communications balance specific claims of investment benefits from a securities product or service (especially complex products) with the key risks specific to that product or service?"[12]

The Report reflects FINRA's concerns about the use of digital communication channels and digital assets, as summarized below:

- Whether a firm's digital communication policy addresses all permitted and prohibited digital communication channels and features available to customers and associated persons;
- Whether the firm reviews for red flags that may indicate a registered representative is communicating through unapproved communication channels, and whether there is any follow up on such red flags;
- How a firm supervises and maintains books and records in accordance with SEC and FINRA rules for all approved digital communications;

[10] The Report is available at: https://bit.ly/3rsCbBK.

[11] Report at 18.

[12] *Id.* at 19.

- If a firm offers an app to customers that includes an interactive element, whether the information provided to customers constitutes a "recommendation" that would be covered by Regulation Best Interest, which requires a broker-dealer to act in a retail customer's "best interest," or suitability obligations under FINRA Rule 2360 (Options);
- If a firm's app platform design includes "game-like" aspects that are intended to influence customers to engage in certain trading or other activities, whether the firm addresses and discloses the associated potential risks to its customers; and
- Whether a firm's communications—regardless of the platform through which they are made—comply with the content standards set forth in FINRA Rule 2210.[13]

FINRA's question on whether a member firm's app platform includes "game-like" aspects follows on the heels of a complaint by the Massachusetts Secretary of State, Securities Division, against a FINRA member, alleging, among other things, the "use of strategies such as gamification to encourage and entice continuous and repetitive use of its trading application …."[14]

The Report includes a section, titled "Emerging Digital Communication Risks – New Digital Platforms With Interactive and 'Game-Like' Features," in which FINRA, while acknowledging that such features may improve access to firm systems and investment products, warned that these features may increase risks to customers if not designed with appropriate compliance considerations in mind. In this context, FINRA reminds firms to meet regulatory obligations relating to, among others:

- Regulation Best Interest and Form CRS if any communication constitutes a recommendation to a retail customer;
- Disclosing risks relating to fees, costs, conflicts of interest and required standards of conduct;
- Ensuring that all communications are fair and balanced;
- Developing a comprehensive supervisory system, including identifying red flags and maintaining proper record keeping; and
- Complying with FINRA's communication rules.[15]

Member firms' activities relating to digital assets are also scrutinized, with two questions relating to potential investor confusion about the characteristics of digital assets:

- Does your firm provide a fair and balanced presentation in marketing materials and retail communications, including addressing risks presented by digital asset investments, and not misrepresenting the extent to which digital assets are regulated by FINRA or the federal securities laws or eligible for protections thereunder, such as Securities Investor Protection Corporation coverage?

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[13] See the Report at 20.

[14] See *In Re Robinhood Financial, LLC* at 2, available at: https://www.sec.state.ma.us/sct/current/sctrobinhood/MSD-Robinhood-Financial-LLC-Complaint-E-2020-0047.pdf.

[15] See the Report at 22.

- Do your firm's communications misleadingly imply that digital asset services offered through an affiliated entity are offered through and under the supervision, clearance and custody of a registered broker-dealer?[16]

The exam findings noted deficient digital assets communications by member firms, including false, misleading or unwarranted statements. With respect to digital communications, examinations found insufficient supervision and record keeping to be a problem.

BOOKS AND RECORDS

Under the applicable books and records requirements, a member firm must create and preserve, in an easily accessible place, originals of all communications received and sent relating to its "business as such." These records may be maintained and preserved for the required time on electronic storage media, subject to certain conditions.

FINRA asks in the Report what kind of vendors, including cloud service providers, a member firm uses to comply with the books and records rules requirements, and suggested reviewing vendor contracts to confirm that these comply with those requirements. Exam findings had uncovered that some member firms had not performed sufficient due diligence on third party vendors as to whether they had the ability to comply with the books and records rules requirements.

FIXED INCOME MARK-UP DISCLOSURE

Under FINRA Rule 2232, member firms are required to provide additional transaction-related information to retail customers for certain trades in corporate, agency and municipal debt securities. Disclosed mark-ups and mark-downs must be expressed as both a total dollar amount for the transaction and a percentage of prevailing market price (PMP). The considerations listed by FINRA in the Report relate to how member firms review the accuracy of reporting under Rule 2232 in customer confirmations.

Two items in the examination findings are of note:

- **Disclosure for Structured Notes** – Failing to provide disclosures on customer confirmations for trades in TRACE-reportable structured notes because firms did not realize the notes were subject to FINRA Rule 2232 or did not receive the PMP from the structured note distributors; and
- **Incorrect Designation of Institutional Accounts** – Failing to provide disclosures to certain customers because the firm identified those customers' accounts as "institutional," even though the customers did not meet the "institutional" definition in FINRA Rule 4512(c) (Customer Account Information).[17]

LIBOR End Dates Confirmed

The administrator for LIBOR and other inter-bank offered rates, ICE Benchmark Administration ("IBA"), confirmed on March 5, 2021 its previously announced dates for LIBOR cessation.[18] On the same day, the U.K. Financial Conduct Authority ("FCA") announced that 1-week and 2-month USD LIBOR will cease publication

[16] Report at 20.

[17] Report at 17.

[18] See our previous article at: https://bit.ly/3u5KrJs.

after December 31, 2021, as will all non-USD LIBOR tenors, and that 3-month, 6-month and 1-year USD LIBOR will cease publication after June 30, 2023.

What does this mean for outstanding USD LIBOR floating rate notes that have the Alternative Reference Rates Committee's ("ARRC") recommended fallback provisions? A "Benchmark Transition Event," as defined in the ARRC fallbacks, has occurred.[19] However, USD LIBOR will not transition to the secured overnight financing rate ("SOFR") under the ARRC fallbacks because the required "Benchmark Replacement Date" has not occurred.

The FCA announcement also was an "Index Cessation Event" under Supplement No. 70 to the 2006 ISDA Definitions. Consequently, the ISDA fallback spread adjustments published by Bloomberg were fixed on March 5, 2021, which was the "Spread Adjustment Fixing Date" under ISDA Supplement No. 70. The ARRC has previously stated that it will use the same spread adjustments as ISDA for floating rate notes.

For 3-month USD LIBOR floating rate notes using the ARRC fallbacks, on the first business day after June 30, 2023, the replacement rate will be either Term SOFR, if available, or Compounded SOFR, plus the spread adjustment of 0.26161.[20]

In the FCA's announcement on the cessation of LIBOR, there was some discussion of a possible "synthetic" USD LIBOR. Synthetic USD LIBOR would be published after the respective cessation date of a USD LIBOR tenor, but would not be representative.[21] Synthetic IBORs would be used, according to the FCA, for "tough legacy contracts," *i.e.*, legacy IBOR contracts that, by their terms, do not include workable fallback provisions to transfer to a replacement rate. It is hard to see an application for synthetic USD LIBOR in the US capital markets, as the proposed New York and federal legislative solutions will, once passed, automatically cause outstanding legacy USD LIBOR floating rate notes and other USD LIBOR securities and contracts to fall back to SOFR under the ARRC's recommended fallback provisions.

SEC Division of Examinations 2021 Examination Priorities

This March, the Securities and Exchange Commission released its new report on its 2021 Examination Priorities (the "Report").[22] The Report covers a broad spectrum of issues. This article focuses on areas of interest to the structured products industry.

RETAIL INVESTORS

The Division of Examination (the "Division") stated in the Report its continued desire to emphasize the protection of retail investors, and the Division will prioritize examinations of financial intermediaries such as registered investment advisers ("RIAs") and registered investment companies, broker-dealers and dually-registered or affiliated firms. These examinations will focus on investments and services marketed to retail investors.

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19 See the ARRC announcement at: https://nyfed.org/3fpNKqM and the related FAQs at: https://nyfed.org/39HwvOn.

20 See the Bloomberg notice at: https://bit.ly/3m055bk.

21 Synthetic USD LIBOR would be a rate published as USD LIBOR, but would not be based on an interbank offered rate. For example, synthetic USD LIBOR could be Term SOFR or Compounded SOFR, plus a spread adjustment, but published as "USD LIBOR." This is the equivalent of pulling the handle marked "vanilla" on the soft serve ice cream machine, getting chocolate, and calling it vanilla.

22 This Report is available at: https://www.sec.gov/files/2021-exam-priorities.pdf. On December 17, 2020, the Commission renamed the Office of Compliance Inspections and Examinations (OCIE) the Division of Examinations.

REGULATION BEST INTEREST

The Division plans to expand the scope of examinations of Regulation Best Interest. While prior examinations focused on the implementation of Regulation Best Interest by broker-dealers, future examinations will evaluate the processes used for compliance and alterations made to product offerings, as well as question the recommendations made by broker-dealers to customers, including whether such recommendations are in the customers' best interests.[23] Additionally, the Division will also conduct enhanced transaction testing by "evaluating firm policies and procedures designed to meet additional elements of Regulation Best Interest, the recommendation of rollovers and alternatives considered, complex product recommendations, assessment of costs and reasonably available alternatives, how sales-based fees paid to broker-dealers and representatives impact recommendations, and policies and procedures regarding how broker-dealers identify and address conflicts of interest."[24]

REGISTERED INVESTMENT ADVISER FIDUCIARY DUTY AND FORM CRS

The Division's restated its commitment to examine the fiduciary duties of care and loyalty that RIAs owe to their clients, and the Division will focus on, among other items:

- RIA advice on whether account or program types are in the best interest of the client;
- RIA disclosure of all conflicts of interests "which might incline RIAs—consciously or unconsciously—to render advice which is not disinterested such that their clients can provide informed consent to the conflict;"[25] and
- Risks associated with "fees and expenses, complex products, best execution, and undisclosed or inadequately disclosed, compensation arrangements" and the risk associated with each.[26]

With respect to ensuring compliance with Form CRS, the Division plans to prioritize examinations of broker-dealers and RIAs.

FRAUD, SALES PRACTICES, AND CONFLICTS

Examinations will focus on conduct related to retail investors, with a particular emphasis on: "(1) seniors, including recommendations and advice made by entities and individuals targeting retirement communities; (2) teachers; (3) military personnel; and (4) individuals saving for retirement."[27] The Division also plans to hone in on the following:

- Recommendations regarding account type, conversions, and rollovers;
- The sales practices used for each product type, including structured products;
- Whether broker-dealers are meeting their legal and compliance obligations when providing retail customers access to complex strategies;

[23] See the Report at 20.

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] See Report at 21.

- How firms are complying with recent changes to the definition of accredited investor when recommending and selling certain private offerings;
- Whether fees, expenses and revenue sharing arrangements are adequately disclosed, encompassing revenue sharing arrangements between a registered firm and issuer, service providers, and others, and direct or indirect compensation to personnel for executing client transactions; and
    - Examination of RIA fee calculation will include: "(1) advisory fee calculation errors, including but not limited to, failure to exclude certain holdings from management fee calculations; (2) inaccurate calculations or tiered fees, including failure to provide breakpoints and aggregate household accounts; and (3) failures to refund prepaid fees for terminated accounts."
- RIAs operation and use of turnkey asset management platforms.[28]

RETAIL-TARGETED INVESTMENTS

The Division restated its commitment to monitor securities products that can pose increased risks to retail investors such as mutual funds and ETFs, municipal securities, microcap securities and other fixed income securities. With respect to mutual funds and ETFs, the Division will focus on:

- The incentives provided to financial services firms and professionals that may cause them to select a higher cost mutual fund when a similar lower cost option is available.
- "Financial intermediaries' recommendations and disclosures involving ETFs, including adequacy of risk disclosure, and suitability, particularly in niche or leveraged/inverse ETFs."[29]

With respect to municipal securities and other fixed income securities, the Division will examine broker-dealers, underwriters and municipal advisors in order to determine whether each is meeting their obligations under municipal issuer disclosure. The Division will further examine "broker-dealer trading activity in municipal and corporate bonds for compliance with best execution obligations; fairness of pricing, mark-ups and mark-downs, and commissions; and confirmation disclosure requirements, including disclosures related to mark-ups and mark-downs."[30]

With respect to microcap securities, the Division restated its commitment to deterring fraud and cited concerns over false claims made by these companies regarding the pandemic, to which the Commission responded to by suspending trading in various securities. The Division plans to hone in on:

- "Transfer agent handling of microcap distributions and share transfers;
- Broker-dealer sales practices and their consistency with Regulation Best Interest; and
- Broker-dealer compliance with certain regulatory requirements, including the locate requirements of Regulation SHO, penny stock disclosures under Rules 15g-2 through 15g-6 of the Securities Exchange Act of 1934, and the obligation to monitor for and report suspicious activity and other anti-money laundering obligations."[31]

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[28] See Report at 22.

[29] *Id.*

[30] See Report at 23.

[31] *Id.*

FINANCIAL TECHNOLOGY (FINTECH) AND INNOVATION, INCLUDING DIGITAL ASSETS

The Division restates its commitment to staying updated on recent fintech innovations and plans to focus its efforts on:

- Implementation and integration of RegTech in firms' compliance programs
- Implementation of controls and compliance around the creation, receipt, and use of alternative data
- Examining digital asset market participants for: "(1) whether investments are in the best interests of investors; (2) portfolio management and trading practices; (3) safety of client funds and assets; (4) pricing and valuation; (5) effectiveness of compliance programs and controls; and (6) supervision of representatives' outside business activities."[32]

THE LIBOR TRANSITION

The Division intends to examine the risks of "market participants such as RIAs, broker-dealers, investment companies, municipal advisors, transfer agents and clearing agencies in order to assess their understanding of any exposure to LIBOR, their preparations for the expected discontinuation of LIBOR and the transition to an alternative reference rate, in connection with the registrants' own financial matters and those of their clients and customers."[33]

Events

IN CASE YOU MISSED IT…

- **REVERSEinquiries Workshop: ISDA 2020 IBOR Fallbacks Protocol** (January 2021). *Watch this webinar*
- **4th Debt Capital Markets Seminar** (January 2021). *View the presentation materials*
- **REVERSEinquiries Workshop: Proprietary Indices, US and European Considerations** (February 2021). *Watch this webinar*
- **REVERSEinquiries Workshop: Bank Regulatory Development Recap** (March 2021). *Watch this webinar*

[32] See Report at 26.

[33] See Report at 27.

GlobalCapital Derivatives Awards

Mayer Brown is pleased to have been shortlisted for Americas Law Firm of the Year (Overall), US Law Firm of the Year – Transactions and US Law Firm of the Year – Regulatory for *GlobalCapital*'s Americas Derivatives Awards 2021.

This follows our win as European Law Firm of the Year – Transactions and US Law Firm of the Year – Transactions for *GlobalCapital*'s Americas and Global Derivatives Awards 2020, respectively. We would like to thank *GlobalCapital* for its continued recognition and thank our friends and our colleagues for their trust in our work.

ANNOUNCEMENTS

MAYER BROWN CAPITAL MARKETS TAXQUARTERLY
DON'T TAX YOU. DON'T TAX ME. TAX THAT FELLOW BEHIND THE TREE.

Capital Markets Tax Quarterly. Mayer Brown's Capital Markets Tax Quarterly provides capital markets-related US federal tax news and insights. In our latest issue, we cover tax plans in the new administration, US tax considerations for SPACs, guidance on the settlement payments to REMIC regular interest holders, extended relief for mortgages, and more.

LinkedIn Group. Stay up to date on structured and market-linked products news by joining our LinkedIn group.

Suggestions? *REVERSEinquiries* is committed to meeting the needs of the structured and market-linked products community, so you ask and we answer. Send us questions that we will answer on our LinkedIn anonymously or topics for future issues.

To request to join the LinkedIn group or send us suggestions/comments, please scan the QR code, which will notify us via email at REVERSEinquiries@mayerbrown.com.

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MAYER BROWN'S IBOR TRANSITION RESOURCES

The final countdown to the LIBOR cessation date has begun. With fewer than 500 days left until December 31, 2021, rely on Mayer Brown to assist you.

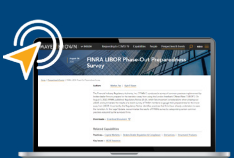
With our global presence, deep knowledge of the affected markets and products, participation in trade and industry groups and considerable experience in using technology solutions (including artificial intelligence and other technology-assisted review tools), Mayer Brown is uniquely positioned to advise financial institutions and other affected market participants.

Our IBOR Transition Task Force, composed of nearly 100 partners globally, is perhaps the best reflection of our strength and depth.

Below we provide a sampling of our resources:

IBOR Transition Digest: A compendium of global regulatory and market news as well as insights on the complex issues confronting financial market participants as they transition from LIBOR and its variants to replacement benchmark interest rates.

Recent publications, include:



FINRA LIBOR Phase-Out Preparedness Survey (August 2020)

"Comparable" Alternative Reference Rates to LIBOR: The Low Bar for Official Designation, the Much Higher Hurdle of "Fit for Use" and Implementation for Market Participants (August 2020)

IBOR Transition: It's Later Than You Think! (August 2020)

IBOR Transition Webinar Series: Detailed discussions and insights—in 30 minutes or less—on a range of topics from setting and executing an effective IBOR Transition strategy to assessing the impact of IBOR issues on specific financial products.

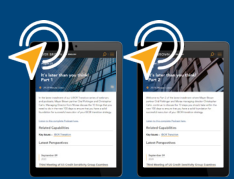
Subscribe on: Google Play Spotify

Recent webinars, include:

Part 5.1 Part 5.2

LIBOR Transition: Issues impacting Floating Rate Notes, Preferred Stock, Depositary Shares, and Capital Securities (Part 5.1 & Part 5.2) (August / September 2020)

Issues impacting Floating Rate Notes, Preferred Stock, Depositary Shares, and Capital Securities: Part 1 (August 2020)



Part 1 Part 2

It's later than you think! (Part 1 & Part 2) (August 2020)

morae

We are collaborating with Morae Global Corporation, a leading provider of legal and compliance technology solutions, to assist clients in the transition from the IBORs to alternative risk-free reference rates. To more effectively serve our client, Mayer Brown has teamed up with Morae, to offer clients data analytics and remediation, technology enablement, repapering and program management capabilities.

Our firm and our partners are ranked as leaders for capital markets, structured finance and securitization, derivatives, structured products, financial services and bank regulatory, litigation, and tax by:

TOP RANKED Chambers GLOBAL 2020

"Esteemed firm with excellent securitisation, structured finance and derivatives capital markets practices. Regularly sought after for advice on cross-border and transatlantic securitisation and structured finance transactions"

TOP RANKED Chambers USA 2020

"A strong global reach allows the team to handle cross-border cases with ease, while the presence of several former regulatory officials provides insight into the most cutting-edge matters."

The LEGAL 500 UNITED STATES

"The firm routinely leads on cross-border offerings from the US but it can also draw on its extensive network of offices for support on complex, multi-jurisdictional transactions... Among its industry sweet spots, the group is most prominent in the financial services..."

IFLR 1000

"Mayer Brown has leading structured finance, project development and project finance practices, as well as additional strengths in debt and equity capital markets."

Question? Please contact Marlon Paz, mpaz@mayerbrown.com, or see our Global IBOR Transition Task Force contacts.

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MAYER BROWN CAPITAL MARKETS

TAXQUARTERLY

DON'T TAX YOU. DON'T TAX ME. TAX THAT FELLOW BEHIND THE TREE.*

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Editor's Note

CMTQ couldn't help notice in mid-April when the stock market was "shocked, shocked" at a news report that President Joe Biden would propose increasing individual federal income tax rates on long-term capital gains to equal ordinary income rates (39.6% under Biden's proposal).[1] If only folks had read CMTQ last quarter, they would have realized this proposal was lurking in the wings.[2] We checked and the last time tax rates on long-term capital gains were higher was immediately before the 1978 Revenue Act during the Carter Administration when the effective long-term capital gain rate was 49%.[3] And individual long-term capital gain and ordinary income tax rates have not been equal since the George H.W. Bush Administration, albeit at a much lower 28% rate. This recent capital gains "news" was good for several days of media reports, analysis and talking head air time and, some would say, increased volatility in the stock market--exactly what we need. Unfortunately for tax advisors as of this writing there is no legislative language for any of the President's tax proposals (which BTW are discussed below); for example the effective date of any change in individual long-term capital gain

In This Issue

1 Including the 3.8% Medicare tax on investment income, the maximum federal income tax rate on long-term capital gains would be 43.4%. The maximum long-term capital gain rate would apply to individual taxpayers with incomes over $1 million.

2 See Vol. 03, Issue 1 and Vol. 3, Issue 2.

3 See Report to Congress on the Capital Gains Tax Reductions of 1978, US Treasury, Government Printing Office, Washington DC (1985). The report notes that the 49% maximum rate resulted from the combined effect of several Internal Revenue Code provisions.

* As described in the original Editor's Note, this quote is attributed to, among others, Sen. Russell Long (D., LA).

(and ordinary income) rates is currently unknown.[4] So, dear reader, stay tuned. As always, CMTQ will continue to cover the ups and downs of the legislative process as it unfolds in 2021.

In the meantime, this CMTQ also covers a private letter ruling approving the settlement of debt without CODI in a bankruptcy, some highlights from recent tax proposals from President Biden's Administration, and more.

PLR 202050014: Another Ruling Supporting Debt Settlement Without CODI

In PLR 202050014 (the "Ruling"), the IRS blessed a tax-efficient bankruptcy reorganization, again blessing tax planning technology that is at least as old as 2016. The Ruling bolsters authority for the use of bankruptcy transactions as a means of settling debt without triggering cancellation of indebtedness income ("CODI").

First, the facts of the Ruling: A parent corporation ("Parent") owned all of the equity interests of two disregarded entities, LLC1 and LLC2. The substantial majority of the value of Parent was owned by LLC1 and its subsidiaries. Parent, LLC1 and LLC1's subsidiaries subsequently filed for bankruptcy, with LLC1 being the direct borrower of a significant portion of the group's debt. Significantly, the Parent was not a guarantor of LLC1's debt. Under the Ruling, Parent proposed to contribute its assets (including the equity and assets of LLC1 and LLC2) to a newly formed corporation ("NewCo"). Then, pursuant to the same plan, Parent distributed the equity of NewCo to creditors in satisfaction of a portion of LLC1's debt. The Ruling concludes that the LLC1 debt is treated as nonrecourse indebtedness, and the transaction as a whole satisfied the requirements to be treated as a "G reorganization."

Generally, debt of a disregarded entity is treated as owed by the disregarded entity's owner. However, there is uncertainty regarding whether indebtedness that is nominally recourse to the disregarded entity borrower is better treated as recourse indebtedness or nonrecourse indebtedness. On the one hand, because the debt is recourse indebtedness under local law, it is possible to view the indebtedness as recourse indebtedness of the owner. On the other hand, because creditors may only look to the assets of the disregarded entity in order to satisfy any claims, and not to the assets of the owner generally, the tax law may alternatively view the indebtedness as nonrecourse indebtedness of the owner. The difference in treatment is significant. Satisfaction of recourse indebtedness for an amount less than the principal amount of the indebtedness generally results in CODI. If certain requirements are met, CODI may be excluded from the owner's income if the owner is bankrupt or insolvent, although the price of such exclusion is a reduction of the debtor's tax attributes. Alternatively, satisfaction of nonrecourse indebtedness for an amount less than the principal amount

4 For some interesting reading on legislative action and effective dates, see United States v. Carlton, 512 U.S. 26, at 30-31 (1994); *Welch v Henry*, 305 U.S. 134, at 146-147 (1931).

of the indebtedness may in certain circumstances be treated as a sale of the collateral, resulting in gain rather than CODI.[5] Although gain cannot be excluded under Section 108, gain may qualify for nonrecognition treatment where a transaction qualifies as a tax-free reorganization.

The Ruling illustrates the use of this principle. Although the Ruling does not indicate the dollar amounts at issue, the principles of the Ruling can be used to satisfy indebtedness to creditors without incurring CODI. Gain may be realized on the transaction to the debtors, but if the requirements are met to treat the transaction as a tax-free reorganization, the gain is not recognized. The end result is that no tax is owed by the creditors for settling their indebtedness for less than the face amount. Furthermore, because CODI is not applicable, tax attributes of the debtor are not reduced.

The issues addressed in the Ruling are similar to the transactions undertaken as part of a major bankruptcy for which a ruling was sought in 2016, part of which sought the same advice as that requested in the Ruling.[6]

Refresher in Info Letter 2020-0033: Short Sales Not UBTI

THE SHORT OF IT

On December 31, 2020, the IRS published Info Letter 2020-0033[7], confirming that, under certain circumstances, income of retirement plans that is attributable to a short sale of publicly traded stock through a broker is not subject to the unrelated business income tax under section 511 of the Code.[8]

Following, we summarize the applicable provisions of the Code relating to the taxation of unrelated business taxable income ("UBTI") and we briefly analyze the rulings that the IRS cited in Info Letter 2020-0033 in order to understand which income attributable to a short sale of publicly traded stock is excluded from UBTI.

UBTI – GENERAL BACKGROUND

Code section 511(a) imposes a tax on the UBTI of certain taxpayers that are otherwise exempt from federal income taxation under Code section 501(a).

Code section 512(a)(1) of the Code defines UBTI as gross income derived by any organization from any unrelated trade or business regularly carried on by it, less certain deductions which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in Code section 512(b). Section 512(b)(4) provides, in part, that UBTI includes certain income from "debt-financed property" as defined in Code section 514(b).

5 *See Commissioner v. Tufts*, 461 U.S. 300 (1983). Treas. Reg. section 1.1001-2(c), Ex. 7.

6 PLR 201644018.

7 INFO 2020-0033 (December 31, 2020).

8 All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code").

Code section 514(b)(1) defines the term debt-financed property as any property that is held to produce income and with respect to which there is "acquisition indebtedness" at any time during the taxable year (or during the 12 months preceding disposition in the case of property disposed of during the taxable year).

Code section 514(c)(1) provides that the term acquisition indebtedness means, with respect to any debt-financed property, the unpaid amount of (A) indebtedness incurred by the organization in acquiring or improving the property, (B) indebtedness incurred before the acquisition or improvement of the property if the indebtedness would not have been incurred but for the acquisition or improvement, and (C) indebtedness incurred after the acquisition or improvement of the property if the indebtedness would not have been incurred but for the acquisition or improvement and the incurrence of the indebtedness was reasonably foreseeable at the time of the acquisition or improvement.

THE IRS LOOKS TO REV. RUL. 95-8 TO CLARIFY THAT INCOME FROM SHORT SALES IS NOT UBTI

In Rev. Rul. 95-8,[9] the IRS addressed a situation where a tax-exempt organization sought to earn, as part of its investment strategy, a profit from the decline in the value of certain publicly traded stock. To sell the stock short, the tax-exempt organization, through its broker, borrowed 100 shares of A stock and sold the shares. The tax-exempt organization's broker retained the sale proceeds and any income earned on these proceeds as collateral for the tax-exempt organization's obligation to return 100 shares of A stock. In addition, the tax-exempt organization put up additional collateral from its own (not borrowed) funds and earned a "rebate fee" equal to a portion of the income earned on the investment of the collateral.

Under the facts described above, the IRS ruled that income of the tax-exempt organization attributable to the short sale (i.e., income earned on the decline in value of the 100 shares of A stock) was not subject to the tax on UBTI because such income was not income from "debt-financed property." The IRS clarified that income attributable to a short sale can be UBTI if the short seller incurs acquisition indebtedness with respect to the property on which the short seller realizes that income; however, the IRS concluded that, even though a short sale created an obligation, it did not create indebtedness.[10]

Further, the IRS determined that neither gain realized on a short sale attributable to the decline in value of stock nor income derived from the proceeds of the short sale, such as rebate fees, are income from debt-financed property.

As a result, if a tax-exempt organization sells publicly traded stock short through a broker, then neither the gain or loss attributable to the change in value of the underlying stock nor any rebate fees earned in connection with this transaction are UBTI unless the tax-exempt organization incurs

9 1995-4 I.R.B. 29.

10 *See Deputy v. du Pont*, 308 U.S. 488, 497-98 (1940).

acquisition indebtedness in connection with these transactions. The revenue ruling does caveat, however, that no inference is intended with respect to a borrowing of property other than publicly traded stock sold short through a broker.

Cum-Ex Developments

Recently, both Denmark and Germany charged taxpayers for involvement in cum-ex dividend trading arrangements.[11] Generally speaking, in a cum-ex trade, Party A in country Y agrees to transfer shares in a country X company to Party B in country Z around the time of a dividend payment. The actual owner of the shares may be unclear to the taxing authorities. Tax treaties between country X and countries Y and Z permit taxpayers subject to withholding to receive a refund of tax withheld. In the cum-ex structure, due to the uncertainty of ownership, both Party A and Party B claim the refund for tax withheld, even though the tax may have been withheld only once or not at all. These arrangements are similar to the "swapping out" of dividends that led to the enactment of section 871(m).

Coffey: Information Reporting Isn't the Same as Filing

On December 15, 2020, the Eighth Circuit reversed the Tax Court's decision in *Coffey v. Commissioner*, 150 T.C. 60 (2018), agreeing with the IRS in its holding that, for statute of limitation purposes, a federal income tax return had not been filed even if the IRS received and stamped as received certain tax return documents from the US Virgin Islands Bureau of Internal Revenue ("VIBIR").[12] A holding in the opposite direction could possibly have turned information reporting exchanges, including FATCA, into taxpayer-friendly reporting mechanisms.

The taxpayers, a husband and wife, owned a profitable enterprise that purportedly relocated to the US Virgin Islands ("USVI") and Judith Coffey claimed to be a USVI resident thereafter. The couple filed joint tax returns for 2003 and 2004 with VIBIR, but not with the IRS. The VIBIR sent the first two pages of the taxpayers' returns to the IRS as part of its normal process to claim "cover over" funds (i.e., tax revenue) from the US Treasury, which the IRS stamped, recorded and processed. Disputing the taxpayers' assertion that they were bona fide residents of the USVI, the IRS conducted an audit and sent them notices of deficiency in 2009, more than three years after it received the taxpayers' returns from the USVI. The taxpayers moved for summary judgment on the ground that the deficiency notices were barred by the statute of limitations under Code section 6501(a). The taxpayers argued that assuming they were nonresidents of the USVI, the returns were filed with the IRS either at the time the returns were filed with the VIBIR or when the IRS Service Center received

11 *See* William Hoke, Denmark Charges Six U.S. and U.K. Nationals in Cum-Ex Case, 102 TAX NOTES INT'L (April 19, 2021); William Hoke, Germany Investigates Cum-Ex Trades by Securities Companies, 101 TAX NOTES INT'L 1717 (March 29, 2021).

12 *Coffey v. Commissioner*, 987 F.3d 808 (8th Cir. 2021).

the partial return from the VIBIR. The Tax Court agreed, finding that the taxpayers' returns were filed with the IRS more than three years before the notices were issued.

The Eighth Circuit reversed the Tax Court and confirmed the long-standing principle that the statute of limitations begins only when a return is filed. The Court noted that neither the Code nor the regulations define the term "file" or "filing," but said that as a general rule, taxpayers must meticulously comply with the statutory conditions in order to begin the statute of limitations. Courts have also held that a return is considered filed if it was delivered, in the appropriate form, to the specific individual or individuals identified in the Code or regulations.

The Eighth Circuit found that the IRS's actual knowledge was not a filing. Although the IRS received actual knowledge of the taxpayers' information, it did not receive a filing according to the Court. The taxpayers intended to file their returns only with the USVI and failed to meticulously comply with federal filing requirements for USVI nonresidents. Further, the Court reasoned that the VIBIR did not file the taxpayers' returns when they transmitted them to the IRS. The taxpayers also never authorized the USVI to file the returns. In addition, the Court found that it is irrelevant for statute of limitations purposes that the IRS actually received the documents, processed and audited them, and issued deficiency notices.

The Eighth Circuit was also not persuaded by the taxpayers' second argument that their filings with the VIBIR began the statute of limitations period. The taxpayers argued that although their filings were imperfect, they should satisfy their burden to file a return under Code section 6501(a) because they made a genuine and honest attempt to file, even if they were mistaken about residency. The Court held that a prerequisite to an honest and genuine return is that it is filed with the correct individual. Further, the Court pointed out that there is no exception to Code section 6501(a) for a taxpayer's mistaken position about residency. Therefore, because the taxpayers did not comply with the requirements to file returns with the IRS, the Eighth Circuit held that the statute of limitations never began to run.

FBAR to Pick Up Crypto

On December 31, 2020, FinCEN announced, in FinCEN Notice 2020-2[13], the agency's intention to propose amended regulations implementing the Bank Secrecy Act ("BSA") regarding the Report on Foreign Bank and Financial Account ("FBAR") to include virtual currency as a type of reportable account. The Notice concedes that currently, the FBAR regulations do not define a foreign account holding virtual currency as a type of reportable account, and thus, such account is not currently reportable on the FBAR (unless it is a reportable account because it holds reportable assets other

13 FinCEN Notice 2020-2 is available at https://www.fincen.gov/sites/default/files/shared/NoticeVirtual%20Currency%20Reporting%20on%20the%20FBAR%20123020.pdf#page=1&zoom=auto,-90,792.

than virtual currencies). The Notice is otherwise sparse in details, and does not indicate *when* such regulations will be published or implemented.

Key Tax Changes in President's American Jobs Plan and American Families Plan

President Biden recently released policy plans for both the business and individual sides of the tax law, each discussed below. For now, there is no legislation fleshing out either plan.

INDIVIDUAL TAX CHANGES

On April 28, 2021, President Biden proposed the American Families Plan (the "Families Plan"), intended to help families by providing education benefits and certain tax cuts, raising revenue for those expenditures with some tax increases on "high-income Americans."[14] Here are the highlights:

- *Change information reporting*. The Families Plan proposes to require financial institutions to report information on account flows such that earnings from investments and business activity are subject to similar reporting to wages. It is unclear what these changes would look like.
- *Increase individual tax rate*. The Tax Cuts and Jobs Act cut the top individual tax rate from 39.6% to 37% – the Families Plan would reverse this change.
- *Limit preferential rate for capital gains*. The Families Plan would require households making more than $1 million to pay tax on capital gains and dividends at the ordinary income tax rate. It is unclear what tax filing status is meant by "households" and whether the $1 million threshold would look to adjusted gross income.
- *Limit LKEs*. The Families Plan would also limit like-kind exchanges for gains in excess of $500,000. It is unclear whether that is on a property-by-property basis. After the TCJA effective January 1, 2018, LKEs are only permitted for real estate.

BUSINESS TAX CHANGES

On March 31, 2021, President Biden's administration proposed the American Jobs Plan to create domestic jobs, rebuild national infrastructure and increase American competitiveness. Along with the American Jobs Plan, the administration also proposed the America Tax Plan (the "America Tax Plan"), which includes a mix business tax of renewed tightening of offshore profits shifting and higher

14 The Fact Sheet for the American Families Plan is available at https://www.whitehouse.gov/briefing-room/statementsreleases/2021/04/28/fact-sheet-the-american-families-plan/

income tax rates on corporations.[15] Following the America Tax Plan's release, the Treasury Department released a report providing additional details for the plan.[16] Here are the highlights:[17]

- *Corporate income tax rate*. The America Tax Plan proposes increasing the current corporate income tax rate from 21 percent to 28 percent.
- *Minimum book profits tax*. The America Tax Plan proposes a 15% minimum take on certain large corporations' on-the-book profits reported to investors. The Treasury report states that, in recent years, only forty-five corporations would have been required to pay the minimum book tax. It is unclear what deductions, if any, would be permitted.
- *Repeal FDII*. The America Tax Plan also contemplates eliminating the tax incentives in the Tax Cuts and Jobs Act (TCJA) for Foreign Derived Intangible Income (FDII). The revenue derived from the repeal would be used to expand research and development investment incentives.
- *Replace the BEAT*. The base erosion and antiabuse tax (BEAT) regime targets large multinationals that make deductible payments to foreign related parties over certain thresholds. The BEAT rate of 10 percent is scheduled to jump to 12.5 percent after 2025. Probably unrelated to the similar comic-book acronym, the America Tax Plan proposes to replace the BEAT with SHIELD (Stopping Harmful Inversions and Ending Low-Tax Developments), which would generally deny certain multinational corporations federal tax deductions paid to related parties subject to a lower rate of tax. As the name implies, the America Tax Plan contemplates bolstering the already complex anti-inversion regime.
- *Strengthen GILTI*. The America Tax Plan aims to strengthen a global minimum tax that was imposed on U.S. companies as part of the TCJA. The Global Intangible Low-Taxed Income (GILTI) amount receives a 50 percent deduction, which causes the nominal GILTI rate to be half of the statutory rate. The America Tax Plan wants to trim the deduction to 25 percent, causing the nominal GILTI rate to climb to three quarters of the statutory rate. If the corporate income tax rate is increased to 28 percent as the America Tax Plan proposed, that would result in a nominal GILTI rate of 21 percent. In addition, the America Tax Plan would apply the GILTI regime on a per-country basis to negate the ability of taxpayers to blend high-taxed foreign income with low-taxed foreign income.

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15 The Fact Sheet for the Made in America Jobs Plan is available at https://www.whitehouse.gov/briefing-room/statementsreleases/2021/03/31/fact-sheet-the-american-jobs-plan/

16 The Treasury report is available at https://home.treasury.gov/system/files/136/MadeInAmericaTaxPlan_Report.pdf

17 For a discussion of the potential impact of the America Tax Plan on life sciences companies, see our client alert entitled Déjà Vu All Over Again: Life Sciences Companies Brace for More US and Global Tax Reform, available at https://www.mayerbrown.com/en/perspectives-events/publications/2021/04/deja-vu-all-over-again-life-sciences-companies-brace-for-more-us-and-global-tax-reform

- *Push for a global agreement to end profit shifting.* The America Tax Plan emphasizes that the Treasury Department will continue to push for global coordination on an international tax rate that would apply to multinational corporations regardless of their location of headquarters.
- *Replace fossil fuel tax subsidies with clean-energy incentives.*[18] The America Tax Plan would strip away longstanding subsidies for oil, gas and other fossil fuels and replace them with incentives for clean energy. The America Tax Plan would include an incentive for long-distance transmission lines, expand incentives for electricity storage projects and extend other existing clean-energy tax credits.
- *Ramp up enforcement against corporations.* The America Tax Plan includes proposals to bolster the Internal Revenue Service resources it needs to effectively enforce the tax laws against corporations, which will be combined with a broader enforcement initiatives to be announced that will address tax evasion among corporations and high-income Americans.

Diminished Anonymity: The Corporate Transparency Act ("CTA")

On January 1, 2021, the National Defense Authorization Act for Fiscal Year 2021 ("NDAA") became law after Congress overrode former President Trump's veto. Buried in the NDAA is the Corporate Transparency Act ("CTA"), which generally requires a broad array of business entities, including limited liability companies ("LLCs"), to register with the US Financial Crimes Enforcement Network ("FinCEN") and to disclose, among other things, their beneficial owners. Such registration and disclosure requirements generally apply to both (i) US corporate entities and (ii) non-US corporate entities that are registered to do business in the United States. Although this sweeping initiative is intended to further combat the use of corporate entities by criminals to engage in crimes such as fraud, tax evasion and money laundering, these reporting and disclosure requirements appear to be relevant to all such business entities.

The CTA requires the Secretary of the Treasury to promulgate regulations under the CTA no later than one year after the enactment of the CTA (i.e., no later than January 1, 2022). In an effort to implement the CTA, FinCEN published an Advanced Notice of Proposed Rulemaking on April 5, 2021[19], seeking public comments on several issues that need to be addressed before final regulations can be released. The comment period closes on May 5, 2021.[20]

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18 For additional information, please see our client alert entitled Energy Tax Implications of New Infrastructure and Tax Plans, available at https://www.mayerbrown.com/en/perspectives-events/publications/2021/04/energy-tax-implications-of-new-infrastructure-and-tax-plans

19 The Advanced Notice of Proposed Rulemaking is available at https://www.federalregister.gov/documents/2021/04/05/2021-06922/beneficial-ownership-information-reporting-requirements

20 For additional information on the CTA and the Advanced Notice or Proposed Rulemaking, please see our Legal Update available at https://www.mayerbrown.com/en/perspectives-events/publications/2021/04/fincen-moves-to-implement-the-corporate-transparency-act

In the News

RECENT SPEAKING ENGAGEMENTS

- ***Upcoming*** – Commodity Pool Regulation Following the enactment of the Dodd-Frank Act, and resulting changes to the definition of commodity pool, more passive investment vehicles, including trusts and funds, must focus on possible characterization as commodity pools. During this briefing hosted by PLI on May 7, 2021, Matthew Kluchenek and Anna Pinedo will address the commodity pool and CTA definitions, types of structures that may raise particular concerns, including funds, trust, securitization and repackaging vehicles, the scope of relief and exemptions, the regulation of commodity pools, CPO enforcement, and more. *Register for the session here.*

- ***Upcoming*** – IBOR Transition: Current Status of US Federal Tax Guidance On May 12, 2021, Mayer Brown tax lawyers Tom Humphreys and Brennan Young will provide an overview of IBOR replacement under current federal tax guidance and a discussion of practical considerations in connection with various different types of instruments during a webcast hosted by Intelligize. *Register for the session here.*

- ***Upcoming*** – Special Purpose Acquisition Companies Under SEC Scrutiny: Mitigating Potential Liability for Offering Participants On May 12, 2021 as part of the Banking & Financial Services webinar series hosted by Mayer Brown, partners Anna Pinedo, Chris Houpt and Brian Massengill will discuss SPACs and mitigating potential liability for offering participants. *Register for this session here.*

- ***Upcoming*** – 2021 Structured Products Legal, Regulatory & Market Briefing On May 13, 2021, alongside the Structured Products Association, we are inviting industry leaders to speak on the latest legal, regulatory and market developments in the structured products market. This briefing will include four short panels covering innovations in ESG-linked structures, Nasdaq Fund Network ("NFN") valuation, an update on the LIBOR transition, as well as ARCC developments and the New York state legislation, and SEC, FINRA and CFTC regulatory announced priorities and enforcement expectations under the Biden Administration. *Register for the session here.*

- Third Annual Mortgage REIT Summit 2021 This year's Summit, held on April 29, focused on the Biden Administration's blueprint for housing finance and other issues. Partners in Mayer Brown's REIT practice were joined by guest speakers from Barclays; EY's Center for Board Matters; and Keefe, Bruyette & Woods. Divided into three sessions, this year's Summit addressed market and policy overview, asset finance and tax considerations, and securities developments and "what's on the horizon."

- Global Capital Markets & the US Securities Laws 2021 As capital markets have continued to adjust to changing regulatory standards, PLI dedicated an entire day to providing updates on market developments. On April 7, 2021, speakers gave an in-depth perspective at how the US securities laws work in the context of a rapidly evolving global regulatory environment. Among this group of speakers, Mayer Brown tax partner Christina Thomas participated on a panel discussing the global state of capital markets, the SEC's international regulatory agenda, areas of focus for issuers raising capital in global markets, and current trends in foreign offerings in the United States.

- The SPAC Life Cycle: Business, Legal and Accounting Considerations Forum 2021 On April 20, 2021, PLI hosted an all-day event to provide a comprehensive examination of special purpose acquisition companies (SPACs) and the various business, legal, SEC reporting and accounting considerations that must be addressed in each phase of the SPAC's finite, but fast-paced and complex life cycle. Mayer Brown partner Eddie Best participated on a panel discussing the de-SPACing transition. He addressed proxy and shareholder vote considerations, raising additional capital, SEC reporting and accounting considerations, market communications during the de-SPAC process, financial statement requirements of the target company, auditor requirements, the "Super Form 8-K," and more.

- Private Placements and Hybrid Securities Offerings 2021 A two-day webinar event was hosted by PLI on April 20 and 21, 2021, which covered the basics of private placements, resales of restricted securities, Section 4(a)(1-1/2) transactions and block trades, where Mayer Brown partner Anna Pinedo kicked-off each day with opening remarks. Panels ranged, speaking to changes to private and exempt offerings brought about by the JOBS Act and the SEC's Concept Release on Harmonization of Securities Offering Exemptions, including "accredited investor" crowdfunding offerings, the changes to Rule 701 and the SEC Concept Release on Rule 701 and Form S-8. Various speakers discussed the documentation, principal negotiating issues, and market developments relating to late-stage or pre-IPO private placements, PIPE transactions, 4(a)(2) and 144A offerings, and confidentially marketed public offerings.

- MBA Live: Spring Conference & Expo 2021 Mortgage Bankers Association Hosted by the Mortgage Bankers Association (MBA), this conference, from April 20 to 23, combined four robust categories, including independent mortgage banking, secondary and capital markets, servicing, and technology into one event. Anna Pinedo participated on a panel which revealed the bigger picture to help C-suite executives consider what business structure may be best for their respective independent mortgage bankers. Specifically, topics of discussion included trends and takeaways from companies going public, either via an IPO or SPAC, installing ESOPs, conventional M&A activity, and bank acquisitions.

- Choosing a Path Forward in a Changed World Tax Executive Institute hosts a four-day virtual program that examined a broad range of technical, policy, and management topics. The Midyear Conference featured dedicated sessions focusing on U.S. federal, international, and state tax, as well as Canadian tax and COVID-19-related measures. Mayer Brown tax partners participated on several panels including: Leah Robinson – “Locals Going Loco: The Disturbing Rise of Aggressive Local Taxes”; Jason Bazar – “Important Trends in COVID-Era M&A Transactions”; Gary Wilcox – “Understanding and Applying Section 163(j) Under the Final Regulations”; Brian Kittle – “Tracking Transfer Pricing Developments Around the World”; Jim Barry – “Tax Attributes in Consolidated Groups, Including Losses, Loss Limitations & TCJA Changes”.

- International Tax Issues in SPAC Transactions On March 18, 2021, Mayer Brown tax partner Mike Lebovitz participated in a program which provided an overview of the SPAC lifecycle and discussed some of the key international tax issues associated with SPAC transactions arising at formation as well as at the de-SPAC’ing transaction hosted by IFA USA.

- ABA/IPT Advanced State Income Tax Seminar On March 18, 2021, Mayer Brown tax partner Zal Kumar participated in the Primer on SALT Issues Arising in M&A panel.

- Computing Private Business Use On March 2, 2021, Mayer Brown tax partner Steven Garden participated on a panel discussing the rules for calculating and measuring private business use during a program hosted by NABL institute. The discussion address common situations for which application of the rules has proven challenging.

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Legal Update

FDIC Finalizes Changes to Brokered Deposits Restrictions

On December 15, 2020, the Federal Deposit Insurance Corporation ("FDIC") finalized revisions to its rules and prior guidance regarding brokered deposits (the "Revisions").[1] The Revisions had been proposed in 2019 (the "Proposal") and were the subject of considerable industry feedback generating over 160 comment letters.[2] The Revisions are intended to modernize the FDIC's framework for regulating brokered deposits, and they alter both the substantive regulations for brokered deposits and the procedures for requesting exceptions and filing reports. They also modify the restrictions on interest rates for certain types of deposits and clarify the application of the brokered deposit requirements to non-maturity deposits (e.g., deposits without a maturity date).

The Revisions generally will become effective on April 1, 2021, but there is an extended compliance period until January 1, 2022, during which institutions and putative deposit brokers may continue to rely on existing public staff advisory opinions and submit notices that are newly required by the Revisions.

In this Legal Update, we discuss the background of the brokered deposit restrictions and describe the key elements of the Revisions.

Background

Following the savings and loan crisis, in 1989, Congress enacted Section 29 of the Federal Deposit Insurance Act to impose restrictions on brokered deposits and notification obligations on deposit brokers.[3] The action was based on the regulators' view that brokered deposits were risky because they potentially drove growth and risk-taking by troubled institutions and were volatile in that they would move based on rates paid by competitor institutions. As a result, several regulatory initiatives were undertaken beginning in the 1980s to address risks associated with brokered deposits.

To address these concerns, the FDIC issued a regulation under Section 29 that restricts the use of brokered deposits and limits rates paid on interest-bearing deposits that are solicited by banks that are less than "well capitalized" under the Prompt Corrective Action framework.[4] If an institution is "adequately capitalized," it must seek a waiver from the FDIC to accept new brokered deposits, and some institutions may be subject to limits on the rate of interest they may pay on brokered deposits. Brokered deposits also are subject to less favorable treatment under the deposit insurance assessment regulation and Liquidity Coverage Ratio requirements.

Section 29 defines a "brokered deposit" as simply a deposit accepted through a "deposit broker." Thus, the meaning of the term "brokered deposits" turns upon the definition of "deposit broker" — if a deposit is accepted through a person who is a "deposit broker," the deposit is a brokered deposit. The FDIC expansively interpreted the scope of the restrictions on brokered deposits by adopting a broad definition of "deposit broker" that was further expanded through subsequent, fact-specific staff interpretations.[5] For example, affiliates and subsidiaries of a depository institution have been considered deposit brokers, as were employees of a depository institution who are not employed exclusively by the institution (e.g., certain individuals dually employed by a financial institution and an affiliate).

Under the FDIC's prior regulation, a deposit broker was defined as:

> Any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions, or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties; and
>
> An agent or trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan.[6]

Consistent with Section 29, the FDIC excluded certain persons from the definition of deposit broker. Persons excluded from the definition of deposit broker include those "whose primary purpose is not the placement of funds with depository institutions" (referred to as the "Primary Purpose Exception").[7] While helpful, many of these exceptions proved difficult to interpret or apply because of general changes to the business of banking and the specific changes to the acceptance of deposits.

The FDIC's framework for identifying and regulating brokered deposits had not changed for many years, although the agency recently amended its regulations to implement a provision of the 2018 regulatory reform legislation that excludes a capped amount of certain reciprocal deposits from treatment as brokered deposits.[8] As noted above, this inaction increased the burden from applying the FDIC's framework; for example, as technology has evolved, many banks have innovated away from the branch model that made deposit solicitation analysis simple and straightforward. Also, the FDIC released a study on brokered deposits in 2011 that was required by the Dodd-Frank Act and published an advanced notice of proposed rulemaking on the topic in December 2018 that is the predicate to the Proposal.[9] These developments highlighted the vagueness and effort associated with reviewing contracts and agreements to determine brokered deposit status.

Substantive Changes to Definitions and Exclusions

The Revisions narrow the definition of "deposit broker" by more clearly defining the term and creating more exclusions . The Revisions also change the way in which the limitations on the rates paid on interest-bearing deposits that are solicited by certain banks are calculated and clarify the application of Section 29 to non-maturity deposits.

WHO IS A DEPOSIT BROKER?

First, the Revisions replace the current two-part definition of "deposit broker" with the following four-part definition, which is focused on whether the putative broker has certain types of business relationships with a customer:

(i) Any person engaged in the business of placing deposits of third parties with insured depository institutions;

(ii) Any person engaged in the business of facilitating the placement of deposits of third parties with insured depository institutions;

(iii) Any person engaged in the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties;[10] and

(iv) An agent or trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan.

Second, the Revisions limit the definitions of "engaged in the business" to situations in which a person acts with respect to more than one depository institution and has a business relationship with the depositor on whose behalf the deposit is being placed. These changes were not in the Proposal, but are intended to respond to industry comments and more closely adhere to the language and intent of Section 29. The primary consequence of these changes is that persons operating exclusive deposit placement arrangements (i.e., a person places deposits at one and only one insured depository institution) will not be deposit brokers, and, therefore, the deposits they place will not be brokered deposits.[11] This may be particularly significant for affiliates and subsidiaries of a depository institution and dual employees, who may place deposits only with the affiliated depository institution.

Third, the Revisions limit the definition of "engaged in the business of placing deposits" to situations in which the person actually receives third-party funds and deposits those funds at more than one depository institution. This change is intended to provide additional clarity on the acts required to be a deposit broker.

Fourth, the Revisions more narrowly define facilitation of deposit placement to limit it to circumstances in which the putative broker takes an active role in opening the account or maintains a level of influence or control over the account after it is open. This reflects the FDIC's intent to tailor the definition of facilitation to circumstances where deposits are less stable as a result of the ability of deposit brokers to control the movement of deposits between depository institutions, as well as the FDIC's view that the non-business activities and purely administrative activities should not cause a person to become a deposit broker.

Under the Revisions, facilitation of deposit placement would occur when the putative broker:

(i) Has legal authority, contractual or otherwise, to close the account or move the third party's funds to another insured depository institution;

(ii) Is involved in negotiating or setting rates, fees, terms, or conditions for the deposit account; or

(iii) Is engaged in matchmaking activities.[12]

This definition is somewhat narrower than was in the Proposal and reflects the FDIC's determination that certain information sharing administrative activities by a person would not influence the movement of deposits between insured depository institutions.[13]

WHO IS EXCLUDED FROM BEING A DEPOSIT BROKER?

Historically, one of the statutory exceptions, the Primary Purpose Exception, was narrowly construed and effectively limited to a handful of specific circumstances that were articulated in FDIC staff interpretations. The Revisions expand the Primary Purpose Exception to explicitly be available to an agent or nominee that is engaged in one or more of 14 designated businesses.[14] This is broader than the Proposal, which would have extended the Primary Purpose Exception to be available to a person who (i) has assets under administration for customers and places less than 25 percent of its total assets under administration for a business line at depository institutions or (ii) places customer funds in transactional accounts at depository institutions to enable transactions or make payments. The 14 designated businesses are listed in Appendix A and largely adopt concepts from prior FDIC staff interpretations. For example, the designated business exclusion for assets under administration effectively codifies the industry-wide relief provided in Advisory Opinion 05-02, although at a more generous ratio than previously provided by staff.[15]

Eligibility for the designated business exclusions will assessed on a business line basis, which means that a person may be able to rely on multiple exclusions for different business lines. The FDIC expects that a person will determine their own appropriate business lines in good faith, bearing in mind that a business line will usually consist of the business relationships with the specific group of customers for whom the person places or facilitates the placement of deposits. The FDIC also expects that depository institutions will have awareness of persons involved in the placement of deposits (i.e., deposit broker or person relying on an exclusion under the Primary Purpose Exception) to properly complete Call Report fields for brokered deposits and will be able to access records related to the Primary Purpose Exception that are maintained by such persons.

The Revisions recognize that other arrangements may qualify for the Primary Purpose Exception, and will allow agents and nominees to apply to use the Primary Purpose Exception on a case-by-case basis. The FDIC also may determine that an approved arrangement should be made generally available to the industry as another arrangement that the FDIC has specifically identified as a designated businesses. However, the preamble to the Revisions explicitly states that the Primary Purpose Exception will not be available if the purpose of the broker's relationship with the customer is to encourage savings, maximize yield, or provide deposit insurance, or has a similar purpose to those examples.

INTEREST RATE LIMITS ON INSTITUTIONS THAT ARE NOT WELL CAPITALIZED

Under Section 29, well capitalized institutions are not subject to any interest rate restrictions. However, the statute imposes interest rate restrictions on insured depository institutions that are less than well capitalized, as defined under the prompt corrective action framework. Specifically, the statutory interest rate restrictions generally limit a less than well capitalized institution from offering rates on deposits that significantly exceed rates in its prevailing market.

The Revisions amend the FDIC's methodology for calculating the national rate, the national rate cap, and the local rate cap for these purposes. The Revisions also provide a new simplified process for institutions that seek to offer a competitive rate when the prevailing rate in an institution's local market area exceeds the national rate cap.

Under the Revisions, the national rate cap will be the higher of: (i) the national rate, as based on weighting by deposits rather than branches (and including credit unions), plus 75 basis points; or (ii) 120 percent of the current yield on similar maturity US Treasury obligations, plus 75 basis points.

The Treasury-based second prong would also provide that, for non-maturity deposits, the prong is the federal funds rate, plus 75 basis points.

Further, the local market rate cap will be 90 percent of the highest offered rate in the institution's local market geographic area. Specifically, a less than well capitalized institution will be permitted to provide evidence that any bank or credit union with a physical presence in its local market area offers a rate on a particular deposit product in excess of the national rate cap. The local market area may include the state, county or metropolitan statistical area in which the insured depository institution accepts or solicits deposits.

The Revisions also eliminate the current two-step process where less than well capitalized institutions request a high rate determination from the FDIC and, if approved, calculate the prevailing rate within local markets. Instead, a less than well capitalized institution may notify the FDIC that it intends to offer a rate that is above the national rate cap and provide evidence that an insured depository institution or credit union with a physical presence in the less than well capitalized institution's normal market area is offering a rate on a particular deposit product in its local market area in excess of the national rate cap.

TREATMENT OF NON-MATURITY DEPOSITS

Section 29 does not explicitly explain how its restrictions apply to deposits that are non-maturity deposits. The Revisions adopt a new interpretation for the solicitation and acceptance of non-maturity deposits that focuses on whether the institution is opening a new account for a customer, accepting deposits in excess of those a customer held at the institution prior to the prompt corrective action downgrade, or increasing the interest rate on the account. Non-maturity deposits would be considered accepted in instances when, after the institution becomes less than well capitalized, a non-maturity brokered deposit account is open; the amount of non-maturity brokered deposit through a particular deposit broker increases the balance above the level existing at the institution at the time of the downgrade; or, for an agent or nominee accounts, when new funds of a new beneficial owner are added to the account.

The preamble to the Revisions notes that the FDIC is considering further modifications to its deposit insurance assessment regulations. Any modifications, however, will be addressed through separate rulemakings at a later date.

Procedural Changes for Primary Purpose Exception

The Revisions add a new process that may be used by any insured depository institution or deposit broker to qualify for the Primary Purpose Exception, thus allowing persons who would otherwise be deposit brokers to avoid this classification.

Persons relying on the designated business exclusions for (i) having assets under administration for customers and placing less than 25 percent of those total assets under administration at depository institutions or (ii) placing customer funds in transactional accounts at depository institutions to enable transactions or make payments must submit a notice to the FDIC or have the institutions at which the deposits are placed submit notice. A person also must notify the FDIC if it previously relied on one of these two designated business exclusions but no longer satisfies the Primary Purpose Exception. The FDIC may request information from filers, but generally expects to make such requests only if there is a reason to believe that the person does not meet or no longer meets the criteria for exclusion.

An institution or person that relies on the 25 percent exclusion will need to provide reports, generally quarterly, on its brokered deposits activity. The reports would need to be submitted to the FDIC. A person or institution that invokes the payments facilitator exclusion will need to provide an annual certification to the FDIC that the person continues to place all customer funds at depository institutions into transaction accounts and that customers do not receive or accrue any interest, fees, or other remuneration.

For 12 other designated business exclusions, no notice is required by the person involved in the placement of deposits or the institution receiving the deposits.

For arrangements not covered by a designated business exclusion, a person or institution would need to submit an application to qualify for the Primary Purpose Exception. Applications would need to include sufficient information to demonstrate that the primary purpose of the person's particular business line is something other than the placement of funds and address the relationship's revenue structure, marketing activities, and fee arrangements.[16] While an application may be submitted by an institution, the FDIC expects that most applications will be submitted by persons involved in the placement of deposits. The FDIC notes that it may impose reporting requirements in connection with approved applications.

Key Takeaways from the Revisions

It is expected that a large portion of existing brokered deposits will no longer be characterized as brokered under the Revisions. These deposits may still be subject to certain reporting requirements, but they would not be subject to the general restrictions on brokered deposits or the less favorable treatment for brokered deposits under the Liquidity Coverage Ratio and deposit insurance assessments.

While the FDIC notes that only 10 institutions (as of June 30, 2020) are subject to the restrictions on brokered deposits (i.e., are not well capitalized), the Revisions are relevant to the more than 1,900 institutions currently reporting brokered deposits. These institutions may be able to reclassify their existing brokered deposits to obtain more favorable treatment for brokered deposits under the Liquidity Coverage Ratio (or the Net Stable Funding Ratio, once effective) or deposit insurance assessments. These institutions also may need to revise their compliance programs to account for the inactivation of all prior public staff advisory letters (as of January 1, 2022) and the creation of new exclusions in the Revisions.

Furthermore, the FDIC estimates that hundreds of persons will be required to make filings to (i) rely on one of the two designated business exclusions that require prior notice or (ii) obtain approval for arrangements that are not covered by any of the exclusions. Putative deposit brokers should consider submitting filings as early as possible, particularly for applications, given that this is a new reporting regime for the FDIC and agency resources may be constrained as the January 2022 deadline approaches.

Overall, the Revisions are a significant step toward rationalizing the FDIC's approach to regulating brokered deposits. They also are consistent with the movement away from relying on staff guidance in place of formal agency action, as all existing public interpretations (listed at the end of the Revisions) will be moved to inactive status. However, some of the remaining problematic elements of the restrictions on brokered deposits are hardcoded into the statute (e.g., limitations on FDIC's waiver authority), and, therefore, action from Congress may be necessary to effect full reform.

Endnotes

[1] Press Release, *FDIC Board Approves Final Rule on Brokered Deposit and Interest Rate Restrictions* (Dec. 15, 2020), https://www.fdic.gov/news/press-releases/2020/pr20136.html.

[2] Press Release, *FDIC Issues Proposed Rule on Brokered Deposit Restrictions* (Dec. 12, 2019), https://www.fdic.gov/news/news/press/2019/pr19121.html; Press Release, *FDIC Issues Proposed Rule on Interest Rate Restrictions Applicable to Less Than Well Capitalized Institutions* (Aug. 20, 2019), https://www.fdic.gov/news/press-releases/2019/pr19072.html. See our article on the Proposal: https://www.mayerbrown.com/en/perspectives-events/publications/2020/01/reverseinquiries.

[3] 12 U.S.C. § 1831f. The requirement for deposit brokers to notify the FDIC was repealed by Congress in 2000.

[4] 12 C.F.R. § 337.6.

[5] FDIC, *Advisory Opinions: Brokerage Activities* (Aug. 30, 2019), https://www.fdic.gov/regulations/laws/rules/4000-100.html#fdicbrok.

[6] 12 C.F.R. § 337.6(a)(5)(i).

[7] 12 C.F.R. § 337.6(a)(5)(ii)(I).

[8] 84 Fed. Reg. 1346 (Feb. 4, 2019).

[9] 84 Fed. Reg. 2366 (Feb. 6, 2019); FDIC, *Study on Core Deposits and Brokered Deposits* (July 8, 2011; updated in 2019 to reflect 2017 data in Appendix 2).

[10] The FDIC has stated that this prong of the definition is intended to "capture" the brokered certificate of deposit ("CD") market and would apply to registered broker-dealers who subdivide bank-issued "master CDs" and then sell the modified CDs to brokerage customers. Such arrangements, however, are within the scope of the existing definition of "deposit broker," and, therefore, should not be viewed as an expansion of the restrictions.

[11] The preamble to the Revisions notes that a person may not create multiple entities to indirectly maintain "exclusive" relationships with multiple insured depository institutions.

[12] Matchmaking is further defined as proposing "deposit allocations at, or between, more than one bank based upon both (a) the particular deposit objectives of a specific depositor or depositor's agent, and (b) the particular deposit objectives of specific banks, except in the case of deposits placed by a depositor's agent with a bank affiliated with the depositor's agent."

[13] The FDIC discusses elsewhere in the preamble to the Revisions that deposit broker status is determined on a person-by-person basis, and, therefore, a third-party intermediary that provides administrative functions to a person placing deposits would need to separately determine if it is a deposit broker.

[14] The Revisions did not expand the exclusion for deposits that an institution places with itself to include subsidiaries of a depository institution on the basis that such entities should be able to rely upon the new exclusion for exclusive arrangements.

[15] *See* FDIC, Adv. Op. 05-02 (Feb. 3, 2005). This option excludes broker-dealers that sweep uninvested cash balances into deposit accounts, so long as those cash balances do not exceed 25 percent of the broker's assets under administration.

[16] The Revisions explicitly exclude brokered CD placement from being part of a business line that is the subject of an application.

Appendix A: Designated Businesses Within the Primary Purpose Exception

Business relationships where, with respect to a particular business line:

(i) less than 25 percent of the total assets that the agent or nominee has under administration for its customers are placed at depository institutions;

(ii) 100 percent of depositors' funds that the agent or nominee places, or assists in placing, at depository institutions are placed into transactional accounts that do not pay any fees, interest, or other remuneration to the depositor;

(iii) a property management firm places, or assists in placing, customer funds into deposit accounts for the primary purpose of providing property management services;

(iv) the agent or nominee places, or assists in placing, customer funds into deposit accounts for the primary purpose of providing cross-border clearing services to its customers;

(v) the agent or nominee places, or assists in placing, customer funds into deposit accounts for the primary purpose of providing mortgage servicing;

(vi) a title company places, or assists in placing, customer funds into deposit accounts for the primary purpose of facilitating real estate transactions;

(vii) a qualified intermediary places, or assists in placing, customer funds into deposit accounts for the primary purpose of facilitating exchanges of properties under section 1031 of the Internal Revenue Code;

(viii) a broker dealer or futures commission merchant places, or assists in placing, customer funds into deposit accounts in compliance with 17 C.F.R. § 240.15c3-3(e) or 17 C.F.R. § 1.20(a);

(ix) the agent or nominee places, or assists in placing, customer funds into deposit accounts for the primary purpose of posting collateral for customers to secure credit-card loans;

(x) the agent or nominee places, or assists in placing, customer funds into deposit accounts for the primary purpose of paying for or reimbursing qualified medical expenses under section 223 of the Internal Revenue Code;

(xi) the agent or nominee places, or assists in placing, customer funds into deposit accounts for the primary purpose of investing in qualified tuition programs under section 529 of the Internal Revenue Code;

(xii) the agent or nominee places, or assists in placing, customer funds into deposit accounts to enable participation in the following tax-advantaged programs: individual retirement accounts under section 408(a) of the Internal Revenue Code, SIMPLE individual retirement accounts under section 408(p) of the Internal Revenue Code, and Roth individual retirement accounts under section 408A of the Internal Revenue Code;

(xiii) a federal, state, or local agency places, or assists in placing, customer funds into deposit accounts to deliver funds to the beneficiaries of government programs; and

(xiv) the agent or nominee places, or assists in placing, customer funds into deposit accounts pursuant to such other relationships as the FDIC specifically identifies as a designated business relationship that meets the Primary Purpose Exception.

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SPA
Structured Products Association

2021 STRUCTURED PRODUCTS LEGAL, REGULATORY AND MARKET BRIEFING

SUPPLEMENTAL MATERIALS | MAY 13, 2021

Panel 1

Innovations in ESG-linked Structures

MAYER | BROWN

April 19
2021

US Interest in Sustainability-Linked Loans on the Rise

Eye on ESG Blog

On April 15, 2021, General Mills, a leading global food company, announced that it had closed the first-ever sustainability-linked loan (**SLL**) facility for a US consumer packaged goods company.

The $2.7 billion five-year multi-currency revolving credit facility (**RCF**) was arranged by Bank of America (which acts as administrative agent) and syndicated to a significant number of banks and other lenders.

The RCF was filed with the US Securities and Exchange Commission and includes a matrix that will adjust the applicable interest rate and fees under the RCF based on General Mills' reductions in its greenhouse gas emissions in owned operations (i.e., only Scope 1 and 2 emissions) and its use of renewable electricity for global operations.

Relatedly, the US Loan Syndications and Trading Association, together with the Loan Market Association (**LMA**) and the Asia Pacific Loan Market Association, released their Social Loan Principles earlier this month.

SLLs are more common in the European loan market, and on April 7, 2021, the LMA and the European Leveraged Finance Association (**ELFA**) published an insights report titled "*Are ESG margin ratchets saving the planet, or saving borrowers money?*" The report covers the current state of ESG-linked provisions in the European leveraged finance market and looks at how the industry can respond, the LMA and ELFA's next steps, and how to get involved.

Based on our previous analyses of international loan market developments in green, social and sustainable finance (see our earlier Perspectives here, here and here) and the steadily increasing interest in SLLs from our clients—both borrowers and lenders—we expect to see steady growth of this product in the United States.

The post US Interest in Sustainability-Linked Loans on the Rise appeared first on Eye on ESG.

MAYER | BROWN

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The Growth of ESG in Fund Finance and Other Financial Products in the United States

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"[C]limate risk is investment risk … And because capital markets pull future risk forward, we will see changes in capital allocation more quickly than we see changes to the climate itself." – Larry Fink, BlackRock, Annual Letter to CEOs

I. Introduction

In recent years, there has been a trend in the financial markets towards greener, environmentally friendly investments, and private equity funds ("Funds") are no exception. Such Funds and their limited partners are increasingly interested in environmental, social and governance ("ESG") aspects of Fund investments. For instance, in 2019, $20.6 billion was invested by US investors in sustainable Funds, nearly four times more than in 2018.[1] And even in these unprecedented times, investments in sustainable Funds for the first half of 2020 reached $20.9 billion, and total assets in sustainable Funds hit a record high of $1.1 trillion as of the end of June 2020.[2] The COVID-19 pandemic and its effect on global economies has only intensified the focus on ESG principles, with many policymakers and investors drawing parallels between the unforeseen risks of a pandemic and issues such as climate change and calling attention to the importance of considering environmental, social and governance performance, together with more traditional financial metrics, in evaluating investment risks.[3]

While ESG investing still largely takes the form of "impact investing"—investments into companies or funds with the intention to generate a measurable, beneficial social or environmental impact along with a financial return—ESG investing is not just about aligning investment strategies with investor values but also the general principle that ESG-negative behaviors impact investment returns. This Legal Update will focus on the impact of ESG principles on the financial markets in the United States and their growing impact on the fund finance industry.

II. Definition of ESG

As noted above, ESG is shorthand for the environmental, social and governance criteria that, taken together, establish a framework for assessing the impact of the sustainability and ethical practices of a company on its financial performance and operations. The three so-called "ESG pillars" are summarized below:

- <u>Environmental</u>: This category tracks a broad range of environmental issues and environment-related actions. These include use of or dependence on fossil fuels, use of renewable energy, use of hazardous materials, and pollution levels.
- <u>Social</u>: This category considers factors such as conflict risk, human rights, workers' rights, health and safety considerations, community engagement and relations, and equal inclusion.
- <u>Governance</u>: This category considers how a company operates and governs itself and looks at such factors as management of corruption, executive compensation, board diversity and board independence, ownership and shareholder rights, and transparency.

It is important to note that the three ESG pillars can be used to assess not only the risks presented by a particular company or investment but also the opportunities. For example, a Fund that invests in companies in areas of conflict might have a higher risk of financial or reputational difficulties, but those companies may also be taking positive actions to address social issues and improve their relationships with impacted communities. Similarly, a company using fossil fuels may be implementing positive policies or technologies to mitigate the impact of such use.

One of the greatest challenges faced by investors or Fund managers with incorporating ESG principles is the existence of multiple ESG reporting frameworks and the lack of consistency and comparability of metrics among them. This has resulted in concerns of "greenwashing" or investments misleadingly or falsely categorized as abiding by ESG principles.[4] To address this concern, the World Economic Forum recently published a White Paper defining a common set of metrics to measure ESG performance.[5] Regulators in the United States and the European Union have taken note of this as well. In June 2020, the European Parliament adopted regulations to establish an EU-wide classification system or taxonomy for environmentally sustainable economic activities[6] that will impose disclosure requirements on Funds marketed in the European Union, and, in May 2020, the US Securities and Exchange Commission ("SEC") published recommendations on ESG disclosure.[7] Although US regulators have not yet imposed mandatory disclosure regimes or even recommended particular disclosure standards, given the increased investor attention on ESG and pressure to adopt certain ESG disclosure standards, US regulations on ESG should be expected and closely monitored. As the SEC stated in its May 2020 recommendations, the US capital markets are the largest and deepest in the world, and the SEC should take the lead on establishing a reporting regime that will provide investors the information required to make investment decisions on ESG criteria.

III. ESG Investments/Green Bonds Market Trends

ESG spans multiple asset classes. There are "green bonds" and "social bonds," ESG money market funds, "green" mortgage-backed securities, "green loans" and "sustainability-linked" loans. These types of products have recently received significant publicity, including the issuance in the United States of Fannie Mae's Green MBS series and a variety of COVID-19-related Social Impact Bonds issued during 2020. So far, bonds have made up the majority of ESG financial products in the US market. In 2018, there were over $257 billion of ESG bond issuances globally,[8] and, in the third quarter of 2020, ESG bond issuances reached $69 billion, more than any other third-quarter period.[9] US issuers made up the largest portion of this market in 2019, contributing $51 billion to the total. The majority of ESG bonds are "use of proceeds" or asset-linked bonds, where the proceeds are used to fund projects that have positive environmental or climate benefits or which are backed by green assets (for example, a portfolio of residential solar systems or mortgage loans for energy-efficient homes). Compared to ESG bonds, ESG loans make up a much smaller sector of the ESG asset class, with only $10 billion in new loans reported globally in 2019.[10]

Although the principles are voluntary, generally to qualify as a green or social bond an issuance would need to follow principles published by the International Capital Markets Association ("ICMA"), and in the loan market green or social loans would need to follow principles established by the Loan Market Association ("LMA") or the Loan Syndications and Trading Association ("LSTA"). The ICMA, LMA and LSTA identify four core components that should be included in legal documentation for ESG bonds or loans:

- Use of Proceeds. Proceeds of the financing need to be used for green (e.g., renewable energy, energy efficiency, pollution prevention, clean transportation) or social projects (e.g., affordable housing, basic infrastructure such as water or sanitation, food security or socioeconomic advancement), which should be described in the financing documentation.
- Process for Evaluation and Selection. Particular green or social objectives, the process by which projects fit green or social criteria and the process to manage environmental and social risks should be clearly identified.
- Management of Proceeds. Proceeds of the financing should be tracked by the issuer or the borrower to ensure application to green or social projects, and proceeds should be adjusted to match allocations to eligible projects.
- Reporting. Issuers and borrowers should maintain information on use of the proceeds and provide annual reports on the financed projects and the expected impact using qualitative and quantitative performance indicators.

IV. Fund Finance Impact

In recent years, limited partners in Funds have become increasingly prominent in bringing forward the desire to invest in Funds with ESG objectives and many are now monitoring whether the Funds they invest in align with their focus on the social and environmental impacts of various investment strategies. This trend is now evident in many limited partnership agreements ("LPAs") and letter agreements between limited partners and Funds through various provisions that either require or encourage the Fund to consider ESG objectives/factors when sourcing new investments.

The Institutional Limited Partners Association ("ILPA") has also recognized the importance of focusing on sustainable investments. In June 2019, ILPA released its *Principles 3.0: Fostering Transparency, Governance and Alignment of Interests for General and Limited Partners*. The updated principles encourage general partners of Funds to consider "maintaining and periodically updating an ESG policy…[which] should include information sufficient to enable an LP to assess the degree to which the GP's investment strategy and operations are aligned with an individual LP institution's ESG policies." While limited partners may seek to narrowly define ESG metrics to align with their own internal policies, Funds will prefer a more flexible approach that will allow the Fund to meet the ESG expectations of differently situated limited partners, as well as provide room for growth and adaptation of evolving ESG metrics and policies over the life of the Fund. And as further evidence of the evolution of ESG in the context of Funds, recent fund finance transactions in both the United States and Europe have focused on ESG funds that invest in businesses that contribute measurable progress toward one or more of the United Nations Sustainable Development Goals.

We expect that this area will be one of further interest to Funds in the US market, such that we will see more credit facilities tailored to meet certain ESG criteria with respect to how loan proceeds are used (rather than for general corporate purposes). Additionally, we will see more Funds qualify for such financings, as partnership agreements and investment strategies become more tailored to include ESG investment focus and ongoing monitoring and reporting on sustainability factors. We expect to see similar sustainability-focused products offered by other banks in the fund finance market as we move forward in the next few years. In particular, with the changing political environment in the United States and calls for the implementation of new green deals, we anticipate increased focus on ESG principles over the course of the next four years.

V. Conclusion

Sustainable investing is no longer a bespoke niche in the private equity market, and it seems likely an increasing number of Funds will emphasize ESG investment policies moving forward. In a competitive environment for attracting new capital, incorporating ESG-focused policies into LPAs and more general fund investment objectives may not only help to increase marketability to existing and potential limited partners but also promote the important objective of increasing the number of sustainable investments. This has been a growing trend globally, as well as increasingly prominent in the United States in connection with its changing political landscape and overall recognition of the importance of ESG principles.

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[2] https://medium.com/the-esg-advisor/global-esg-fund-assets-top-1-trillion-strong-opposition-to-proposal-limiting-esg-in-retirement-55b3e2d570c3

[3] https://www.jpmorgan.com/insights/research/covid-19-esg-investing

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[9] https://www.climatebonds.net/files/reports/cbi_q3_2020_report_01c.pdf

[10] https://www.climatebonds.net/files/reports/2019_annual_highlights-final.pdf

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ICMA Issues *Climate Transition Finance Handbook* and FAQs

Authors J. Paul Forrester

On December 9, 2020, the International Capital Market Association (ICMA) released its *Climate Transition Finance Handbook* (Handbook) and related Q&As to guide issuers in connection with the issuance of:

- "Use of proceeds" bonds, in line with the Green and Social Bond Principles or Sustainability Bond Guidelines; and
- General corporate purpose bonds, in line with the Sustainability-Linked Bond Principles.

The Handbook is based on the work of the Climate Transition Finance Working Group, made up of representatives from more than 80 entities participating in the capital markets and under the auspices of the Green and Social Bond Principles Executive Committee.

The Handbook's recommendations have four key elements:

- Issuer's climate transition strategy and governance;
- Business model environmental materiality;
- Climate transition strategy to be "science-based," including targets and pathways; and
- Implementation transparency.

The Handbook specifies that relevant disclosures can be included in the issuer's annual report, framework document or investor presentation as long as they are publicly accessible to investors. Concurrently, the recommended independent review, assurance and verifications can be included as either a Second Party Opinion or provided in the context of an issuer's ESG reporting.

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The Future of Data and Tech in the ESG Era

Eye on ESG Blog

Authors Tim Baines Alexander W. Burdulia

Two recent developments indicate the priority importance of, and increasing attention to, ESG data and technology:

- MSCI (a provider of decision support tools and services for the global investment community) recently listed "The ESG Data Deluge" as one of its five ESG Trends for 2021. MSCI recognizes that the voluntary disclosure of ESG data by companies is increasing at a time when mandatory disclosure regulations are taking shape around the world, creating the "perfect storm" for a flood of company-related ESG data.
- Meanwhile, ESMA (the EU securities regulator) recently called for the supervision and regulation of the ESG ratings and assessment industry, which relies on a range of ESG inputs, including company disclosures, to rate and analyze the sustainability performance of companies. These ratings and analyses are in turn used by a range of market participants as ESG data inputs for a variety of purposes.

As a flood of ESG data converges with a call for increased regulation by a critical securities regulator, data issues are likely to stay at the forefront of the ESG discussion for the foreseeable future. In this Blog Post, we highlight the significant commercial interest in ESG data and tech, as well as how some deficiencies in ESG data have led to increased regulatory attention.

The Current Landscape

Companies can't "do ESG" in a vacuum, nor can investors. Data users must be able to analyze and compare ESG information in order to determine how well companies are performing against their peers, as well as for lending and investment purposes. The need for data has created numerous startups focused on ESG data collection, ratings and analysis, as well as noteworthy M&A activity involving established firms. Further, artificial intelligence and new, different types of data will increasingly support compliance with existing and new ESG regulations, creating even more opportunities for innovation.

Continued Commercial Interest

It is difficult to overstate the commercial interest in ESG data. Earlier this year, BlackRock bought a stake in the sustainability platform Clarity AI. This investment is the latest step for BlackRock's Aladdin platform, which continues to invest in its sustainability capabilities. Last year, it added 1,200 sustainability metrics and established data partnerships to help investors understand ESG and physical climate risks and opportunities.

Elsewhere, according to S&P Global:

"Several big financial companies have looked to build out their ESG data offerings through M&A in recent years. Moody's Corp. struck three separate ESG deals in 2019, including acquisitions of [ESG research and services firm] Vigeo Eiris, [climate data, intelligence and analysis firm] Four Twenty Seven Inc. and a minority stake in [consultancy and research firm] SynTao Green Finance. Institutional Shareholder Services Inc., the U.S.-based proxy advisory giant, has purchased four separate ESG data and research providers since 2015. And MSCI Inc. and S&P Global Inc. have each announced several ESG-related purchases of their own."

The Shortcomings of ESG Data and Tech

Given this acquisitive interest from established market players, it is not surprising that there hundreds of different ESG data providers with as many unique approaches. For example, ESG Tech describes itself as solving the "scalability of KPI-linked financial products offered by financial institutions." They do this by "advancing the acquisition and verification process of ESG material disclosure of corporate clients, underlying assets, for corporate banking, fixed income and alternative investments." Datamaran describes itself as "the market leader in external risk management" with an approach "based on evidence and facts, not opinions." Datamaran's "technology supports a structured business process for external risk identification and monitoring, so you make confident decisions now and for the future."

These are but two examples in an increasingly crowded marketplace. But how consistent is the ESG data generated by different firms? Unlike financial data, ESG disclosure currently does not have generally-accepted principles, which leads to problems of comparability and decision-usefulness across data from different service providers and companies.

Indeed, according to some, ESG data analysis still needs significant improvement. For example, Boston-based PanAgora Asset Management still collects most of its own ESG data. When the firm does buy data from third parties, it collects the underlying information in its raw format in order to avoid any "pre-bottled scores". PanAgora doesn't want to invest in ideas that are "offered up to everybody". As noted by Curt Custard, CIO at Newton Investment Management, "Data and the quality of it is very important . . . . In the asset management space, we are used to robust data infrastructure and reporting, but now it just doesn't exist for ESG." Further, in the words of MSCI, "new regulations are taking effect and voluntary reporting standards are becoming mandatory in some countries, and these requirements are putting a lot more pressure on your investors".

Increased Regulatory Scrutiny

As regulators require the disclosure of more ESG information from more companies, the ability to scrutinize this data will improve. It will then become increasingly easier to identify the inconsistencies and non sequiturs that investors already find in disclosures. Amidst this backdrop, additional regulatory responses are likely to follow.

ESMA's statement on the need to regulate ESG ratings and assessment firms is indicative of potential regulatory responses to the current shortcomings of ESG data. Among other things, ESMA suggests a legislative solution that:

- develops a common legal definition for an "ESG rating";
- requires registration and supervision of ESG ratings agencies by public authorities;
- sets out specific product requirements applicable to ESG ratings and assessments; and
- ensures that larger, systemic entities are subject to more robust requirements.

Whether or not the European Commission moves forward with a legislative initiative in line with ESMA's proposal, regulators around the world may take note of this approach. As the flood of ESG data continues into the future, surely we can expect regulators to follow ESMA's lead and adopt new regulation around this increasingly valuable commodity?

The post The Future of Data and Tech in the ESG Era appeared first on Eye on ESG.

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VOLUME 03, ISSUE 1 | January 6, 2020

REVERSE inquiries

Structured and market-linked product news for inquiring minds.

IRS Again Extends Phase-In of Section 871(m) Regulations

On December 16, 2019, the Internal Revenue Service (the "IRS") released Notice 2020-2 (the "Notice"),[1] which further extends the phase-in of regulations under Section 871(m) of the Code[2] (the "Regulations")[3] and related provisions. Section 871(m) and its Regulations generally treat "dividend equivalents" paid (or deemed paid) under certain contracts as U.S. source dividends that are subject to withholding tax if paid to a non-U.S. person.

In This Issue

Prior to the release of the Notice, the IRS had issued the following guidance on the Regulations:

- Notice 2010-46 containing the qualified securities lender (the "QSL") regime, published in June 2010;
- Notice 2016-76 delaying the effective date of the Regulations, among other things, published in December 2016, and its corresponding final and temporary regulations published in January 2017;[4]
- Revenue Procedure 2017-15 containing the final Qualified Intermediary Agreement (the "2017 QI Agreement"), published in January 2017;
- IRS Notice 2017-42 providing a similar phase-in of the Regulations and related provisions, published in August 2017; and
- IRS Notice 2018-72 also providing a similar phase-in of the Regulations and related provisions, published in October 2018.[5]

The Notice is a near mirror image of Notice 2018-72, again providing for extensions to four areas related to Section 871(m): (1) the phase-in for non-delta-one transactions, (2) the simplified standard for determining

[1] Notice 2020-2 is available at http://bit.ly/2YRdrXa.

[2] All section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations promulgated thereunder.

[3] For a more detailed discussion of the 2015 final regulations, see http://bit.ly/2ZPqIA6.

[4] For a more detailed discussion of Notice 2016-76, see http://bit.ly/2SKXwbJ.

[5] For a more detailed discussion of Notice 2018-72, see http://bit.ly/39wBSxW.

whether transactions are "combined transactions" within the meaning of the Regulations, (3) relief for qualified derivative dealer ("QDD") reporting,[6] and (4) the transition out of the qualified securities lender (the "QSL") regime. Each of these extensions is discussed in more detail below.

In addition to the Notice, the IRS also released a small set of regulations finalizing some temporary regulations under Section 871(m).[7] Those final regulations do not make significant changes.

Extension of Phase-in for Delta-One and Non-Delta-One Transactions

Under previous IRS guidance, the Regulations would not apply to potential Section 871(m) transactions[8] that were not delta-one and that were entered into before January 1, 2021. The Notice extends this relief for non-delta-one transactions to cover transactions entered into before January 1, 2023.[9] This additional two-year extension is welcome to the structured products market, since a majority of structured products are non-delta-one transactions.

The Regulations still apply to any potential Section 871(m) transaction that has a delta of one entered into on or after January 1, 2017.

Previous IRS guidance provided that 2017-2020 would be phase-in years for delta-one transactions, meaning that the IRS would take into account a taxpayer's or withholding agent's good faith effort[10] to comply with the Regulations when enforcing the same. Prior guidance also provided that through 2020 non-delta-one transactions would be reviewed on this good faith standard. The Notice extends this more lenient enforcement standard through 2022 for delta-one transactions and provides that examinations of non-delta-one transactions will use the good faith standard through 2022. Additionally, previous IRS guidance provided that the IRS would take into account the extent to which a qualified derivatives dealer (a "QDD") made a good faith effort to comply with the Regulations and the relevant provisions of the 2017 QI Agreement through 2020. The Notice extends this similar good faith enforcement standard through 2022.

Extension of the Simplified Standard for Determining Whether Transactions Are Combined Transactions

IRS guidance provides for a simplified standard for withholding agents to apply in determining whether two or more transactions should be combined in order to determine whether the transactions are subject to Section 871(m), namely that a broker may presume that transactions should not be combined for Section 871(m) purposes unless they are over-the-counter transactions that are priced, marketed, or sold in connection with each other. Under the general rule in the Regulations, a short party could have presumed that transactions that

[6] For a more detailed discussion of the QDD rules, see http://bit.ly/2tnBu4f.

[7] Those final regulations are available at http://bit.ly/2FcslhC.

[8] See Treas. Reg. Section 1.871-15(a)(12). A "potential Section 871(m) transaction" is any securities-lending or sale-repurchase transaction, NPC, or ELI that references one or more underlying securities.

[9] The Notice and thus the grandfather for non-delta-one instruments does not apply to a "specified NPC," as described in Treas. Reg. section 1.871-15(d)(1).

[10] Relevant considerations for the determination of good faith include whether a taxpayer or withholding agent made a good faith effort to: (i) build or update its documentation and withholding systems to comply with the Section 871(m) regulations, (ii) determine whether transactions are combined, (iii) report information required under the Section 871(m) regulations, and (iv) implement the substantial equivalence test. *See* Notice 2016-76.

together generate the required dividend equivalent payments are not entered into in connection with each other if either (i) the long party holds the transaction in separate accounts and the short party does not have actual knowledge that the accounts were created separately to avoid Section 871(m) or (ii) the transactions were entered into two or more business days apart. IRS guidance provided a simplified standard for 2017-2020. The Notice extends application of the simplified standard through 2022.

Extension of Phase-ins for QDDs

The Notice extends the same three QDD phase-ins that were pushed until 2021 by prior IRS guidance. Previous IRS guidance provided that a QDD:

- will not be subject to tax on dividends and dividend equivalents received in the QDD's equity derivatives dealer capacity until 2021;
- will be required to compute its Section 871(m) tax liability using a net delta approach beginning January 1, 2021; and
- pursuant to the 2017 QI Agreement must perform certain periodic reviews with respect to its QDD activities, but only beginning in 2021.

The Notice pushes each of these dates back to begin in 2023.

Extension of QSL Transition Rules

Notice 2010-46 contained an early IRS solution to potential overwithholding on a chain of dividends and dividend equivalents (i.e., where an intermediary is withheld upon and subsequently withholds on the same payment stream). The QSL regime provides for (1) an exception to withholding for payments to a QSL, and (2) a framework to credit forward prior withholding on a chain of dividends and dividend equivalents. The QDD rules were meant to replace the QSL regime; however, IRS guidance provided that withholding agents may use the QSL rules for payments made in 2018 through 2020. The Notice provides that withholding agents can use the QSL rules for payments made in 2021 and 2022 as well.

Looking Forward

What will ultimately become of Section 871(m) and its regulations? The tax community has wondered whether non-delta-one transactions might one day become exempt from the Regulations completely. However, with extensions until 2023, Section 871(m) and its regulations may go back on the back burner for the immediate future. The Notice states that taxpayers are permitted to rely on it until the Regulations and the 2017 QI Agreement are amended to reflect the extensions contained in the Notice.

FDIC Proposes Changes to Brokered Deposits Restrictions

On December 12, 2019, the Federal Deposit Insurance Corporation ("FDIC") proposed revisions to the restrictions on brokered deposits (the "Proposal").[11] The Proposal is intended to modernize the FDIC's

[11] Press Release, *FDIC Issues Proposed Rule on Brokered Deposit Restrictions* (Dec. 12, 2019), http://bit.ly/2SO9PEc.

framework for brokered deposits, and would revise both the substantive regulations for brokered deposits and the procedures for requesting exceptions and filing reports.

The Proposal would narrow the scope of the brokered deposits regulation by (i) more explicitly defining who is a deposit broker and (ii) expanding the exclusions for putative brokers that are subsidiaries of the insured depository institution or operate with a primary purpose other than placing funds at depository institutions (the "Primary Purpose Exception").

As is relevant to structured products, the Proposal would define "deposit broker" to include: "Any person engaged in the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties." The FDIC states that this prong of the definition is intended to "capture" the brokered certificate of deposit ("CD") market and would apply to registered broker-dealers who subdivide bank-issued "master CDs" and then sell the modified CDs to brokerage customers. Such arrangements, however, are within the scope of the existing definition of "deposit broker," and, therefore, should not be viewed as an expansion of the restrictions.

With respect to the Primary Purpose Exception, the Proposal would:

1. Expand the Primary Purpose Exception to explicitly be available to an agent or nominee that (i) has assets under management for customers and places less than 25 percent of its total assets under management at depository institution[12] and (ii) places customer funds in transactional accounts at a depository institution to enable transactions or make payments. The assets under management option appears to be designed for broker-dealers that sweep uninvested cash balances into deposit accounts, so long as those cash balances do not exceed 25 percent of the broker's assets under management.
2. Provide that assets under management will be measured based on the total market value of all financial assets that are managed on behalf of customers that participate in a particular business line of an agent or nominee.[13] The inclusion of a business line element in this provision is intended to prevent brokers from amalgamating unrelated business lines to satisfy the 25 percent aggregate threshold discussed above.
3. Clarify that the Primary Purpose Exception will not be available if the purpose of the broker's relationship with the customer is to encourage savings, maximize yield, or provide deposit insurance, or has a similar purpose to those examples.
4. Provide a formal process for institutions and putative deposit brokers to apply to qualify for the Primary Purpose Exception (including arrangements beyond the assets under management and enabling transactions), thus allowing persons who would otherwise be deposit brokers to not be treated as such.

It is expected that a portion of existing brokered deposits would no longer be characterized as brokered under the Proposal. While such deposits may be subject to certain reporting requirements, they would not be subject

[12] This action would effectively codify the industry-wide relief provided in Advisory Opinion 05-02, although it would be more generous than the staff relief. *See* FDIC, Adv. Op. 05-02 (Feb. 3, 2005).

[13] A "business line" would be defined as the group of customers for whom the agent or nominee places or facilitates the placement of deposits as part of a broader business relationship.

to the general restrictions on brokered deposits or the less favorable treatment for brokered deposits under the Liquidity Coverage Ratio and deposit insurance assessments.[14]

Comments on the Proposal must be submitted to the FDIC within 60 days of publication in the Federal Register. Please stay tuned for Mayer Brown's more fulsome alert and webinar on the Proposal in early 2020.

Proposed Sales Practice Rule Affects Leveraged/Inverse ETFs; ETNs and Structured Notes Also in the Crosshairs

On November 25, 2019, the Securities and Exchange Commission ("SEC") re-proposed Rule 18f-4, a new rule under the Investment Company Act of 1940 (the "1940 Act"), which is designed to address the investor protection purposes and concerns underlying Section 18 of the 1940 Act, and update the SEC's approach to the regulation of funds' use of derivatives. The proposed rule would apply to, among others, exchange-traded funds ("ETFs").[15]

The Release also proposed two new sales practice rules, which would require a broker, dealer or investment adviser that is registered (or required to be registered) with the SEC (a "RIA") under the Investment Advisers Act of 1940 (the "Advisers Act") to exercise due diligence in approving a retail customer's or client's account to buy or sell shares of certain "leveraged/inverse investment vehicles" before accepting any order from, or placing an order for, the customer or client to engage in these transactions.[16] The proposed sales practice rules are designed to address specific risks posed by "leveraged/inverse investment vehicles," which include registered investment companies and exchange-listed or commodity- or currency-based trusts or funds that seek, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specific multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time, generally on a daily basis.[17]

Proposed Rule 15*l*-2 under the Securities Exchange Act of 1934 ("the Exchange Act") would require a broker-dealer (or any of its associated persons) to exercise due diligence to ascertain certain essential facts about a customer who is a retail investor before accepting the customer's order to buy or sell shares of a leveraged/inverse ETF, or approving the customer's account to engage in those transactions. Proposed Rule 211(h)-1 under the Advisers Act would have a similar effect on an RIA. Under both of these proposed rules, a firm could approve the retail investor's account to buy or sell shares of a leveraged/inverse ETF only if the firm had a reasonable basis to believe that the investor is capable of evaluating the risks associated with these products.[18]

[14] The preamble to the Proposal notes that the FDIC is considering further modifications to its deposit insurance assessment regulations.

[15] Release No. 34-87607 (Nov. 25, 2019) (the "Release") is available at: http://bit.ly/39BkXKu.

[16] The proposed sales practice rules are contained in Rule 15*l*2 under the Securities Exchange Act of 1934 and Rule 211(h)-1 under the Advisers Act.

[17] See the Release at 13 and FN13. For the purposes of this article, we will refer only to ETFs.

[18] See the Release at 181-182.

The SEC noted in the Release that compliance with the proposed rules would not supplant, by itself, other broker-dealer or investment adviser obligations, such as a broker-dealer's obligations under Regulation Best Interest or a RIA's fiduciary duty under the Advisers Act. The Release did not mention broker-dealers' obligations under Financial Industry Regulatory Authority, Inc. ("FINRA") Rule 2111 (Suitability), perhaps because the market anticipates that Regulation Best Interest will essentially supplant FINRA Rule 2111's suitability requirements.

The proposed sales practice rules are modeled on current FINRA rules governing options account approval requirements for broker-dealers.[19] Under these FINRA rules, a broker-dealer may not accept a customer's options order unless the broker-dealer has approved the customer's account for options trading. The SEC used these FINRA rules as a model because leveraged/inverse ETFs, when held over longer periods of time, may have certain similarities to options. Like the FINRA rules, the proposed sales practice rules would not require firms to evaluate retail investors' eligibility to transact in these products on a transaction-by-transaction basis.

In the Release, the SEC requested comments on a number of aspects of the proposed sales practice rules, including the definition of "leveraged/inverse investment vehicle." Request for comment number 173 asks whether the scope of the definition should be expanded to include exchange traded notes ("ETNs") with the same or similar return profile as, for example, a leverage/inverse ETF. The same request for comment also asks whether additional "complex products," such as those discussed in FINRA Regulatory Notice 12-03 (including, among others, certain structured or asset-backed notes, unlisted REITs, securitized products, and products that offer exposure to stock market volatility) should be subject to the same due diligence and account approval requirements as in the proposed sales practice rules.[20]

The proposed due diligence requirement provides that a broker-dealer must exercise due diligence to ascertain the essential facts relative to the retail investor, his or her financial situation, and investment objectives. At a minimum, a firm must seek to obtain information about a retail investor's:

- investment objectives and time horizon;
- employment status;
- estimated annual income;
- estimated net worth;
- estimated liquid net worth;
- percentage of the retail investor's liquid net worth that he or she intends to invest in the leveraged/inverse investment vehicles; and
- investment experience and knowledge regarding leveraged/inverse investment vehicles, options, stocks and bonds, commodities and other financial instruments.[21]

After evaluating this information, a firm would be required to specifically approve or disapprove the retail investor's account for purchase or sale of a leveraged/inverse ETF. An approval must be in writing. The firm

[19] See FINRA Rule 2360(b)(16), (17) (requirements for options accounts firm approval, diligence and recordkeeping). Release at 183.

[20] See the Release at 186-187.

[21] See the Release at 188.

must have a reasonable basis for believing that the retail investor has the financial knowledge and experience to be reasonably expected to be capable of evaluating the risks of buying and selling leveraged/inverse ETFs. According to the SEC, this would not be a bright-line determination; rather, it would be based on all relevant facts and circumstances.

A "retail investor" is limited to a "natural person" or "a legal representative of a natural person," with the definitions aligning with the definitions used in Regulation Best Interest. High net worth individuals are considered retail investors.

The proposed rules would require firms to adopt and implement written policies and procedures addressing compliance with the applicable rule.

One of the requests for comment (number 187) asks whether the proposed rule should require firms to provide a short, plain-English disclosure generally describing the risks associated with inverse/leveraged ETFs (such as risks relating to compounding and other risks that the inverse/leveraged ETFs disclose in their prospectuses).

Why the concern about leveraged/inverse ETFs?

As discussed in the Release, leveraged/inverse ETFs rebalance their portfolios on a daily (or other predetermined) basis to achieve a constant leverage ratio. As a result, the reset, and the effects of compounding, can result in performance over longer holding periods (even for longer than one day) that differs significantly from the leveraged or inverse performance of the underlying reference asset (such as an index) over the same holding periods. Consequently, buy-and-hold investors who have an intermediate- or long-term time horizon, and who may not evaluate their portfolios frequently, may experience large and unexpected losses or otherwise experience returns that are different from what was expected.[22]

As a result, inappropriate sales of leveraged/inverse ETFs and ETNs have been the focus of regulatory scrutiny for a long time. Both FINRA and the SEC have issued investor alerts regarding leveraged/inverse ETFs and ETNs with daily resets.[23] There have also been a number of enforcement actions relating to inappropriate sales to retail investors of leveraged/inverse ETFs and ETNs, including sales into retirement accounts.[24]

Issuers are well aware of the regulatory concerns about leveraged/inverse ETFs and ETNs, particularly those with daily resets. Offering documents for leveraged/inverse ETNs with daily resets normally include fulsome risk factor disclosure about the potential negative effects of compounding and leveraged inverse exposure, and also warnings that they should not be purchased by investors as a buy-and-hold investment. These offering documents also warn investors that they should not purchase the leveraged/inverse ETNs unless they are sophisticated investors who plan to monitor their investments on a daily basis.

With the proposed sales practice rules, the SEC is adding another layer of protection for retail investors in leveraged/inverse ETFs. However, structured notes issuers should take note of potential regulatory over-reach,

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[22] Release at 178-179.

[23] See FINRA Regulatory Notice 09-31 (FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds); SEC Investor Alert (Aug. 1. 2009) (Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors); FINRA Investor Alert (July 10, 2012) (Exchange-Traded Notes-Avoid Unpleasant Surprise); and SEC Investor Bulletin (Dec, 1, 2015) (Exchange Traded Notes (ETNs)).

[24] See Reverse Inquiries, Vol. 2, Issue 9, available at: http://bit.ly/2VbyzWf, discussing a FINRA Letter of Acceptance, Waiver and Consent. See also the Release at FN 315.

particularly request for comment 173, which asks whether ETNs and certain "complex products" covered in FINRA Regulatory Notice 12-03 should also be subject to the proposed sales practice rules.

NAIC Developments Related to Principal-Protected Notes

At the NAIC Valuation of Securities (E) Task Force meeting on December 8, 2019 the SVO director and task force chair provided the following update regarding the initiative relating to "principal protected securities":

The SVO has been working with industry representatives, particularly the American Council of Life Insurers (ACLI), to refine the definition of "principal protected securities." They are taking seriously the concern that the definition needs to be carefully drafted so as not to be inadvertently over-inclusive.

Two examples of securities that the SVO wants to make sure are *excluded* from the definition are defeasance bonds and *bona fide* securitizations. The revised definition of "principal protected securities" that will be forthcoming in 2020 will be more "robust" and will include examples. It may not be until mid-February before the revised definition is available.

Three types of characteristics were mentioned as likely to bring a security *within* scope of the (revised) definition:

1. When the security includes underlying performance assets that are intended to provide additional returns above the "promised" return.
2. When the underlying fixed-income asset has a below-market return for its tenor, such that an insurer would not have invested in it on a standalone basis.
3. When the security results in a more favorable risk-based capital treatment than if the insurer had owned the underlying assets directly.

A representative of the American Council of Life Insurers (ACLI) spoke briefly to express appreciation on behalf of the ACLI for the SVO's willingness to work with industry in refining the definition. There was nothing said at the meeting that would suggest that the SVO or Task Force will be revisiting the decision (evident on the October 31, 2019 conference call) not to change course on the retroactivity issue raised by some of the original commenters. Rather, the comment they have taken on board is the call for a more carefully drafted definition of "principal protected securities." Having said that, it is clear that the process has slowed down, and that a lot of thought and deliberation, including input from the ACLI, is going into developing the revised definition — and that is a welcome development.

Proposed Amendments to Advertising Rule for Registered Investment Advisers

In November 2019, the SEC proposed amendments to the advertising rules promulgated under the Advisers Act for RIAs. Among other things, the proposed rules would allow the use of hypothetical performance, related performance, and extracted performance subject to satisfaction of certain conditions. An RIA would be required to adopt policies and procedures reasonably designed to ensure that hypothetical performance is disseminated only to persons for whom it is relevant to their financial situation and investment objectives. The hypothetical information would have to be accompanied by disclosure related to the criteria used, the assumptions made and the limitations of, and associated risks of reliance on, the information. Perhaps if adopted these amended rules relating to hypothetical performance may provide a useful analogy for structured products marketing materials that frequently include hypothetical backtested data.

FINRA Tips on ESG Investing

The appetite for socially responsible investing has intensified over the past decade, with particular emphasis on environmental, social and governance ("ESG") factors. This trend has led wealth managers, broker-dealers and investment advisers to examine ESG factors of public companies through public filings and disclosures as an increasing number of retail investors are becoming more interested in ESG investments, including structured products linked to ESG-themed indices.

On December 11, 2019, FINRA published an article explaining how each ESG investment "is unique, and should be evaluated on its own terms." This type of investment uses a variety of ESG criteria in selecting specific investment components with the primary aim of generating competitive financial returns while enabling a positive impact on society. Positive impacts on the environment may include clean energy technology and water conservation; on society, the promotion of human rights, gender equality, fair labor standards and safe working conditions; and on governance, anti-bribery and corruption policies and board diversity.

FINRA reminded ESG investors to keep these tips in mind:

1. Know one's investment goals and risk tolerance.
2. Understand the ESG fund's investment criteria.
3. Be alert to potential "green washing."
4. Do a values check.
5. Stay diversified.
6. Be prepared for lack of "criteria consistency."
7. Be on the lookout for "green" scams.
8. Look beyond marketing materials.
9. Know and compare fees.

For more details, a copy of the FINRA article is available here.

Proposed Changes to the Definition of Accredited Investor and the Definition of Qualified Institutional Buyer

On December 18, 2019, the SEC approved a proposing release for public comment that would amend the definition of "accredited investor," as well as amend the definition of "qualified institutional buyer." Many structured note issuers include a Regulation D offering alternative in their continuous issuance programs, which would be affected by these amendments, if adopted. The Regulation D offerings typically rely on the Rule 506(b) safe harbor and allow for offers and sales to be made solely to "accredited investors." The changes set forth in the SEC's proposing release would have the effect of broadening the potential universe of individuals and entities that might qualify as accredited investors. In particular, the proposed amendments to the accredited investor definition would add new categories of natural persons based on professional knowledge, experience or certifications (such as Series 7, 65 and 82 licenses) and would leave intact the current net income and asset tests. Knowledgeable employees of private funds also would be considered accredited investors eligible to invest in their funds. The proposed amendments would also add new categories of entities, including a "catch-all" category for any entity owning in excess of $5 million in investments so long as it is not formed for purposes of investing in the offered securities. Family offices with at least $5 million of assets under management and their family clients would be considered accredited investors. Qualified institutional buyers (QIBs) would be considered accredited investors, and certain limited liability companies would also qualify as accredited investors. The proposed amendments would similarly expand the definition of a QIB to include additional entities.

Mayer Brown was named Global Law Firm of the Year (Overall) at *GlobalCapital's* 2019 Global Derivatives Awards.

In 2019, Mayer Brown was also named Americas Law Firm of the Year (Overall) at *GlobalCapital*'s Americas Derivatives Awards.

Many thanks to *GlobalCapital* magazine for this recognition and to our clients for their trust in us and continued support.

ANNOUNCEMENTS

Capital Markets Tax Quarterly. Mayer Brown's Capital Markets Tax Quarterly provides capital markets-related US federal tax news and insights.

In our latest issue we look at Q3 2019.

LinkedIn Group. Stay up to date on structured and market-linked products news by joining our LinkedIn group. To request to join, please email REVERSEinquiries@mayerbrown.com.

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FREE WRITINGS + Perspectives

The Free Writings & Perspectives, or FW&Ps, blog provides news and views on securities regulation and capital formation. The blog provides up-to-the-minute information regarding securities law developments, particularly those related to capital formation. FW&Ps also offers commentary regarding developments affecting private placements, mezzanine or "late stage" private placements, PIPE transactions, IPOs and the IPO market, new financial products and any other securities-related topics that pique our and our readers' interest. Our blog is available at: www.freewritings.law.

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2021 STRUCTURED PRODUCTS LEGAL, REGULATORY AND MARKET BRIEFING

SUPPLEMENTAL MATERIALS | MAY 13, 2021

Panel 2

Latest Developments in Structured Investments Trading and Technology

MAYER | BROWN

VOLUME 04, ISSUE 02 | March 29, 2021

REVERSE inquiries

Structured and market-linked product news for inquiring minds.

FDIC Proposes to Rescind 1996 Statement of Policy on the Use of Offering Circulars and Replace It with a New Rule of Narrower Scope

In This Issue

The disclosure requirements for offerings of securities by state non-member banks have long been governed by the Federal Deposit Insurance Corporation's ("FDIC") 1996 Statement of Policy on the Use of Offering Circulars in Connection with Public Distribution of Bank Securities (the "1996 Statement").[1] The 1996 Statement focuses on disclosure, requires that specific legends be included in offering circulars used by state non-member banks issuing securities and has no filing requirement. The 1996 Statement also refers to the disclosure requirements of the former Office of Thrift Supervision.

On January 19, 2021, the FDIC proposed, among other items, rescinding the 1996 Statement and replacing it with a new regulation to be codified in Subpart A of 12 C.F.R. Part 335, as "Securities of State Nonmember Banks and State Savings Associations" (the "Proposed Rule").[2] The Proposed Rule is limited in its scope, as opposed to the 1996 Statement, which applies to all state nonmember banks. Comments on the Proposed Rule must be submitted to the FDIC by April 5, 2021.

The Proposed Rule applies to offerings of bank securities in the following circumstances:

- FDIC-supervised institutions (*i.e.*, state nonmember banks and state savings associations) in organization;
- FDIC-supervised institutions subject to an enforcement order or capital restoration plan that intend to issue securities;
- FDIC-supervised institutions converting from a mutual to stock form of ownership; and
- Subsidiaries of state savings associations in any of the three situations above.[3]

[1] 61 Fed. Reg. 46,807 (Sept. 5, 1996).

[2] FDIC FIL-6-2021 is available at: https://bit.ly/3cwA0c0. The Proposed Rule is available at: https://bit.ly/3sz7wUt. The Proposed Rule also would rescind the rules for securities offerings by state savings associations, which the FDIC inherited from the Office of Thrift Supervision in 2011.

[3] See Proposed Rule at 335.1(b). The offers and sales of the securities of state savings associations in connection with a mutual-to-stock conversion also are subject to the rules set forth by the Office of the Comptroller of the Currency at 12 C.F.R. pt. 192.

Unlike under the 1996 Statement, an insured state nonmember bank issuing debt securities outside of the first three bullet points above would not be subject to the Proposed Rule. However, the Proposed Rule is instructive as to the type of disclosure to include in an offering circular for an offering of bank securities by a state nonmember bank, and the FDIC indicates that in its experience, many state nonmember banks comply with federal securities offering rules even if they are not legally required to do so.

State nonmember banks and state savings associations subject to the Proposed Rule would be required to file a registration statement, including a prospectus, with the appropriate regional FDIC office, notwithstanding the availability of the exemption from the registration requirements of Section 5 of the Securities Act of 1933 ("Securities Act") provided by Section 3(a)(2) thereunder.[4] The registration statement and prospectus would need to conform to Regulation C under the Securities Act, unless provided otherwise in the Proposed Rule.[5] With respect to disclosure, the documents would need to conform to the requirements of Regulations S-K and S-X under the Securities Act.[6]

The Proposed Rule would exempt the following types of offerings from the registration statement and prospectus requirements of Regulation C (*i.e.*, an offering document would still need to be filed with the FDIC, but no particular form would be required):

- Regulation A under the Securities Act;
- Regulation D under the Securities Act;
- Rule 701 under the Securities Act;
- Rules 144 and 144A under the Securities Act; and
- Other reorganization and dissolution events.[7]

Registration statements, prospectuses and any offering circular used in connection with any of the exempt offerings listed above would need to be filed with the FDIC prior to the commencement of an offering. Once the FDIC confirms in writing that no additional changes or information to the offering circular are required, the offering could commence.[8]

As in the 1996 Statement, the standard legends (*i.e.*, the securities are not deposits, not FDIC insured, no approval by the FDIC is implied and debt securities are subordinated to deposits) would need to be included in the offering circular in bold capital letters.[9]

Because all offerings of securities, including those by state nonmember banks, are subject to the anti-fraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, offering circulars of state nonmember banks tend to include the full scope of disclosure included in registration statements and prospectuses for offerings registered under the Securities Act. Consequently, it is unlikely that the disclosure in

[4] See Proposed Rule at 335.3(a).

[5] See Proposed Rule at 335.3(b).

[6] See Proposed Rule at 335.3(c), (d).

[7] See Proposed Rule at 335.4(a). The Proposed Rule does not explain the meaning of the reference to Rule 144 beyond a statement that it and Rule 144A "provide guidance for persons who are not deemed to be engaged in a distribution and therefore are not underwriters, and for private resales of securities to institutions."

[8] Proposed Rule at 335.7.

[9] Proposed Rule at 335.6.

offering circulars for offerings of securities by state nonmember banks will change at all if the Proposed Rule is finalized.

2021 Report on FINRA's Examination and Risk Monitoring Program

This February, the Financial Industry Regulatory Authority, Inc. ("FINRA") released its Report on FINRA's Examination and Risk Monitoring program (the "Report").[10] The Report replaces FINRA's former Report on FINRA Examination Findings and Observations, and its Risk Monitoring and Examination Priorities Letter. The Report, in its new format, will be released annually.

The Report covers a broad spectrum of issues. This article focuses on areas of interest to the structured products industry.

REGULATION BEST INTEREST

This part of the Report generally asks firms whether they have policies, procedures and controls in place to implement all aspects of Regulation Best Interest, including relating to recommendations, record keeping, disclosures and training. There are also inquiries relating to the use of Form CRS. FINRA Rule 2111 (Suitability) is still relevant, as the Report asks whether a member firm's "policies, procedures and controls continue to address compliance with FINRA Rule 2111 (Suitability), which still applies to recommendations made to non-retail investors …."[11]

COMMUNICATIONS WITH THE PUBLIC (FINRA RULE 2210)

FINRA reminds firms that all communications must be fair, balanced and not misleading, noting that if a communication promotes the benefits of a high-risk or illiquid security, it should also explain the associated risks. In particular, the Report asks "[d]o your firm's communications balance specific claims of investment benefits from a securities product or service (especially complex products) with the key risks specific to that product or service?"[12]

The Report reflects FINRA's concerns about the use of digital communication channels and digital assets, as summarized below:

- Whether a firm's digital communication policy addresses all permitted and prohibited digital communication channels and features available to customers and associated persons;
- Whether the firm reviews for red flags that may indicate a registered representative is communicating through unapproved communication channels, and whether there is any follow up on such red flags;
- How a firm supervises and maintains books and records in accordance with SEC and FINRA rules for all approved digital communications;

[10] The Report is available at: https://bit.ly/3rsCbBK.

[11] Report at 18.

[12] *Id.* at 19.

- If a firm offers an app to customers that includes an interactive element, whether the information provided to customers constitutes a "recommendation" that would be covered by Regulation Best Interest, which requires a broker-dealer to act in a retail customer's "best interest," or suitability obligations under FINRA Rule 2360 (Options);
- If a firm's app platform design includes "game-like" aspects that are intended to influence customers to engage in certain trading or other activities, whether the firm addresses and discloses the associated potential risks to its customers; and
- Whether a firm's communications—regardless of the platform through which they are made—comply with the content standards set forth in FINRA Rule 2210.[13]

FINRA's question on whether a member firm's app platform includes "game-like" aspects follows on the heels of a complaint by the Massachusetts Secretary of State, Securities Division, against a FINRA member, alleging, among other things, the "use of strategies such as gamification to encourage and entice continuous and repetitive use of its trading application …."[14]

The Report includes a section, titled "Emerging Digital Communication Risks – New Digital Platforms With Interactive and 'Game-Like' Features," in which FINRA, while acknowledging that such features may improve access to firm systems and investment products, warned that these features may increase risks to customers if not designed with appropriate compliance considerations in mind. In this context, FINRA reminds firms to meet regulatory obligations relating to, among others:

- Regulation Best Interest and Form CRS if any communication constitutes a recommendation to a retail customer;
- Disclosing risks relating to fees, costs, conflicts of interest and required standards of conduct;
- Ensuring that all communications are fair and balanced;
- Developing a comprehensive supervisory system, including identifying red flags and maintaining proper record keeping; and
- Complying with FINRA's communication rules.[15]

Member firms' activities relating to digital assets are also scrutinized, with two questions relating to potential investor confusion about the characteristics of digital assets:

- Does your firm provide a fair and balanced presentation in marketing materials and retail communications, including addressing risks presented by digital asset investments, and not misrepresenting the extent to which digital assets are regulated by FINRA or the federal securities laws or eligible for protections thereunder, such as Securities Investor Protection Corporation coverage?

[13] See the Report at 20.

[14] See *In Re Robinhood Financial, LLC* at 2, available at: https://www.sec.state.ma.us/sct/current/sctrobinhood/MSD-Robinhood-Financial-LLC-Complaint-E-2020-0047.pdf.

[15] See the Report at 22.

- Do your firm's communications misleadingly imply that digital asset services offered through an affiliated entity are offered through and under the supervision, clearance and custody of a registered broker-dealer?[16]

The exam findings noted deficient digital assets communications by member firms, including false, misleading or unwarranted statements. With respect to digital communications, examinations found insufficient supervision and record keeping to be a problem.

BOOKS AND RECORDS

Under the applicable books and records requirements, a member firm must create and preserve, in an easily accessible place, originals of all communications received and sent relating to its "business as such." These records may be maintained and preserved for the required time on electronic storage media, subject to certain conditions.

FINRA asks in the Report what kind of vendors, including cloud service providers, a member firm uses to comply with the books and records rules requirements, and suggested reviewing vendor contracts to confirm that these comply with those requirements. Exam findings had uncovered that some member firms had not performed sufficient due diligence on third party vendors as to whether they had the ability to comply with the books and records rules requirements.

FIXED INCOME MARK-UP DISCLOSURE

Under FINRA Rule 2232, member firms are required to provide additional transaction-related information to retail customers for certain trades in corporate, agency and municipal debt securities. Disclosed mark-ups and mark-downs must be expressed as both a total dollar amount for the transaction and a percentage of prevailing market price (PMP). The considerations listed by FINRA in the Report relate to how member firms review the accuracy of reporting under Rule 2232 in customer confirmations.

Two items in the examination findings are of note:

- **Disclosure for Structured Notes** – Failing to provide disclosures on customer confirmations for trades in TRACE-reportable structured notes because firms did not realize the notes were subject to FINRA Rule 2232 or did not receive the PMP from the structured note distributors; and
- **Incorrect Designation of Institutional Accounts** – Failing to provide disclosures to certain customers because the firm identified those customers' accounts as "institutional," even though the customers did not meet the "institutional" definition in FINRA Rule 4512(c) (Customer Account Information).[17]

LIBOR End Dates Confirmed

The administrator for LIBOR and other inter-bank offered rates, ICE Benchmark Administration ("IBA"), confirmed on March 5, 2021 its previously announced dates for LIBOR cessation.[18] On the same day, the U.K. Financial Conduct Authority ("FCA") announced that 1-week and 2-month USD LIBOR will cease publication

[16] Report at 20.

[17] Report at 17.

[18] See our previous article at: https://bit.ly/3u5KrJs.

after December 31, 2021, as will all non-USD LIBOR tenors, and that 3-month, 6-month and 1-year USD LIBOR will cease publication after June 30, 2023.

What does this mean for outstanding USD LIBOR floating rate notes that have the Alternative Reference Rates Committee's ("ARRC") recommended fallback provisions? A "Benchmark Transition Event," as defined in the ARRC fallbacks, has occurred.[19] However, USD LIBOR will not transition to the secured overnight financing rate ("SOFR") under the ARRC fallbacks because the required "Benchmark Replacement Date" has not occurred.

The FCA announcement also was an "Index Cessation Event" under Supplement No. 70 to the 2006 ISDA Definitions. Consequently, the ISDA fallback spread adjustments published by Bloomberg were fixed on March 5, 2021, which was the "Spread Adjustment Fixing Date" under ISDA Supplement No. 70. The ARRC has previously stated that it will use the same spread adjustments as ISDA for floating rate notes.

For 3-month USD LIBOR floating rate notes using the ARRC fallbacks, on the first business day after June 30, 2023, the replacement rate will be either Term SOFR, if available, or Compounded SOFR, plus the spread adjustment of 0.26161.[20]

In the FCA's announcement on the cessation of LIBOR, there was some discussion of a possible "synthetic" USD LIBOR. Synthetic USD LIBOR would be published after the respective cessation date of a USD LIBOR tenor, but would not be representative.[21] Synthetic IBORs would be used, according to the FCA, for "tough legacy contracts," *i.e.*, legacy IBOR contracts that, by their terms, do not include workable fallback provisions to transfer to a replacement rate. It is hard to see an application for synthetic USD LIBOR in the US capital markets, as the proposed New York and federal legislative solutions will, once passed, automatically cause outstanding legacy USD LIBOR floating rate notes and other USD LIBOR securities and contracts to fall back to SOFR under the ARRC's recommended fallback provisions.

SEC Division of Examinations 2021 Examination Priorities

This March, the Securities and Exchange Commission released its new report on its 2021 Examination Priorities (the "Report").[22] The Report covers a broad spectrum of issues. This article focuses on areas of interest to the structured products industry.

RETAIL INVESTORS

The Division of Examination (the "Division") stated in the Report its continued desire to emphasize the protection of retail investors, and the Division will prioritize examinations of financial intermediaries such as registered investment advisers ("RIAs") and registered investment companies, broker-dealers and dually-registered or affiliated firms. These examinations will focus on investments and services marketed to retail investors.

[19] See the ARRC announcement at: https://nyfed.org/3fpNKqM and the related FAQs at: https://nyfed.org/39HwvOn.

[20] See the Bloomberg notice at: https://bit.ly/3m055bk.

[21] Synthetic USD LIBOR would be a rate published as USD LIBOR, but would not be based on an interbank offered rate. For example, synthetic USD LIBOR could be Term SOFR or Compounded SOFR, plus a spread adjustment, but published as "USD LIBOR." This is the equivalent of pulling the handle marked "vanilla" on the soft serve ice cream machine, getting chocolate, and calling it vanilla.

[22] This Report is available at: https://www.sec.gov/files/2021-exam-priorities.pdf. On December 17, 2020, the Commission renamed the Office of Compliance Inspections and Examinations (OCIE) the Division of Examinations.

REGULATION BEST INTEREST

The Division plans to expand the scope of examinations of Regulation Best Interest. While prior examinations focused on the implementation of Regulation Best Interest by broker-dealers, future examinations will evaluate the processes used for compliance and alterations made to product offerings, as well as question the recommendations made by broker-dealers to customers, including whether such recommendations are in the customers' best interests.[23] Additionally, the Division will also conduct enhanced transaction testing by "evaluating firm policies and procedures designed to meet additional elements of Regulation Best Interest, the recommendation of rollovers and alternatives considered, complex product recommendations, assessment of costs and reasonably available alternatives, how sales-based fees paid to broker-dealers and representatives impact recommendations, and policies and procedures regarding how broker-dealers identify and address conflicts of interest."[24]

REGISTERED INVESTMENT ADVISER FIDUCIARY DUTY AND FORM CRS

The Division's restated its commitment to examine the fiduciary duties of care and loyalty that RIAs owe to their clients, and the Division will focus on, among other items:

- RIA advice on whether account or program types are in the best interest of the client;
- RIA disclosure of all conflicts of interests "which might incline RIAs—consciously or unconsciously—to render advice which is not disinterested such that their clients can provide informed consent to the conflict;"[25] and
- Risks associated with "fees and expenses, complex products, best execution, and undisclosed or inadequately disclosed, compensation arrangements" and the risk associated with each.[26]

With respect to ensuring compliance with Form CRS, the Division plans to prioritize examinations of broker-dealers and RIAs.

FRAUD, SALES PRACTICES, AND CONFLICTS

Examinations will focus on conduct related to retail investors, with a particular emphasis on: "(1) seniors, including recommendations and advice made by entities and individuals targeting retirement communities; (2) teachers; (3) military personnel; and (4) individuals saving for retirement."[27] The Division also plans to hone in on the following:

- Recommendations regarding account type, conversions, and rollovers;
- The sales practices used for each product type, including structured products;
- Whether broker-dealers are meeting their legal and compliance obligations when providing retail customers access to complex strategies;

[23] See the Report at 20.

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] See Report at 21.

- How firms are complying with recent changes to the definition of accredited investor when recommending and selling certain private offerings;
- Whether fees, expenses and revenue sharing arrangements are adequately disclosed, encompassing revenue sharing arrangements between a registered firm and issuer, service providers, and others, and direct or indirect compensation to personnel for executing client transactions; and
    - Examination of RIA fee calculation will include: "(1) advisory fee calculation errors, including but not limited to, failure to exclude certain holdings from management fee calculations; (2) inaccurate calculations or tiered fees, including failure to provide breakpoints and aggregate household accounts; and (3) failures to refund prepaid fees for terminated accounts."
- RIAs operation and use of turnkey asset management platforms.[28]

RETAIL-TARGETED INVESTMENTS

The Division restated its commitment to monitor securities products that can pose increased risks to retail investors such as mutual funds and ETFs, municipal securities, microcap securities and other fixed income securities. With respect to mutual funds and ETFs, the Division will focus on:

- The incentives provided to financial services firms and professionals that may cause them to select a higher cost mutual fund when a similar lower cost option is available.
- "Financial intermediaries' recommendations and disclosures involving ETFs, including adequacy of risk disclosure, and suitability, particularly in niche or leveraged/inverse ETFs."[29]

With respect to municipal securities and other fixed income securities, the Division will examine broker-dealers, underwriters and municipal advisors in order to determine whether each is meeting their obligations under municipal issuer disclosure. The Division will further examine "broker-dealer trading activity in municipal and corporate bonds for compliance with best execution obligations; fairness of pricing, mark-ups and mark-downs, and commissions; and confirmation disclosure requirements, including disclosures related to mark-ups and mark-downs."[30]

With respect to microcap securities, the Division restated its commitment to deterring fraud and cited concerns over false claims made by these companies regarding the pandemic, to which the Commission responded to by suspending trading in various securities. The Division plans to hone in on:

- "Transfer agent handling of microcap distributions and share transfers;
- Broker-dealer sales practices and their consistency with Regulation Best Interest; and
- Broker-dealer compliance with certain regulatory requirements, including the locate requirements of Regulation SHO, penny stock disclosures under Rules 15g-2 through 15g-6 of the Securities Exchange Act of 1934, and the obligation to monitor for and report suspicious activity and other anti-money laundering obligations."[31]

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[28] See Report at 22.

[29] *Id.*

[30] See Report at 23.

[31] *Id.*

FINANCIAL TECHNOLOGY (FINTECH) AND INNOVATION, INCLUDING DIGITAL ASSETS

The Division restates its commitment to staying updated on recent fintech innovations and plans to focus its efforts on:

- Implementation and integration of RegTech in firms' compliance programs
- Implementation of controls and compliance around the creation, receipt, and use of alternative data
- Examining digital asset market participants for: "(1) whether investments are in the best interests of investors; (2) portfolio management and trading practices; (3) safety of client funds and assets; (4) pricing and valuation; (5) effectiveness of compliance programs and controls; and (6) supervision of representatives' outside business activities."[32]

THE LIBOR TRANSITION

The Division intends to examine the risks of "market participants such as RIAs, broker-dealers, investment companies, municipal advisors, transfer agents and clearing agencies in order to assess their understanding of any exposure to LIBOR, their preparations for the expected discontinuation of LIBOR and the transition to an alternative reference rate, in connection with the registrants' own financial matters and those of their clients and customers."[33]

Events

IN CASE YOU MISSED IT...

- **REVERSEinquiries Workshop: ISDA 2020 IBOR Fallbacks Protocol** (January 2021). *Watch this webinar*
- **4th Debt Capital Markets Seminar** (January 2021). *View the presentation materials*
- **REVERSEinquiries Workshop: Proprietary Indices, US and European Considerations** (February 2021). *Watch this webinar*
- **REVERSEinquiries Workshop: Bank Regulatory Development Recap** (March 2021). *Watch this webinar*

[32] See Report at 26.

[33] See Report at 27.

Mayer Brown is pleased to have been shortlisted for Americas Law Firm of the Year (Overall), US Law Firm of the Year – Transactions and US Law Firm of the Year – Regulatory for *GlobalCapital*'s Americas Derivatives Awards 2021.

This follows our win as European Law Firm of the Year – Transactions and US Law Firm of the Year – Transactions for *GlobalCapital*'s Americas and Global Derivatives Awards 2020, respectively. We would like to thank *GlobalCapital* for its continued recognition and thank our friends and our colleagues for their trust in our work.

ANNOUNCEMENTS

Capital Markets Tax Quarterly. Mayer Brown's Capital Markets Tax Quarterly provides capital markets-related US federal tax news and insights. In our latest issue, we cover tax plans in the new administration, US tax considerations for SPACs, guidance on the settlement payments to REMIC regular interest holders, extended relief for mortgages, and more.

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To request to join the LinkedIn group or send us suggestions/comments, please scan the QR code, which will notify us via email at REVERSEinquiries@mayerbrown.com.

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MAYER BROWN'S IBOR TRANSITION RESOURCES

The final countdown to the LIBOR cessation date has begun. With fewer than 500 days left until December 31, 2021, rely on Mayer Brown to assist you.

With our global presence, deep knowledge of the affected markets and products, participation in trade and industry groups and considerable experience in using technology solutions (including artificial intelligence and other technology-assisted review tools), Mayer Brown is uniquely positioned to advise financial institutions and other affected market participants.

Our IBOR Transition Task Force, composed of nearly 100 partners globally, is perhaps the best reflection of our strength and depth.

Below we provide a sampling of our resources:

IBOR Transition Digest: A compendium of global regulatory and market news as well as insights on the complex issues confronting financial market participants as they transition from LIBOR and its variants to replacement benchmark interest rates.

Recent publications, include:

FINRA LIBOR Phase-Out Preparedness Survey (August 2020)

"Comparable" Alternative Reference Rates to LIBOR: The Low Bar for Official Designation, the Much Higher Hurdle of "Fit for Use" and Implementation for Market Participants (August 2020)

IBOR Transition: It's Later Than You Think! (August 2020)

IBOR Transition Webinar Series: Detailed discussions and insights—in 30 minutes or less—on a range of topics from setting and executing an effective IBOR Transition strategy to assessing the impact of IBOR issues on specific financial products.

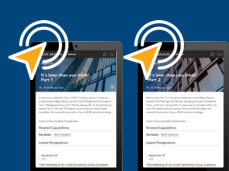
Subscribe on: Google Play Spotify

Recent webinars, include:

Part 5.1 Part 5.2

LIBOR Transition: Issues impacting Floating Rate Notes, Preferred Stock, Depositary Shares, and Capital Securities (Part 5.1 & Part 5.2) (August / September 2020)

Issues impacting Floating Rate Notes, Preferred Stock, Depositary Shares, and Capital Securities: Part 1 (August 2020)



Part 1 Part 2

It's later than you think! (Part 1 & Part 2) (August 2020)

morae

We are collaborating with Morae Global Corporation, a leading provider of legal and compliance technology solutions, to assist clients in the transition from the IBORs to alternative risk-free reference rates. To more effectively serve our client, Mayer Brown has teamed up with Morae, to offer clients data analytics and remediation, technology enablement, repapering and program management capabilities.

Our firm and our partners are ranked as leaders for capital markets, structured finance and securitization, derivatives, structured products, financial services and bank regulatory, litigation, and tax by:

TOP RANKED Chambers GLOBAL 2020	TOP RANKED Chambers USA 2020	The LEGAL 500 UNITED STATES	IFLR 1000
"Esteemed firm with excellent securitisation, structured finance and derivatives capital markets practices. Regularly sought after for advice on cross-border and transatlantic securitisation and structured finance transactions"	"A strong global reach allows the team to handle cross-border cases with ease, while the presence of several former regulatory officials provides insight into the most cutting-edge matters."	"The firm routinely leads on cross-border offerings from the US but it can also draw on its extensive network of offices for support on complex, multi-jurisdictional transactions... Among its industry sweet spots, the group is most prominent in the financial services..."	"Mayer Brown has leading structured finance, project development and project finance practices, as well as additional strengths in debt and equity capital markets."

Question? Please contact Marlon Paz, mpaz@mayerbrown.com, or see our Global IBOR Transition Task Force contacts.

MAYER | BROWN

VOLUME 04, ISSUE 01 | January 19, 2021

REVERSE inquiries

Structured and market-linked product news for inquiring minds.

In This Issue

A Brief Reprieve on LIBOR Cessation

On November 30, 2020, ICE Benchmark Administration ("IBA"), the administrator of US Dollar LIBOR ("USD LIBOR") and other IBORs, relieved the pressure with respect to the upcoming cessation of USD LIBOR. IBA announced that, following a consultation in December and January, (i) it intends to cease publication of 1-week and 2-month USD LIBOR at the end of 2021 and (ii) subject to compliance with applicable regulations, including as to representativeness, it does not intend to cease publication of the remaining USD LIBOR tenors until June 30, 2023.[1] This IBA announcement followed an earlier IBA announcement on November 18, 2020, that all GBP, EUR, JPY, and CHF IBOR tenors would cease publication after December 31, 2021.

UK and U.S. regulatory authorities, in guidance that appeared to be coordinated with the IBA announcement, quickly responded with supporting statements regarding the timing of USD LIBOR cessation and the effect of the IBA announcement on the transition plans of market participants. According to the UK Financial Conduct Authority ("FCA"), clarifying the end date for USD LIBOR will "incentivize swift transition, while allowing time to address a significant proportion of legacy contracts that reference USD LIBOR."[2] The FCA's announcement was issued in tandem with a joint statement of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (applicable to the financial institutions that they regulate),[3] and a press release by the Board of Governors of the Federal Reserve System,[4] and is consistent with the July statement by the Federal Financial Institutions Examination Council.[5]

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[1] The IBA announcement is available at: https://ir.theice.com/press/news-details/2020/ICE-Benchmark-Administration-to-Consult-on-Its-Intention-to-Cease-the-Publication-of-One-Week-and-Two-Month-USD-LIBOR-Settings-at-End-December-2021-and-the-Remaining-USD-LIBOR-Settings-at-End-June-2023/default.aspx

[2] The FCA announcement is available at: https://www.fca.org.uk/news/statements/fca-response-iba-proposed-consultation-intention-cease-us-dollar-libor

[3] The joint statement is available at: https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20201130a1.pdf

[4] The Federal Reserve Board press release is available at: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20201130b.htm

[5] The FFIEC statement is available at: https://www.ffiec.gov/press/PDF/FFIEC%20Statement%20on%20Managing%20the%20LIBOR%20Transition.pdf

The statements by the U.S. regulators shared the following main points, which apply to their regulated institutions but have implications for other market participants:

- Banks are encouraged to stop entering into new USD LIBOR contracts "as soon as practicable," and by no later than December 31, 2021;
- Entry into such contracts after December 31, 2021, would create safety and soundness risks for banks;
- The USD LIBOR June 30, 2023, cessation date will allow more time for existing legacy USD LIBOR contracts to mature; and
- Banks should use this extra time to continue to prepare for the transition away from LIBOR.[6]

IBA issued the proposed consultation on December 4, 2020.[7] It is open for comment until January 25, 2021. IBA has noted that the consultation is required under its Changes and Cessation Procedure, which requires that IBA's Consultation Policy apply "[i]f cessation of some or all of the LIBOR settings were under consideration."[8] The consultation, therefore, appears to be driven by procedural requirements, rather than uncertainty about the LIBOR cessation path proposed by IBA and supported by U.K. and U.S. regulators. IBA plans to share the results of the consultation with its regulator, the FCA, "and to publish a feedback statement summarizing responses from the consultation shortly thereafter." We expect that IBA will release that feedback statement in February and reaffirm the cessation plans that it announced in November.

Effect on Floating Rate Notes

Two groups that are most likely breathing a large but temporary sigh of relief are (i) issuers of legacy USD LIBOR floating rate notes without updated fallback provisions ("Legacy FRNs") and (ii) the trustees for these Legacy FRNs. Issuers and trustees have been concerned about potential liabilities arising from Legacy FRNs and how to mitigate those liabilities. Assuming that the IBA consultation is completed favorably and in a timely fashion, there is now an additional 18 months of lead time before Legacy FRNs, if no action is taken, will default into fixed rate notes. Potential solutions that have been discussed include exchange offers, tender offers, consent solicitations, and state and federal legislative solutions.

The proposed delay in USD LIBOR cessation would allow some short-term Legacy FRNs to mature before June 30, 2023. The delay would also allow more time for back-office systems to prepare for secured overnight financing rate ("SOFR") calculations, which will be required when more recently issued USD LIBOR FRNs that include the Alternative Reference Rate Committee's ("ARRC") USD LIBOR-to-SOFR fallback provisions switch over to SOFR upon a USD LIBOR cessation.

Nonetheless, issuers of Legacy FRNs should not let their guard down. It is not certain that the IBA consultation will result in an extension of the currently anticipated date of USD LIBOR cessation for the subject tenors. While

[6] In a webcast hosted by ISDA on December 4, 2020, Edwin Schooling Latter and other speakers made clear that market participants are expected to continue active transition away from LIBOR. "[T]his does not give market participants a reason to not adhere to the ISDA IBOR Fallbacks Protocol or otherwise defer transition in relation to U.S. dollar LIBOR." The transcript of the webcast is available at: http://assets.isda.org/media/f1a442f2/80e230bf-pdf/.

[7] ICE LIBOR Consultation on Potential Cessation is available at: https://www.theice.com/publicdocs/ICE_LIBOR_Consultation_on_Potential_Cessation.pdf.

[8] IBA's Changes and Cessation Procedures, which cites and links to IBA's Consultation Policy, is available at https://www.theice.com/publicdocs/BMR_LIBOR_Change_Cessation_Procedure.pdf.

awaiting the results of the IBA consultation, issuers of Legacy FRNs should continue to consider potential solutions based on a December 31, 2021, USD LIBOR cessation. Those potential solutions will be helpful for Legacy FRNs that mature after June 30, 2023.

We note that the IBA's proposed plan to cease publication of 1-week and 2-month USD LIBOR on December 31, 2021, poses no concern for the USD LIBOR FRN market, which generally bases interest rates on 3- and 6-month USD LIBOR.

Major Indices Expel Some Chinese Companies in Response to Executive Order

Three major equity index sponsors – S&P Dow Jones Indices, FTSE Russell and MSCI – announced that they would remove ten Chinese companies from their indices. These actions were in response to the Executive Order signed by the President on November 12, 2020. The Executive Order bans investments by U.S. persons in publicly traded securities of Chinese Communist military companies (as defined in the Executive Order) ("CCMCs"), or securities that are derivative of, or designed to provide investment exposure to, such securities. There are 31 CCMCs listed in the Executive Order.

S&P Dow Jones Indices and FTSE Russell removed these constituents from their respective indices on December 21, 2020. Removals from the MSCI Indices became effective on January 5, 2021. MSCI Indices notes that the deleted issuers represent 0.04% of the MSCI ACWI Investable Market Indices and 0.28% of the MSCI EM Investable Market Indices.

Risk factors for structured products linked to emerging markets indices tend to be focused on actions by the government of the emerging market home country that might negatively affect the value of the constituent issuer's securities. Draftspersons should consider mentioning the effect of sanctions or other governmental actions by other countries that affect the value of the securities of the emerging market country issuer.[9]

Holders of Structured Notes Linked to Banned Chinese Stocks Will Have to Divest

On January 13, 2021, President Trump signed an Executive Order amending Executive Order 13959 of November 12, 2020. The original Executive Order banned transactions by United States persons in publicly traded securities, or securities derivative of, or designed to provide investment exposure to, securities of designated CCMCs, starting on January 11, 2021. A structured note linked to the performance of a CCMC security would fall within this category, as would an exchange traded fund, no matter how small a percentage

[9] The Securities and Exchange Commission has also raised concerns about risk factors relating to emerging or frontier markets issuers. See our article at: https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/12/finalri211.pdf.

of the ETF's underlying index is represented by a CMCC constituent.[10] As discussed above, certain CCMCs are components of some emerging markets indices, and were removed from those indices by their respective sponsors. Also as a result of the original Executive Order, on January 6, 2021, the NYSE announced the delisting of the American Depositary Shares of China Telecom Corporation Limited (CHA), China Mobile Limited (CHL) and China Unicom (Hong Kong) Limited (CHU).[11] These shares were delisted on January 11, 2021.

The amendment to the original Executive Order (as amended, the "Executive Order") goes further, banning possession by United States persons12 of existing CCMC securities after November 11, 2021. If a Chinese issuer is in the future determined to be a CCMC, possession of the securities of such an issuer by a United States person would be prohibited 365 days after the date of such determination. Structured notes linked to the performance of a CCMC security are subject to these same prohibitions. Any transaction in CCMC securities or a structured note linked to a CCMC security, solely to divest, is permitted prior to the respective cut-off date for ownership.

As one might imagine, the Executive Order has created a stir among structured products issuers. Individual holders of the shares of the delisted CMCCs, who had to dump their shares in a hurry and most likely at a loss, have already been harmed.

What is permitted under the Executive Order with respect to structured notes linked to CCMC securities, and which actions are not permitted? Here is a non-exclusive list:

- Prior to November 11, 2021, structured note issuers may pay coupons, redeem or buy back from holders structured notes linked to existing CCMC securities;
- After November 11, 2021, structured note issuers that are United States persons may not redeem or buy back from holders structured notes linked to existing CCMC securities;
- Prior to 365 days after an issuer of an underlying security is determined to be a CCMC, structured note issuers may pay coupons, redeem or buy back from holders structured notes linked to such CCMC securities;
- 365 days after an issuer of an underlying security is determined to be a CCMC, structured note issuers that are United States persons may not redeem or buy back from holders structured notes linked to such CCMS securities;
- By November 11, 2021, structured notes issuers that are United States persons should cancel any structured notes linked to CCMC securities;
- By 365 days after an issuer of an underlying security is determined to be a CCMC, structured note issuers that are United States persons should cancel any structured notes linked to such CCMC security;

[10] *See* U.S. Department of the Treasury – Office of Foreign Assets Control – Sanctions Programs and Information - Frequently Asked Questions – Chinese Military Companies Sanctions, available at: https://home.treasury.gov/policy-issues/financial-sanctions/faqs/topic/5671 (the "OFAC FAQs")

[11] See the NYSE announcement at: https://s2.q4cdn.com/154085107/files/doc_news/NYSE-Announces-Suspension-Date-for-Securities-of-Three-Issuers-and-Proceeds-with-Delisting-2021.pdf

[12] A "United States person" is defined in Section 4(f) of the Executive Order to mean "any United States citizen, permanent resident alien, entity organized under the laws of the United States or any jurisdiction with in the United States (including foreign branches), or any person in the United States." "Person" is defined in Section 4(c) of the Executive Order to mean an individual or entity.

- Market intermediaries and other participants may engage in ancillary or intermediate activities that are necessary to effect divestiture of CCMC securities during the relevant wind-down period that are not otherwise prohibited under the Executive Order;[13] and
- To the extent that the following support services are not provided to United States persons in connection with prohibited transactions, clearing, execution, settlement, custody, transfer agency, back-end services as well as other support services in CCMC securities are permitted.[14]

What should structured note issuers be doing now?

- Review the delisting provisions in underlying documents governing structured notes linked to equity securities;
- Consider amplifying risk factors for structured notes linked to emerging markets equity securities, indices or ETFs, keeping in mind the reach of the Executive Order;
- Consider the effect of the Executive Order on holders of structured notes linked to CCMC securities and whether to communicate with such holders about the effect of the Executive Order and the relevant cut-off dates; and
- Consider whether buybacks, tender offers or exchange offers may be necessary to help investors who will be forced to divest from any structured notes linked to existing or future CCMC securities.

If a U.S. person does not divest from its structured note linked to a CCMC security by the respective cut-off date, could the issuer of the structured note continue to make any required payments to the holder? It would seem so, as the payment of, for example, a coupon, or the payment at maturity, would not be a "transaction," as defined in the Executive Order. [15] However, the issuer would be in the position of making a contractually required payment to a U.S. person who is in violation of the Executive Order. The OFAC FAQs do not address this point, but that is not to say that the U.S. government will remain silent on this issue. This uncertainty makes it all the more important for issuers to communicate to holders of their structured notes linked to CCMC securities the importance of divesting prior to the respective cut-off date.

It is important for structured notes issuers that are United States persons to plan for the situation where holders of structured notes linked to existing or future CCMC securities have not divested their structured notes prior to the respective cut-off date. Holders of such structured notes should be clearly warned in advance that failing to divest their structured notes prior to the respective cut-off date will result in their being in violation of the Executive Order and holding a security that will be essentially worthless.

The Department of Labor's ESG-less Final ESG Rule

On October 30, 2020, the U.S. Department of Labor ("DOL") released its final regulation ("Final Rule") relating to a fiduciary's consideration of environmental, social and governance ("ESG") factors when making investment decisions for plans subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). In response to the proposed rule (the "Proposal"), the DOL received several thousand comments, the vast majority

[13] OFAC FAQ 865.

[14] OFAC FAQ 863.

[15] The term "transaction" is defined in Section 4(e) of the Executive Order as "the purchase or sale for value, or sale, of any publicly traded security …."

of which opposed the new rule. Many plan sponsors and investment professionals voiced objection to the Proposal's antipathy towards the consideration of ESG factors. In the Final Rule, the DOL generally softened its stance toward the consideration of *economic* ESG factors, but retained its opposition to the consideration of non-pecuniary ESG or other non-pecuniary factors.

Comparing Investment Options

The Proposal modified the longstanding "investment duties" ERISA regulations describing a fiduciary's duties of prudence and loyalty under Section 404 of ERISA by adding that the fiduciary must specifically compare how the relevant investment compares to other similar investments. Some comments to the Proposal wondered whether fiduciaries would be required to "scour the market" and analyze each comparable investment option. Other comments objected on the basis that some investment opportunities may be so unique or time-sensitive that comparing the opportunity against alternatives would not be possible or practical. In response, the Final Rule requires that a fiduciary must compare an investment opportunity with the opportunity for gain associated with reasonably available investment alternatives with similar risks.

Pecuniary vs. Non-Pecuniary Considerations

Perhaps the biggest change from the Proposal is that the Final Rule removes all explicit references to ESG. The DOL explained that the term lacks a precise definition and its use in the Proposal conflated each individual "E" "S," and "G" factor. Instead, the Final Rule requires a fiduciary to base its investment decisions solely on pecuniary factors and not subordinate the interests of participants and their beneficiaries to any non-pecuniary objectives. The DOL acknowledged that ESG factors may be compatible with a purely financial analysis of an investment option or strategy. Under the Final Rule, a fiduciary can appropriately incorporate pecuniary ESG factors into its decision-making process without having to undergo additional documentation requirements, as the Proposal required in certain instances. Conversely, a fiduciary may not consider non-pecuniary factors when choosing an investment option or strategy, regardless of whether the factor relates to ESG, if the investment decision can be made based on pecuniary factors alone.

A "pecuniary factor" is defined as a factor that a fiduciary prudently determines will have a material effect on the risk or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and funding policies. Although not in the express regulatory text, the DOL notes in the preamble that it believes that it would be consistent with ERISA for a fiduciary to consider factors that present "economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories."

Several comments argued that fiduciaries of multiemployer pension plans have unique concerns that they should be able to consider when making investment decisions. They argued that such plans should be able to consider investments that could lead to the benefit of plan participants, such as investments that could lead to increased employment opportunities. The DOL rejected this reasoning, stating that ERISA requires that a plan be operated for the benefit of participants and beneficiaries, in their capacity as such and not in their capacity as union members or employees. The DOL expressed its most vehement disagreement with comments which argued that plan investments should focus on society or economy-wide issues. In response, the DOL Secretary penned an op-ed stating that plan fiduciaries are not tasked "with solving the world's problems" but must focus exclusively on providing retirement benefits to plan participants.

The Final Rule continues to express skepticism towards ESG ratings systems and indexes, since a rating or inclusion on an index may be based on a variety of ESG factors, including non-pecuniary ESG considerations. The preamble to the Final Rule provides that prior to relying on any ESG ratings system, a plan fiduciary must determine the methodology, weighting, data source and assumptions used in such a system. When considering an investment in an ESG-indexed fund, the fiduciary should analyze the index's objective, maintenance, benchmarks and construction to understand whether and how the ESG factors used are pecuniary. Plan fiduciaries should also be wary of funds that contain disclosures that the fund may forego investment opportunities and accept different investment risks in order to pursue ESG objectives.

The Use of Non-Pecuniary Factors as a "Tie-Breaker"

The Proposal allowed plan fiduciaries to use non-pecuniary factors as a theoretical "tie-breaker" when deciding between multiple investment options only if they were economically indistinguishable. Some commenters thought this standard was inappropriately rigid and implied that the tie-breaker exception was unavailable unless the relevant investment options were perfectly identical with respect to each and every risk metric. The Final Rule's wording is slightly more permissive and allows a fiduciary to use non-pecuniary factors to make an investment decision when it is unable to distinguish between the options based on pecuniary factors alone.

When using non-pecuniary factors to distinguish between economically similar investment options, the fiduciary must document: (1) why pecuniary factors were an insufficient basis on which to make the investment decision; (2) a comparison of the investment options; and (3) a description of how the non-pecuniary factors used are consistent with the financial interests of participants and beneficiaries under the plan. It is important to note that even when used as a tie-breaker, the use of non-pecuniary factors is still subject to the duty of loyalty. Accordingly, the Final Rule would allow a fiduciary to break a tie between multiple investments based on the investment leading to job opportunities for plan participants or because it would respond to participant demand for ESG-based investments. However, the fiduciary would always be prohibited from choosing an investment based on personal policy preferences, even where investments are economically similar.

Individual Account Plans

The Final Rule does away with the Proposal's requirement that a fiduciary for an individual account plan (e.g., a 401(k) plan) document its compliance with appropriate standards if it selects an investment option that contains ESG parameters in the investment mandate. No documentation requirement is required as long as the selection is made based on pecuniary factors, even if an investment option also happens to support non-pecuniary goals. In addition, the Proposal did not permit the use of non-pecuniary ESG factors for individual account plans, even to distinguish between identical investment options. The DOL reasoned that such an allowance was unnecessary given that individual account plan platforms are intended to consist of a variety of investment options. The Final Rule continues to express doubt as to whether a tie-breaker is really relevant in the individual account plan context, but ultimately allows for non-pecuniary factors to be used as a tie-breaker for such plans.

However, the Final Rule prohibits the selection of any investment option as a qualified default investment alternative[16] ("QDIA") if its investment objectives, goals or principal investment strategies include, consider or indicate the use of non-pecuniary factors, even if its selection as the plan's QDIA would be based solely on pecuniary considerations. This would include funds that exclude investments from certain sectors (e.g., weapons, gaming or tobacco) in their objectives or principal strategies if the investments are excluded for non-pecuniary reasons. The DOL reasoned that a heightened standard is appropriate for QDIAs since they tend to be used by plan participants with less sophistication and investment experience. The Final Rule notes that an investment option that includes ESG factors could still be selected as a QDIA, provided that such ESG factors are based purely on financial considerations.

Effective Date

The majority of the Final Rule became effective on January 12, 2021 (60 days after its publication in the Federal Register), and applies to investment decisions made after such date. This includes new investments, but also decisions by plan fiduciaries as to whether to retain plan investments. However, fiduciaries need not divest of investments that would have been prohibited by the Final Rule when originally selected if such divestment is not prudent at the relevant time. Plans will have until April 30, 2022, to take action to remove any QDIAs that consider non-pecuniary factors in their investment objectives, goals or principal investment strategies. While a Biden administration could propose new rulemaking to blunt the effect of the Final Rule, this is not a certainty. As we saw with the Trump administration's response to the "Fiduciary Rule," overturning a final regulation that has already been subject to a notice and comment period is not quite as simple as overturning sub-regulatory guidance that the DOL issues in interpretative bulletins or field assistance bulletins. Accordingly, plan fiduciaries should ensure their investment decisions and practices comply with the Final Rule when it takes effect.

Originally published by Joseph Lifsics on Mayer Brown's blog, Funds & Investment Management Law Blog.

Refresher: Determining the Initial Level After Pricing

Investors want to know the material terms of an investment, such as a structured product, in order to make an informed investment decision. Some material terms of a structured note may not be determined on the trade date, the day on which investors commit to purchasing the notes. For example, the starting value (or "initial level" or "initial price") of an index- or stock-linked structured product is very often one of these terms. The starting value can be, as in a "look back" structured note, the lowest value of the underlying asset for a period of time after the trade date. This article briefly discusses the legal issues arising from terms that are not determined on the trade date.

When the starting value, for example, is unknown at the time of sale, the issuer's obligation to disclose material information under Rule 159 under the Securities Act of 1933 (the "Securities Act") at or prior to the time of sale would be satisfied if the issuer disclosed the methodology by which the investor can determine the starting

16 QDIAs are default investment options for participants who have not made their own investment choice. ERISA regulations provide a "safe harbor" for a fiduciary's selection of the investment option if certain conditions are met.

value in the preliminary pricing supplement or free writing prospectus for the offering. Although at the time of sale the investors do not know the starting value, investors can still rely on the methodology to determine, or to understand the calculation of, the starting value. The methodology should also be included in the final pricing supplement. When drafting the methodology, the issuer or counsel for the issuer should ensure that the methodology is explained in plain English.

Under Rule 424(b)(2) under the Securities Act, a final pricing supplement must be filed within two business days following the earlier of the date of the determination of the offering price or the date when such document is first used. If the initial level or price is determined after the trade date but before the filing date, under Rule 423, which allows a pricing supplement to be dated the "approximate date of its issuance," the date of the pricing supplement can be changed from the trade date to the pricing date (in this case, the date on which the initial level or price is determined).

An issuer who offers such notes is not legally required to deliver a new prospectus after the date of the sale, but it is common practice to convey the final terms to investors. The issuer can do this by delivering a short supplement to the final pricing supplement (referred to sometimes as a "sticker"), amend the final pricing supplement, or have the investors' broker confirm the final terms to its customers by phone or e-mail. Therefore, an issuer whose structured products offerings have one or more terms to be determined after the trade date should consider the following:

- Clearly explaining the methodology for determining the unknown terms;
- Disclosing who will make such determination and when that will happen; and
- How investors will receive the final terms.

Upcoming Events

REVERSEinquiries Workshop: ISDA 2020 IBOR Fallbacks Protocol

January 21, 2021 | *Register here*

Ed Parker and Chris Arnold will discussion the features of the ISDA 2020 IBOR Fallbacks Protocol and its underlying document template, as well as issues such as adherence to the protocol and final timing milestones.

Panelists will analyze the protocol and answer the following questions:

- What are the implications for loans and their hedges; structured products, repos, stock lending, non-standard transactions and other cash instruments?
- Who are the adherents to the protocol, and who is not adhering?
- Which agreements are in scope and out of scope under the protocol?
- What are the key issues for "tough legacy" transactions?

Additionally, they will discuss LIBOR cessation, its timeline, and understanding what's to come post-implementation, on January 25, 2021.

4th Debt Capital Markets Seminar

January 26, 2021 | *Register here*

The debt capital markets were busy in 2020 and enabled many issuers to prepare their treasury requirements for the ongoing COVID-19 pandemic on the one hand, but on the other hand, the number of defaults and restructurings are expected to rise.

In 2020, the IBOR transition process received further traction, however, the treatment of legacy issuances remains unsolved in many jurisdictions. Moreover, sustainability and digitalization of debt capital raising have been dominant and continue to be developing topics in the global debt capital markets.

During this seminar, the following topics will be discussed:

- Electronic and Crypto Securities in Germany;
- Updates on the IBOR transition, governmental actions, use of RFR in DCM products, New ISDA Euribor Fallbacks and EURIBOR Fallback consultation;
- Bonds and Schuldschein and COVID-19 restructuring; and
- Sustainability linked Bonds and EU Green Bond regulation.

IN CASE YOU MISSED IT…

Emissions-linked Trading in the US and EU

(November 2020)

Watch this webinar

REVERSEinquiries Workshop: NAIC-related Developments for the Structured Investments Community

(December 2020)

Watch this webinar

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MAYER BROWN'S IBOR TRANSITION RESOURCES

The final countdown to the LIBOR cessation date has begun. With fewer than 500 days left until December 31, 2021, rely on Mayer Brown to assist you.

With our global presence, deep knowledge of the affected markets and products, participation in trade and industry groups and considerable experience in using technology solutions (including artificial intelligence and other technology-assisted review tools), Mayer Brown is uniquely positioned to advise financial institutions and other affected market participants.

Our IBOR Transition Task Force, composed of nearly 100 partners globally, is perhaps the best reflection of our strength and depth.

Below we provide a sampling of our resources:

IBOR Transition Digest: A compendium of global regulatory and market news as well as insights on the complex issues confronting financial market participants as they transition from LIBOR and its variants to replacement benchmark interest rates.

Recent publications, include:

FINRA LIBOR Phase-Out Preparedness Survey (August 2020)

"Comparable" Alternative Reference Rates to LIBOR: The Low Bar for Official Designation, the Much Higher Hurdle of "Fit for Use" and Implementation for Market Participants (August 2020)

IBOR Transition: It's Later Than You Think! (August 2020)

IBOR Transition Webinar Series: Detailed discussions and insights—in 30 minutes or less—on a range of topics from setting and executing an effective IBOR Transition strategy to assessing the impact of IBOR issues on specific financial products.

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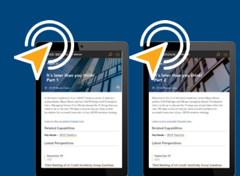
Recent webinars, include:

Part 5.1 Part 5.2

LIBOR Transition: Issues impacting Floating Rate Notes, Preferred Stock, Depositary Shares, and Capital Securities (Part 5.1 & Part 5.2) (August / September 2020)

Issues impacting Floating Rate Notes, Preferred Stock, Depositary Shares, and Capital Securities: Part 1 (August 2020)



Part 1 Part 2

It's later than you think! (Part 1 & Part 2) (August 2020)

morae

We are collaborating with Morae Global Corporation, a leading provider of legal and compliance technology solutions, to assist clients in the transition from the IBORs to alternative risk-free reference rates. To more effectively serve our client, Mayer Brown has teamed up with Morae, to offer clients data analytics and remediation, technology enablement, repapering and program management capabilities.

Our firm and our partners are ranked as leaders for capital markets, structured finance and securitization, derivatives, structured products, financial services and bank regulatory, litigation, and tax by:

TOP RANKED Chambers GLOBAL 2020

"Esteemed firm with excellent securitisation, structured finance and derivatives capital markets practices. Regularly sought after for advice on cross-border and transatlantic securitisation and structured finance transactions"

TOP RANKED Chambers USA 2020

"A strong global reach allows the team to handle cross-border cases with ease, while the presence of several former regulatory officials provides insight into the most cutting-edge matters."

The LEGAL 500 UNITED STATES

"The firm routinely leads on cross-border offerings from the US but it can also draw on its extensive network of offices for support on complex, multi-jurisdictional transactions... Among its industry sweet spots, the group is most prominent in the financial services..."

IFLR 1000

"Mayer Brown has leading structured finance, project development and project finance practices, as well as additional strengths in debt and equity capital markets."

Question? Please contact Marlon Paz, mpaz@mayerbrown.com, or see our Global IBOR Transition Task Force contacts.

Mayer Brown is pleased to have been named the European Law Firm of the Year – Transactions for *GlobalCapital*'s Global Derivatives Awards 2020.

This follows our win as US Law Firm of the Year – Transactions for *GlobalCapital*'s Americas Derivatives Awards 2020. We would like to thank *GlobalCapital* for its continued recognition and thank our friends and our colleagues for their trust in our work.

ANNOUNCEMENTS

Capital Markets Tax Quarterly. Mayer Brown's Capital Markets Tax Quarterly provides capital markets-related US federal tax news and insights. In our latest issue, we cover an update on US Tax Relief for COVID-19; Proposal to Reactivate the New York Stock Transfer Tax; IRS Delays Certain QI Certifications Due in 2020; *US v. Bittner*; and IRS Releases Final and Proposed Anti-Hybrid Tax Regulations.

LinkedIn Group. Stay up to date on structured and market-linked products news by joining our LinkedIn group.

Suggestions? *REVERSEinquiries* is committed to meeting the needs of the structured and market-linked products community, so you ask and we answer. Send us questions that we will answer on our LinkedIn anonymously or topics for future issues.

To request to join the LinkedIn group or send us suggestions/comments, please scan the QR code, which will notify us via email at REVERSEinquiries@mayerbrown.com.

The Free Writings & Perspectives, or FW&Ps, blog provides news and views on securities regulation and capital formation. The blog provides up to the minute information regarding securities law developments, particularly those related to capital formation. FW&Ps also offers commentary regarding developments affecting private placements, mezzanine or "late stage" private placements, PIPE transactions, IPOs and the IPO market, new financial products and any other securities related topics that pique our and our readers' interest. Our blog is available at: www.freewritings.law.

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REVERSE inquiries

Structured and market-linked product news for inquiring minds.

In This Issue

Can the SEC protect investors from themselves?

What do these stories all have in common?

- An event planner loses over $100,000 shorting a 3X inverse leveraged exchange traded note;[1]
- Individual investors lost their investments in mortgage REIT and crude oil leveraged ETNs during the real estate and crude oil collapse earlier this year;[2] and
- Retail investors poured money into an oil-futures linked ETF this Spring, many not understanding that the price of a share of the ETF was not the same as the price of a barrel of oil.[3]

Besides the obvious ("what were they thinking?"), one has to wonder why retail investors are purchasing products, many of which plainly state in their prospectuses that they are designed as short-term investments for sophisticated investors who track their portfolios on a daily basis, and that state that the products are not designed to be long-term investments.

The Securities and Exchange Commission ("SEC") responded to the dislocations in the markets for leveraged inverse products in a joint statement by Chairman Jay Clayton, Dalia Blass, Director, Division of Investment Management, William Hinman, Director, Division of Corporation Finance, and Brett Redfearn, Director, Division of Trading and Markets (the "Joint Statement").[4]

The Joint Statement noted that retail investors may not appreciate that times of "market stress … typically have a disproportionate impact on complex products, such as leveraged/inverse products …." The SEC acknowledged that these types of products "have operated in accordance with their terms," but the "pricing

[1] "Runaway ETNs Trap Investors in the 'Wild West' of Index Investing," *The Wall Street Journal* (Oct. 19, 2020).

[2] "'Bankrupt in Just Two Weeks; - Individual Investors get Burned by Collapse of Complex Securities," *The Wall Street Journal* (June 1, 2020).

[3] "Oil Market's Crisis Spreads to Individual Investors," *The Wall Street Journal* (Apr. 22, 2020).

[4] The October 28, 2020 Joint Statement is available at: https://bit.ly/32hN1AE.

and trading dynamics of these products during the spring market was not consistent with investor expectations."[5]

In other words, the issue isn't disclosure, it's investor education. With greater access to trading sites,

> "self-directed retail investors are typically making investment decisions on their own accord via online trading platforms and without the assistance of a financial professional. In other words, these self-directed investors do not have the required protections that apply when they receive investment advice from a broker or investment adviser, who must understand, and may explain if necessary, the characteristics and potential risks and rewards of the investment, and determine that it is in the best interest of the retail customer."[6]

If these investors had purchased their complex products through a broker-dealer or RIA, they would have benefitted from certain protections. However, as the SEC stated, "Regulation Best Interest and an investment adviser's fiduciary duty do not apply where a retail investor invests on his or her own accord in complex products through a self-directed account."[7]

How can the SEC protect self-directed retail investors independently selecting complex products, which they may not fully understand? The staffs of the Divisions of Investment Management, Corporation Finance and Trading and Markets will be reviewing the effectiveness of current regulations as they relate to retail investors with self-directed accounts who buy leveraged/inverse and other complex products. The results may be potential new rulemaking, guidance or other policy actions. Also, the staff "may consider … additional obligations for broker-dealers and investment advisers relating to complex products … point of sale disclosures and procedures tailored to the risks of complex products."[8]

Regulation S-K Transitional FAQs

On November 5, 2020, the Staff of the SEC's Division of Corporation Finance provided guidance in the form of Frequently Asked Questions (FAQs) relating to the amendments to Regulation S-K Items 101, 103 and 105, which become effective on November 9, 2020.[9]

Many market participants already have begun the process of updating their Risk Factor section disclosures in order to add subheadings as well as to add a brief summary to the section. The FAQs address the obligation to update as follows:

> (1) **Question**: A registrant has a Registration Statement on Form S-3 that became effective before November 9, 2020. If the registrant files a prospectus supplement to the Form S-3 on or after November 9, 2020, must the prospectus supplement comply with the new rules?

[5] *See* the Joint Statement at Section 2.

[6] *Id*. at Section 3.

[7] *Id*. at Section 4.

[8] *Id*.

[9] See the Frequently Asked Questions at https://www.sec.gov/corpfin/transitional-faqs-amended-regulation-s-k-items-101-103-105.

Answer: The prospectus supplement does not need to comply with new Items 101 and 103 because Form S-3 does not expressly require Item 101 or Item 103 disclosure but rather requires the incorporation by reference from Exchange Act reports containing that information. A registrant also need not amend its Form 10-K that is incorporated by reference into the Form S-3 pursuant to Item 12(a)(1) of Form S-3 to comply with new Items 101 and 103.

In contrast, Securities Act Rule 401(a) requires that the form and contents of a prospectus supplement conform to the applicable rules and forms as in effect on the initial filing date of the prospectus supplement. Despite the fact that Item 3 of Form S-3 expressly requires Item 105 disclosure, the staff will not object if the prospectus supplement complies with old Item 105 until the next update to the Registration Statement on Form S-3 for Section 10(a)(3) purposes.

Many issuers rely on a layered approach to their structured products disclosures, with a base prospectus, which is accompanied by a prospectus supplement often relating to a medium-term note program, and that in turn is accompanied by a product supplement describing the features of particular structured products or of products having certain underlying reference assets. The terms of the offered products are usually contained in a pricing supplement and/or a free writing prospectus. Several of these documents may contain Risk Factors sections. Also, many issuers will offer their structured products through their affiliated broker-dealer, as well as through a number of third-party distributors, each of which may have its own preferred approach to risk factor disclosure. Consideration should be given to the totality of the disclosures relating to risks as well as the ordering or grouping of these risks into subheadings or categories.

FINRA Proposes a Retail Communication Filing Requirement for Private Placements

Financial Industry Regulatory Authority, Inc. ("FINRA") Rules 5122 (private placements of securities issued by member firms) and 5123 (private placements of securities) each require a FINRA member to file with the FINRA advertising department any private placement memorandum, term sheet or other offering document that discloses the intended use of the offering proceeds, the offering expenses and the amount of selling compensation that will be paid to the FINRA member. Because offerings covered by both rules to institutional investors are exempt from their respective filing requirements, the rules apply predominantly to private placements made to retail investors. Neither rule requires that a "retail communication," as defined in FINRA Rule 2210, be filed with FINRA. However, many of such retail communications are filed voluntarily or by new FINRA members under Rule 2210(c)(1)(A).

In the proposed rule change filed with the SEC on October 28, 2020, FINRA noted that many of the voluntarily filed retail communications for private placements are deficient and tend to raise more compliance issues than for other products.[10] Consequently, FINRA proposes to amend Rules 5122 and 5123 to require filing with FINRA any retail communication, as defined in Rule 2210, at or prior to the first time the retail communication is provided to a retail investor.

As this is an initial filing with the SEC, no effective date for the amendments was proposed.

[10] The FINRA 19b-4 Application is available at: https://bit.ly/3kXE6M9.

ARRC Provides Recommendations to US Prudential Banking Regulators to Facilitate USD LIBOR Transition to SOFR

On November 2, 2020, the Alternative Reference Rates Committee ("ARRC") sent a detailed memorandum ("Memorandum") to the Board of Governors of the Federal Reserve System ("FRB"), the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC" and, together with the FRB and FDIC, the "Agencies") that summarizes the ARRC's preliminary findings and recommendations on the potential regulatory considerations with the application of current and anticipated capital and liquidity requirements in the context of the market transition from the use of the London Interbank Offered Rate ("LIBOR") to the Secured Overnight Financing Rate ("SOFR") as a contractual reference rate in the United States (the "Transition").

The Memorandum notes that a key policy goal of the Transition is to reduce overall risk in the financial system. The treatment of SOFR-based exposures under prudential capital and liquidity standards during and after the Transition should recognize this policy goal and ensure that prudential treatment of these exposures does not dis-incentivize timely and voluntary transition to SOFR. In general, if the Transition were to lead to unintended increases in capital and liquidity requirements, this would be at cross-purposes with the macro-prudential goal of mitigating risk of the financial system as a whole. To that end, the Basel Committee on Banking Supervision ("BCBS") has issued guidance in the form of FAQs ("BCBS June 2020 FAQs") that clarify application of certain international capital and liquidity standards in light of the transitions in many of its member jurisdictions from IBORs to risk-free rates ("RFRs").

The ARRC states in the Memorandum that it believes US regulators should similarly address these principles with respect to current US capital and liquidity regulatory requirements, as well as to future such requirements, such as quantitative impact studies of the implementation of the Fundamental Review of the Trading Book ("FRTB") because past studies may not have included a robust pro forma analysis reflecting the impact of the Transition and because the BCBS June 2020 FAQs are not legally operative in the United States.

Read our complete Legal Update.

US Bank Regulators Finalize Net Stable Funding Ratio Rule

Despite attracting recent controversy from some—who have noted that if it had been in effect earlier in 2020, initial financial stress from the COVID-19 pandemic would have been worse—the long-anticipated net stable funding ratio (NSFR) rule has been finalized by the Agencies. The NSFR was developed after the 2008 financial crisis revealed that an over-reliance on short-term, less-stable funding sources could make large banking organizations more susceptible to funding changes. The NSFR rule is a quantitative liquidity standard that was originally adopted in October 2014 by the BCBS as part of the Basel III regime and was first proposed by the Agencies in 2016. The proposed and final NSFR rules differ from the standard developed by the BCBS based on US-market specific factors.

The full NSFR rule will apply to nine of the largest US banking organizations and to their consolidated subsidiaries that are depository institutions with $10 billion or more in total consolidated assets. A modified version of the NSFR rule will apply to eleven other depository institution holding companies with assets of at least $100 billion, including certain intermediate holding companies formed by foreign banking organizations (FBOs) under FRB's Regulation YY, as well as certain of their consolidated subsidiaries that are depository institutions with $10 billion or more in total consolidated assets. The NSFR rule will not apply to FBOs or US branches and agencies of FBOs.

The NSFR rule generally is similar to the proposal from May 2016, but, most notably, the scope of the NSFR rule has been recalibrated to be consistent with the Agencies' 2019 tailoring rule. Additionally, FRB indicated that it intends to propose changes to the FR 2052a to incorporate the reporting requirements under the NSFR rule. The NSFR rule will take effect on July 1, 2021.

Read our complete Legal Update.

Exempt Offering Framework Amendments

On November 2, 2020, the SEC voted to adopt amendments proposed in March 2020 that harmonize and modernize the exempt offering framework (referred to as the Amendments). As with several other recent votes to adopt rule proposals, the SEC Commissioners split their vote, with two Commissioners voting against the Amendments. Among other things, the Amendments modernize the framework relating to the integration of securities offering occurring in close proximity to one another. The Amendments include a new, simpler approach to integration consisting of four non-exclusive safe harbors guided by several overriding principles. This simpler approach is set forth in a new Rule 152, which replaces current Rule 152 and Rule 155. The provisions of Rule 152 will not have the effect of avoiding integration for any transaction or series of transactions that are part of a scheme to evade the Securities Act registration requirements. Instead of embedded integration provisions, Regulation D, Regulation A, Regulation Crowdfunding, and Rules 147 and 147A now contain references to new Rule 152.

Read our complete Legal Update.

LIBOR Transition Assistance Legislation Introduced in New York State Senate

On October 28, 2020, New York State Senator Kevin Thomas introduced Senate Bill S9070, which would add a new Article 12 to New York's Uniform Commercial Code that substantially adopts the language from the proposed legislative solution produced by the Alternative Reference Rates Committee (ARRC) in March 2020. For some market participants, this announcement may trigger hearing the Halleluiah chorus from Handel's Messiah, while others may still be asking why it took so long, and still others may be asking why bother given its potential limitations.[11]

11 Some of which we discussed in our prior Perspective US ARRC Proposes a New York State Legislative "Solution" for Legacy LIBOR Contracts Without Adequate Fallbacks—But What Does It Actually "Solve"?

Even if this is properly regarded as "good news," the political reality is that the legislation is unlikely to be taken up until the 2021 legislative session that begins in January 2021.

Meanwhile, prospects for federal legislation that may address some of the limitations of the proposed New York legislation (and would apply in all states, including New York) remains uncertain, although there are encouraging reports of Congressman Brad Sherman[12] seeking sponsors for such legislation.

Originally published on Mayer Brown's new blog, Eye on IBOR, which provides continuing regulatory and legislative announcements, trade group tools, and the status of market transition.

FINRA Study on Overconfidence and Excessive Risk Taking Among Older Investors; FINRA Proposes Amendments to Rules Affecting Seniors

In September 2020, the FINRA Investor Education Foundation published a study, "Does Overconfidence Increase Financial Risk Taking in Older Age?" that is based on a surveys completed by 1,200 adults. Financial literacy was lowest among the oldest adults in the study; however, the confidence in financial knowledge was similar across all ages. The study suggests that overconfidence may contribute to risky financial behavior. The detailed report provides a number of useful insights for broker-dealers and advisers, suggesting, for example, the benefits that may be associated with devoting additional time to understanding financial literacy among clients, spending more time addressing portfolio or investment risk when updating client information, and undertaking more educational outreach with older investors.

In October 2020, FINRA proposed amendments to Rule 2165 on Financial Exploitation of Specified Adults. In Regulatory Notice 20-34, FINRA describes the retrospective review and comments relating to senior issues. Rule 2165 allows a FINRA member firm to place a temporary hold on a disbursement of funds or securities from the account of a "specified adult" customer when the member firm believes that the customer is experiencing financial exploitation. The safe harbor under Rule 2165 allows a firm to place a temporary hold for up to 25 business days to the extent that specified criteria are satisfied. FINRA proposes to amend the rule to permit extension of the temporary hold for an additional 30 business-day period if the incident has been reported to a state agency or to a court. FINRA also proposes to extend the rule to allow for a hold on securities transactions subject to safeguards. The comment period expires on December 4, 2020.

SEC Charges Senior Index Manager for Insider Trading

On September 21, 2020, the SEC announced charges against Yinghang "James" Yang, a senior index manager at a well-recognized index provider, for perpetrating an insider-trading scheme. Yuanbiao Chen, Yang's friend, was named a co-defendant.

12 Democrat, California and Chair of the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets of the House of Representative's Financial Services Committee

The SEC alleged that between June and October of 2019, Yang, while serving on an index committee, purchased options of publicly traded companies before the public announcement of additions or deletions of these companies to the indices that Yang's employer maintained. To conceal these trading activities from his employer's supervision, Yang conducted all the trades in Chen's brokerage account. Chen opened the brokerage account about one month before these trades and misrepresented his trading experience to the brokerage firm in order to obtain options trading authorization. The SEC also alleged that many orders to purchase options were immediately preceded by logins to Chen's brokerage account by IP addresses assigned to Yang's employer. The brokerage account was also accessed by IP addresses assigned to Yang's home and Chen's restaurant.

The SEC alleged that Yang and Chen generated about $900,000 in profits through the insider trading scheme. The Department of Justice also brought criminal charges against Yang.

We usually hear about insider trading cases where unusual options activities happen before a major M&A announcement. This case, however, is possibly the first time that the SEC brought a case against an employee of an index provider, and it serves as a reminder that material non-public information is not limited to information obtained from an issuer, dealer or other distribution participant. Given that trades of this type turned out to be profitable, this case also sheds some light on the potential impact of additions or deletions of a stock to an index and their effects. As more and more investment decisions involve indices and other data aggregates, market-moving information providers may need to implement and enhance the scrutiny of their employees' conduct and the effectiveness of internal information walls that prevent such information from being misused.

Upcoming Events

- **PLI Fund Finance 2020**
  November 11, 2020 | *Register here*
  Lawrence Hamilton will speak on the panel entitled *Overview of Collateralized Fund Obligations and Principal Notes,* discussing structuring considerations; transaction benefits for sponsors and general partners; and NAIC outlook.
- **REVERSEinquiries Webinar: Emissions Linked Trading in the US and EU**
  November 12, 2020 | *Register here*
  Ed Parker and Matthew Kluchenek will discuss key issues with emissions trading, the asset class which is purely a creature of regulation and that leads to many intricacies, nuances and traps for the unwary. They will cover:
    - Relevance of the Kyoto Protocol
    - Emissions Trading Regimes
    - ISDA, EFET and EFET Documentation Platforms
    - Regulatory Treatment of Emissions Products in the US (i.e., as Swaps, Futures or Forwards)
    - Using Emissions Allowances as an Underlying Asset in Structured Products, including property rights issues in different EU Member States, and issues with taking security
    - Awareness of Fraud Issues

IN CASE YOU MISSED IT…

SEC Amends Requirements for Statistical Disclosures for Bank and Savings and Loan Registrants, Formerly Guide 3 (September 2020)

Listen to this podcast.

REVERSEinquiries Workshop: Issuing Credit Linked Notes (October 2020)

Watch this webinar.

Structured Products Association 17th Annual Conference (October 2020)

Watch select panels from this webinar.

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MAYER BROWN'S IBOR TRANSITION RESOURCES

The final countdown to the LIBOR cessation date has begun. With fewer than 500 days left until December 31, 2021, rely on Mayer Brown to assist you.

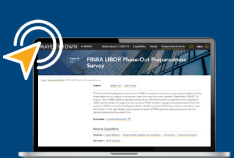
With our global presence, deep knowledge of the affected markets and products, participation in trade and industry groups and considerable experience in using technology solutions (including artificial intelligence and other technology-assisted review tools), Mayer Brown is uniquely positioned to advise financial institutions and other affected market participants.

Our IBOR Transition Task Force, composed of nearly 100 partners globally, is perhaps the best reflection of our strength and depth.

Below we provide a sampling of our resources:

IBOR Transition Digest: A compendium of global regulatory and market news as well as insights on the complex issues confronting financial market participants as they transition from LIBOR and its variants to replacement benchmark interest rates.

Recent publications, include:



FINRA LIBOR Phase-Out Preparedness Survey (August 2020)

"Comparable" Alternative Reference Rates to LIBOR: The Low Bar for Official Designation, the Much Higher Hurdle of "Fit for Use" and Implementation for Market Participants (August 2020)

IBOR Transition: It's Later Than You Think! (August 2020)

IBOR Transition Webinar Series: Detailed discussions and insights—in 30 minutes or less—on a range of topics from setting and executing an effective IBOR Transition strategy to assessing the impact of IBOR issues on specific financial products.

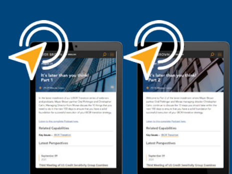
Subscribe on: Google Play Spotify

Recent webinars, include:

Part 5.1 Part 5.2

LIBOR Transition: Issues impacting Floating Rate Notes, Preferred Stock, Depositary Shares, and Capital Securities (Part 5.1 & Part 5.2) (August / September 2020)

Issues impacting Floating Rate Notes, Preferred Stock, Depositary Shares, and Capital Securities: Part 1 (August 2020)



Part 1 Part 2

It's later than you think! (Part 1 & Part 2) (August 2020)

morae

We are collaborating with Morae Global Corporation, a leading provider of legal and compliance technology solutions, to assist clients in the transition from the IBORs to alternative risk-free reference rates. To more effectively serve our client, Mayer Brown has teamed up with Morae, to offer clients data analytics and remediation, technology enablement, repapering and program management capabilities.

Our firm and our partners are ranked as leaders for capital markets, structured finance and securitization, derivatives, structured products, financial services and bank regulatory, litigation, and tax by:

TOP RANKED Chambers GLOBAL 2020

"Esteemed firm with excellent securitisation, structured finance and derivatives capital markets practices. Regularly sought after for advice on cross-border and transatlantic securitisation and structured finance transactions"

TOP RANKED Chambers USA 2020

"A strong global reach allows the team to handle cross-border cases with ease, while the presence of several former regulatory officials provides insight into the most cutting-edge matters."

The LEGAL 500 UNITED STATES

"The firm routinely leads on cross-border offerings from the US but it can also draw on its extensive network of offices for support on complex, multi-jurisdictional transactions... Among its industry sweet spots, the group is most prominent in the financial services..."

IFLR 1000

"Mayer Brown has leading structured finance, project development and project finance practices, as well as additional strengths in debt and equity capital markets."

Question? Please contact Marlon Paz, mpaz@mayerbrown.com, or see our Global IBOR Transition Task Force contacts.

Mayer Brown is pleased to have been named the European Law Firm of the Year – Transactions for *GlobalCapital*'s Global Derivatives Awards 2020.

This follows our win as US Law Firm of the Year – Transactions for *GlobalCapital*'s Americas Derivatives Awards 2020. We would like to thank *GlobalCapital* for its continued recognition and thank our friends and our colleagues for their trust in our work.

ANNOUNCEMENTS

Capital Markets Tax Quarterly. Mayer Brown's Capital Markets Tax Quarterly provides capital markets-related US federal tax news and insights. In our latest issue, we cover an update on US Tax Relief for COVID-19; Proposal to Reactivate the New York Stock Transfer Tax; IRS Delays Certain QI Certifications Due in 2020; *US v. Bittner*; and IRS Releases Final and Proposed Anti-Hybrid Tax Regulations.

LinkedIn Group. Stay up-to-date on structured and market-linked products news by joining our LinkedIn group.

Suggestions? *REVERSEinquiries* is committed to meeting the needs of the structured and market-linked products community, so you ask and we answer. Send us questions that we will answer on our LinkedIn anonymously or topics for future issues.

To request to join the LinkedIn group or send us suggestions/comments, please scan the QR code, which will notify us via email at REVERSEinquiries@mayerbrown.com.

The Free Writings & Perspectives, or FW&Ps, blog provides news and views on securities regulation and capital formation. The blog provides up-to-the-minute information regarding securities law developments, particularly those related to capital formation. FW&Ps also offers commentary regarding developments affecting private placements, mezzanine or "late stage" private placements, PIPE transactions, IPOs and the IPO market, new financial products and any other securities related topics that pique our and our readers' interest. Our blog is available at: www.freewritings.law.

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TAXQUARTERLY

DON'T TAX YOU. DON'T TAX ME. TAX THAT FELLOW BEHIND THE TREE.*

VOLUME 03, ISSUE 04 | February 3, 2021

Editor's Note

After the Georgia Senate elections were decided in early January, CMTQ could see that 2021 would be a busy year tax-wise. As we told you in our last issue, with a new administration and a 50/50 US Senate, and with Vice President Kamala Harris as tiebreaker, there are more chances for President Joe Biden's ambitious tax agenda to become law. This could mean big changes for US capital markets taxation.

Front and center would be tax-rate increases. Most importantly, as we reported in CMTQ Vol. 3, Issue 1, and discuss in the article below, the Biden plan would eliminate the difference between ordinary income and capital gain tax rates. Both would be taxed at the maximum ordinary income rate which would go back to the pre-TCJA 39.6% rate. The new rate for capital gains would only apply to taxpayers with taxable income greater than $1,000,000. One other note: if one adds in the 3.8% Medicare tax on investment income, capital gains subject to that tax would apparently be taxed at an all-in 43.4% rate, higher than the rate on ordinary income. Of course, no one knows what any actual legislation might look like.

Equally important in our little world is the potential for mark to market taxation. Although not quite formalized as of this writing, Democratic Senator Ron Wyden will likely be the new chairman of the Senate Finance Committee. For a look at what he thinks capital markets tax-wise, see his 2019 paper: Treat Wealth Like Wages.[1] That plan also would eliminate preferential rates for long-term capital gains. It would go farther and require that gains and losses on publicly traded stock and debt (i.e.,

In This Issue

1 Available at https://www.finance.senate.gov/imo/media/doc/Treat%20Wealth%20Like%20Wages%20RM%20Wyden.pdf.

* As described in the Editor's Note, this quote is attributed to, among others, Sen. Russell Long (D., LA).

tradable assets)[2] be recognized each year, i.e., a mark to market system. Wyden's plan would subject recognized gains on non-traded assets to retrospective taxation. That is, when gain was recognized, say on the sale of a business held for five years, the taxpayer would be required to pay an additional amount to compensate for the gain deferral. Wyden's plan asks for input on how this additional amount should be computed. Interestingly, one possibility is to impose a surtax on gain from the sale of assets with longer holding periods (thus wholly reversing the current tax system's capital gain preference). The new anti-deferral system would only apply to taxpayers with over 1 million in taxable income or $10 million in assets. According to the Wyden plan the revenue raised from this new anti-deferral system would be used to provide additional funding for Social Security.

Needless to say, these would be big changes in the US federal income tax system as it relates to capital markets and financial instruments. Of course, the new administration has many other priorities in 2021 so it will be interesting to see how they prioritize tax law changes over the next several months.

CMTQ, as always, will keep you up to date.

In this issue, we also cover a Revenue Procedure with extended relief for certain entities owning mortgages, insight into a couple of SPAC tax issues, and more.

Tax Plans of the New Administration

As discussed in a previous issue of CMTQ, President Joe Biden has put forward a variety of tax proposals.[3] With Democratic majorities in the House and a 50/50 Senate (with Vice President Kamala Harris as the tie-breaker), a path has potentially been cleared to advance Biden's tax proposals through Congress into law. Here, we touch on some of the new president's major tax proposals from the campaign trail.

CORPORATE AND BUSINESS TAX PROPOSALS

Biden's tax plan would increase the corporate income tax rate from its current 21% to 28%. In addition, Biden would institute a 15% minimum tax on book profits, or reported annual income net of annual expenses, for corporations with at least $100 million in annual income. When calculating this new minimum tax liability, corporations would still be allowed to claim deductions for losses carried forward from previous years and foreign taxes paid. The tax would function as an alternative

2 Tradable assets are those "for which there is a readily ascertainable fair market value including actively traded property." For this the Wyden plan refers to Treas. Reg. section 1.1092(d)-1 (personal property traded on an established financial market).

3 For the Biden tax plan, see A Tale of Two Tax Policies: Trump Rewards Wealth, Biden Rewards Work (available at https://joebiden.com/two-tax-policies/); The Biden Plan to Ensure the Future is "Made in All of America" by All of America's Workers (available at https://joebiden.com/made-in-america/); and Committee for a Responsible Federal Budget, Understanding Joe Biden's 2020 Tax Plan (July 20, 2020, available at http://www.crfb.org/sites/default/files/CRFB%20USBW%20Biden%20Tax%20Plan%20Analysis_FINAL%20DRAFT_07302020.pdf)

minimum tax, replacing one that was in effect until it was eliminated by the Tax Cuts and Jobs Act of 2017 (the "TCJA").

Under Biden's plan, the effective tax rate on global intangible low-taxed income ("GILTI") would double from 10.5% to 21%. GILTI would be calculated on a country-by-country basis, rather than using a worldwide average, which would, in general, prevent taxpayers from offsetting GILTI amounts between high-tax and low-tax jurisdictions. Further, Biden's plan would eliminate GILTI's exemption for deemed returns under 10% of qualified business asset investment.

Biden also proposes completely phasing out the qualified business income ("QBI") deduction under Code section 199A for filers making more than $400,000. Biden's plan would maintain the current QBI deduction for those making under $400,000 per year. Importantly, REIT dividends are currently eligible for the QBI deduction. One wants to see the fine print, of course, but presumably such dividends could be affected by these changes.

INDIVIDUAL TAX PROPOSALS

Biden's tax plan calls for restoring the top individual income tax rate for taxable income above $400,000 from 37% under current law to the pre-TCJA level of 39.6%. Biden proposes to cap the value of itemized deductions at 28% for those with taxable incomes exceeding $400,000 and restore the Pease limitation on itemized deductions, which was repealed under the TCJA through 2025. Biden would also eliminate the preferential treatment of capital gains and dividends for higher earners. Specifically, capital gains and dividends would be taxed as ordinary income at a rate of 39.6% for individuals and couples earning more than $1 million.

Biden's plan would also impose a 12.4% old-age, survivors, and disability insurance payroll tax on income earned above $400,000, evenly split between employers and employees. Under current law, this payroll tax only applies to wage income up to $137,700.

Finally, Biden's plan would eliminate the Code section 1014 basis step up at death and would return estate and gift tax exemptions to 2009 levels.

Mark-to-Market?

As noted above, in this, the 117th Congress, Senator Ron Wyden (D-Ore.) is poised to become the next chairman of the Senate Finance Committee. On September 12, 2019, Senator Wyden the then ranking Democratic member on the Senate Finance Committee, released his Treat Wealth Like Wages - a tax plan that would establish a mark-to-market tax regime.[4] This plan, which would only apply to

4 For further discussion of the 2019 plan, see Capital Market Tax Quarterly Vol. 2 Issue 3, available at https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/10/capital-markets-tax-quarterly-volume-2-issue-3--oct-2019.pdf.

high income or high-net worth taxpayers, would generally impose annual "mark-to-market" accounting and taxation for tradable assets such as publicly traded stock and lookback taxation upon sale for assets that are less easily valued, such as real estate, closely held businesses and valuable collectibles. Wyden recently stated that he plans to move forward with this proposal now that there is a tie in the Senate with a tie-breaker from the vice president.[5]

Mark-to-market taxation currently only applies to dealers in securities under Code section 475 and regulated futures contracts under Code Section 1256. While there have been proposals going back to former Representative Dave Camp (R, MI) in 2013, mark-to-market was not included in the TCJA.

Select US Tax Considerations for SPACs

Special purpose acquisition companies ("SPACs") had an unprecedented run in 2020 which continues in 2021. At the close of 2020, more than 230 SPACs had raised more than $78 billion through initial public offerings ("IPOs"), surpassing the $13.6 billion raised through approximately 59 SPACs in 2019. While the SPAC profile is straightforward (typically, an IPO for cash followed by an acquisition), there are nevertheless US federal income tax issues in each SPAC offering and acquisition.[6]

For example, one question relates to the timing and character of tax imposed on receipt of founders shares. In a typical SPAC structure, the sponsors contribute nominal cash in exchange for founders shares, which ultimately become a 20 percent equity interest in the SPAC after its IPO. Thus, the sponsors effectively have a zero tax basis in their founders shares while receiving 20 percent of the SPAC's equity. Is this taxed at the time of the IPO, at the time a target is acquired, or when the sponsors sell their founder shares?

In a properly structured SPAC, Sponsors rely on the "realization" principle and determine that receipt of founder's shares does not result in gross income. Thus, under the current US tax system gain on an asset is not realized until the asset is disposed of. With founder's shares even though the SPAC does an IPO (thereby establishing value for the shares) no gain is generally recognized because the founder is not disposing of its shares in the IPO. Moreover, case law suggests that if a sponsor acquires its founders shares before the SPAC has taken any meaningful actions (i.e., when the value of the shares is most speculative), then the interest would not be characterized as compensation.[7] To bolster this position, founders shares should ideally be issued to sponsors as soon as possible in

5 Colin Wilhelm, Incoming Finance Chair Wyden to Move on Capital Gain Changes , Bloomberg Tax (January 13, 2021).

6 For a more in depth analysis of the mechanics of a SPAC, please see our article "*What's the Deal? – Special Purpose Acquisition Companies*" available at https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/08/whats-the-deal--spacs.pdf.

7 *See Berckmans v. Commissioner*, T.C. Memo. 1961-100 (supporting the position that fair market value of stock purchased at par value ($1 per share) was not worth more at the time of a taxpayer's purchase since at the time of purchase the corporation had no assets and only speculative future plans); *but see Husted v. Commissioner*, 47 T.C. 664 (1967) (concluding that a taxpayer was permitted to acquire shares of stock of a corporation for less than its fair market value and that the difference was compensation income for his services in arranging the acquisition of a trailer business by the corporation.

advance of the IPO. Of course, if Senator Wyden's mark-to-market proposal described above becomes law appreciation in a sponsor's founders shares might be taxed at the end of the first taxable year after the IPO because the shares would be traded on an established market at that point.

Note that the acquisition of a target (i.e., the de-SPAC transaction) is generally (although not always) structured as an acquisition by the SPAC of a target company with a business. In this case, the founders do not exchange their shares but continue to hold them so, again, there is no realization event to the founders at the time of the acquisition. Putting this all together, under current law gain on founders shares is only recognized when the founder sells or exchanges the shares.

Another SPAC question relates to the taxation of a "unit." One of the common features in a SPAC is that the IPO is of a unit consisting of common stock and a fraction (e.g., one-third or one-half) of a redeemable warrant. One whole warrant allows the holder of the warrant to acquire additional common stock. The stock and the warrant trade together initially but then, after a period of time, the warrant detaches and the common stock and the warrant trade separately. How is that treated for US federal income tax purposes?

For example, assume that in an offering a unit is offered for $10. Further assume that a few months after the IPO, the unit traded up to $18 and the warrant detached when the common stock price was $12 and the warrant price was $6. To understand the tax consequences of the acquisition, possession, and subsequent disposition of the unit to a holder, the holder must understand when and how the tax basis is allocated between the common stock and the warrant.

When an option or stock is coupled with a debt instrument, Treas. Reg. Section 1.1273-2 provides that—

(h) **Investment units**

(1) *In general*. Under section 1273(c)(2), an investment unit is treated as if the investment unit were a debt instrument. The issue price of the investment unit is determined under paragraph (a)(1), (b)(1), or (c)(1) of this section, if applicable. The issue price of the investment unit is then allocated between the debt instrument and the property right (or rights) that comprise the unit based on their relative fair market values . . . .

(2) *Consistent allocation by holders and issuer*. The issuer's allocation of the issue price of the investment unit is binding on all holders of the investment unit. However, the issuer's determination is not binding on a holder that explicitly discloses that its allocation is different from the issuer's allocation. Unless otherwise provided by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed Federal income tax return for the taxable year that includes the acquisition date of the investment unit . . . .

However, there is no such regulation dealing with the common stock and warrants that are issued as an investment unit. In Rev. Rul. 88-31, the IRS considered the tax characterization of an investment unit issued by a corporation, which consisted of common stock and a contingent payment right (the value of which varied inversely with the value of the common stock). Similar to the units issued by SPACs, the investment unit in the revenue ruling initially could not be separated. After a short period of time, however, the parts could be separately transferred and traded on a national exchange. First, the IRS established that the contingent payment rights were property separate from the common stock. Then, the IRS quickly concluded that the tax basis should be allocated between the common stock and the contingent payment right on the basis of the fair market value of the common stock on the date of issuance. Note, however, that at the time the investment units were issued by the corporation, the corporation's common stock was widely held and publicly traded on a national securities exchange. Thus, the relative fair market values of the common stocks and the contingent payment rights were readily ascertainable.

When trying to allocate tax basis between the common stock and the warrant in a unit issued by a SPAC, one approach, as in Rev. Rul. 88-31, would be to allocate the purchase price initially between the common stock and the warrant based on their relative fair market values. For example, one SPAC that adopted this approach included the following disclosure regarding the tax basis of a unit—

"No statutory, administrative or judicial authority directly addresses the treatment of a unit or instruments similar to a unit for U.S. federal income tax purposes and, therefore, that treatment is not entirely clear. The acquisition of a unit should be treated for U.S. federal income tax purposes as the acquisition of one share of our [common stock] and [one-half of one warrant] to acquire one share of our [common stock]. For U.S. federal income tax purposes, each holder of a unit must allocate the purchase price paid by such holder for such unit between the one share of [common stock] and the one-half of one warrant based on the relative fair market value of each at the time of issuance. Under U.S. federal income tax law, each investor must make his or her own determination of such value based on all the relevant facts and circumstances. Therefore, we strongly urge each investor to consult his or her tax adviser regarding the determination of value for these purposes. The price allocated to each share of [common stock] and the one-half of one warrant should be the stockholder's tax basis in such share or warrant, as the case may be. Any disposition of a unit should be treated for U.S. federal income tax purposes as a disposition of the share of [common stock] and one-half of one warrant comprising the unit, and the amount realized on the disposition should be allocated between the [common stock] and the one-half of one warrant based on their respective relative fair market values (as determined by each such unit holder on all the relevant facts and circumstances) at the time of disposition. The separation of shares of [common stock] and warrants comprising units should not be a taxable event for U.S. federal income tax purposes.

The foregoing treatment of the shares of [common stock] and warrants and a holder's purchase price allocation are not binding on the Internal Revenue Service ("IRS") or the courts. Because there are no authorities that directly address instruments that are similar to the units, no assurance can be given that the IRS or the courts will agree with the characterization described above or the discussion below. Accordingly, each prospective investor is urged to consult its own tax advisors regarding the tax consequences of an investment in a unit (including alternative characterizations of a unit). The balance of this discussion assumes that the characterization of the units described above is respected for U.S. federal income tax purposes."

However, unlike Rev. Rul. 88-31, the ability to correctly allocate tax basis between the common stock and warrant at the time of issuance by a SPAC is not necessarily apparent to the naked eye because there is no separate trading at such time. Put another way, it would be much easier to allocate tax basis between the two pieces when they begin trading separately. For example, in our illustration above, $12 would be allocated to the common stock and $6 to the warrant. Unfortunately, the answer, as in so many financial instrument tax issues, is not clear. Moreover, as can be seen from the above disclosure, it appears that many issuers take the position that the allocation must be done at the time of issuance rather than separation.

PLR 202035003 – Guidance on Settlement Payments to REMIC Regular Interest Holders

On August 28, 2020, the Internal Revenue Service ("IRS") issued a private letter ruling offering guidance on the tax treatment of settlement payments to former real estate mortgage investment conduit ("REMIC") regular interest holders.

As background, the Code generally defines a REMIC as any entity that (i) has made an election to be treated as a REMIC for the current taxable year and all prior taxable years; (ii) all of the REMIC's interests are residual interests or regular interests; (iii) the REMIC only has one class of residual interest; and (iv) substantially all of the REMIC's assets consists of qualified mortgages and permitted investments. For purposes of satisfying the asset requirement, "substantially all" of a qualified entity's assets are qualified mortgages and permitted investments if the qualified entity owns no more than a de minimis amount of other assets. Further, the amount of other assets is considered de minimis if the aggregate of the adjusted basis of such assets is less than one percent of the aggregate of the adjusted basis of all of the REMIC's assets.

The Code also imposes a 100 percent tax on a REMIC's net income derived from a "prohibited transaction." A "prohibited transaction" is defined as one of the following transactions: (A) disposition of any qualified mortgage transferred to the REMIC other than a disposition pursuant to (i) the substitution of a qualified replacement mortgage for a qualified mortgage (or the repurchase in lieu of substitution of a defective obligation), (ii) a disposition incident to the foreclosure, default, or imminent default of the mortgage, (iii) the bankruptcy or insolvency of the REMIC, or (iv) a qualified liquidation; (B) the receipt of any income attributable to any asset which is neither a qualified mortgage nor a permitted investment; (C) the receipt by the REMIC of any amount representing a fee or other compensation for services; or (D) gain from the disposition of any cash flow investment other than pursuant to any qualified liquidation.

The settlement agreement at issue in the ruling arose from a dispute where investor plaintiffs that were holders of the REMIC's regular interests sued the trustee of the REMIC for breach of fiduciary duty. The parties eventually settled out of court and entered into a settlement agreement. In the PLR, the REMIC trustee requested guidance regarding the tax consequences from the execution of the settlement agreement and the distribution of a settlement amount in accordance with the agreement's terms. The IRS ruled that such amounts paid pursuant to the agreement, with respect to each taxpayer that made a timely REMIC election: (i) is a direct payment between trustee and the investor plaintiffs and will not result in a deemed payment to or made by the REMIC for federal income tax purposes; (ii) will not be treated as a "prohibited transaction"; and (iii) will not be treated as an asset of the taxpayers.

In making its determination, the IRS pointed out that, "the distribution of the Settlement Amount is consistent with its treatment as a settlement of direct claims between the [t]rustee and investors because: (i) [t]rustee paid the Settlement Amount into an escrow account for direct distribution to [i]nvestor [p]laintiffs who are eligible class members; (ii) no portion of such Settlement Amount was, or will be, taken from, or reimbursed from, the assets of any [t]axpayer; and (iii) no portion of the Settlement Amount will be paid to or through [t]axpayers."

CIC Services v. IRS: Injunction on Reportable Transaction Reporting?

The Supreme Court heard arguments in the case of *CIC Services v. Internal Revenue Service* on December 2, 2020, regarding the limits of the Anti-Injunction Act (the "Act"). The Act, contained in Section 7421 of the Internal Revenue Code and originally enacted in 1867, prevents persons from suing to enjoin the collection of tax. The primary consequence of the Act is that generally a person seeking to challenging a tax statute must first pay the tax and then sue for a refund.[8]

CIC Services LLC (the "Petitioner") acted as a material adviser to certain captive insurance arrangements. In 2016, the IRS issued Notice 2016-66 (the "Notice") which designated such captive insurance transactions as "reportable transactions" subject to enhanced reporting requirements and penalties. The penalty for failing to report a reportable transaction applies to both taxpayers and material advisors and is labeled by the Code as a "tax."[9]). The Petitioner sought to challenge the Notice on the basis that the issuance of the Notice did not comply with the notice and comment procedures provided for in the Administrative Procedures Act. Both the district court and the U.S. Court of Appeals for the Sixth Circuit ruled against the Petitioner, and the Supreme Court granted certiorari.

8 A major exception to the Act is Section 6213, which allows a taxpayer to litigate a tax in Tax Court prior to assessment. This exception does not apply to penalties under section 6707, at issue in this case.

9 Section 6671(a).

At oral arguments, the Petitioner sought to draw a distinction between challenging the collection of tax (which is prohibited by the Act) versus challenging the Notice itself. The injury in the latter case, according to the Petitioner, was not the payment of a tax but rather the cost of complying with the Notice's reporting requirements. The Petitioner also argued that, if the Act applied to bar a challenge to the Notice, then the Petitioner's only path to challenging the Notice would be to risk large penalties and potential criminal sanctions. The government, on the other hand, argued that the Petitioner could avoid criminal liabilities by filing a good-faith letter with the IRS stating the Petitioner's belief that the Notice was unlawful. The Petitioner could then sue for a refund of the penalty.

According to one commentator, "While predicting an outcome from an argument is always tough, CIC seemingly has a slightly better chance at prevailing."[10] A decision in the case is expected by June 2021.

Rev. Proc. 2021-12: Extended Relief for Mortgages

The IRS previously issued Rev. Proc. 2020-26, which provided safe harbors to protect the federal income tax status of REMICs and investment trusts that provide certain forbearances of mortgage loans they hold or that acquire mortgage loans that have received certain forbearances. Additionally, the IRS issued Rev. Proc. 2020-34, which provided safe harbors to protect the federal income tax status of certain investment trusts whose trustees request or agree to certain forbearances of mortgage loans, make certain modifications of real property leases, or accept certain cash contributions.

The safe harbors, however, were set to expire and would not apply to forbearances and related modifications entered into after December 31, 2020. Due to the ongoing financial hardships posed by the COVID-19 pandemic, the Structured Finance Association submitted a letter to the United States Treasury and the IRS, requesting an extension of tax relief relating to forbearances and related modifications. In response to these comments, the IRS released Rev. Proc. 2021-12, which extends the expiration date relevant to the application of the safe harbors in Rev. Proc. 2020-26 and Rev. Proc. 2020-34 to September 30, 2021.

In the News

Mayer Brown announced the launch of its 10Hundred Series portal, which provides global legal and business guidance on the top 10 key issues and pivotal developments that could affect businesses during a rolling 100-day period. The portal will feature thought leadership, legal updates, videos, podcasts, webcasts and live newsfeeds on global legal and business issues.

10 Blaine Saito, Argument analysis: Justices struggle to define boundaries of Anti-Injunction Act, SCOTUSblog (Dec. 2, 2020, 5:37 PM), https://www.scotusblog.com/2020/12/argument-analysis-justices-struggle-to-define-boundaries-of-anti-injunction-act/.

The portal will showcase a series of 'Spotlights,' which will highlight key issues, historic moments or pivotal change events which clients should be aware of in the next 100-day period.

RECENT RECOGNITION

- Mayer Brown is pleased to announce that we have been shortlisted for *GlobalCapital*'s 2021 Americas Derivatives Awards in the "Americas Law Firm of the Year—Overall", "US Law Firm of the Year—Regulatory", and "US Law Firm of the Year—Transactions" categories. We were named the European Law Firm of the Year—Transactions and US Law Firm of the Year—Transactions by *GlobalCapital* in 2020.

- Mayer Brown named a finalist in the "Finance — unlocking capital" category in Financial Times' 2020 "North America Innovative Lawyers" report - December 10, 2020

  The Mayer Brown Structured Finance Practice was recognized as a finalist in the *Financial Times'* "Finance – unlocking capital" category for representation on the $6.8bn financing plan through United Airlines' loyalty program, MileagePlus, to help the airline increase revenue.

- Mayer Brown named a *Law360* 2020 "Structured Finance Practice Group of the Year" - December 21, 2020

  Mayer Brown was named a *Law360* 2020 "Structured Finance Practice Group of the Year," honoring the major deals that resonated throughout the legal industry throughout the year, including our groundbreaking transaction involving United Airlines and the financing of their frequent flyer program, MileagePlus.

- Mayer Brown ranked in *Asset Backed Alert's* "Law Firm" 2020 rankings, including #1 in "Top issuer counsel for US ABS/MBS" list on January 15, 2021 Mayer Brown was ranked in *Asset Backed Alert's* "Law Firm" 2020 rankings as #1 in "Top Issuer Counsel for US Asset- and Mortgage-Backed Securitizations" for the fifth consecutive year. The #1 spot holds with our highest number of deals stands at 85, while the #2 firm comes in at 56.

- Jennifer Keating and Anna Pinedo named "Top 20 Women in Dealmaking" by *The Deal* on January 26, 2021, Mayer Brown partners Jennifer Keating and Anna Pinedo were named in *The Deal's* "Top 20 Women in Dealmaking" for 2020. The list identifies U.S.-based women who have displayed excellence in their respective legal field, have shown the ability to navigate complex transactions, and who maintain strong client relationships and/or lead in and out of the boardroom. The list recognizes these women as doing great things in the world of dealmaking, as well as in mentorship, advancing gender diversity and thought leadership.

- Ryan Castillo named a *IFLR* 2020 "Rising Star Americas" honoree in "Capital Markets" category on January 28, 2021 Mayer Brown partner Ryan Castillo was named by IFLR a "*Rising Star Americas*" honoree in the "Capital Markets" category for 2020. The list recognizes future legal leaders.

RECENT SPEAKING ENGAGEMENTS

- ***Upcoming*** – Preparing Your 20-F Filing. Brian Hirshberg and Christina Thomas will address the modernization of the requirements applicable to SEC reporting companies on February 10, 2021. During this webinar, they will discuss SEC Staff guidance on COVID-19 disclosures; changes to Risk Factor disclosures; risk factors that are Staff areas of focus, including LIBOR, cybersecurity, Brexit, tariff issues, sanctions issues, etc.; key performance indicators and non-GAAP measures, including COVID related non-GAAP measures; amendments relating to financial statement requirements for acquired businesses; and disclosures for PRC-based companies. *Register for this session here.*

- Commercial Paper Programs. On February 1, 2021, Jerry Marlatt was joined by Stewart Cutler of Barclays to review the considerations relating to the establishment and operation of the commercial paper financing tool used by investment grade corporate issuers. They will discuss the legal framework for commercial paper programs; the US commercial paper and Eurocommercial paper markets; market practice and documentation that is widely used; the US Federal Reserve's commercial paper funding facility; and investor base for commercial paper.

- De-SPACing: Overview, Special Securities Law and Financial Statement Considerations and Derisking the Process with a PIPE Transaction. Hosted by PLI on January 27, 2021, Anna Pinedo and Eddie Best went through the process of a de-SPACing transaction, covering the differences to consider from negotiating the letter of intent (LOI) to the definitive merger agreement and the various ancillary agreements. Specifically, they discussed the SPAC IPO market and notable de-SPAC transactions; negotiating the LOI; key considerations in connection with the definitive agreement; PIPE and other capital raising transactions in connection with de-SPACing; securities law and financial statement requirements; and the proxy statement, its forecasts and related considerations.

- Debt Capital Markets Seminar: 2021 DCM Developments in the Shade of the COVID-19 Pandemic. On January 26, 2021 we held the 4th annual DCM Seminar, led by Patrick Scholl, Barry Cosgrove, Anna Pinedo, James Taylor, Bradley Berman, Berthold Kusserow and Alexei Döhl. The panel covered many topics including electronic and crypto securities in Germany; updates on the IBOR transition, government actions, use of RFR in DCM products, new ISDA Euribor fallbacks and EURIBOR fallback consultation; bonds and Schuldscheine and COVID-19 restructuring; and sustainability-linked bonds and EU green bond regulation.

- The Next Phase of Financial Regulatory Reform: What's Ahead for Nonbank Financial Companies. On January 21, 2021, Andrew Olmem and Laurence Platt participated in a Global Financial Markets Initiative teleconference to talk about the regulatory spotlight on nonbank financial services companies. They discussed prospects of regulatory reform for nonbank financial companies and what it could mean for the future of US financial markets, especially the US mortgage market.

- ESG Investing: How to Do Well by Doing Good. A webinar event with The American Friends of Hebrew University and Professor Ronen Feldman on January 14, 2021 kicked the new year off. Paul Forrester, Stephanie Hurst, Phyllis Korff, Anna Pinedo and James Taylor were panelists for a discussion on ESG related developments. After Professor Feldman covered text mining, AI and natural language processing, Mayer Brown speakers focused on what ESG and ESG investing is; regulatory and other frameworks for ESG reporting; green, social and sustainable bonds and loans, as well as sustainability-linked bonds; ESG indices; ESG investors' expectations; and benefit corporations and corporate structures that incorporate ESG and other mission-oriented objectives with corporate purposes.

- Ethics for the In-House Tax Professional – Part II. On January 13, 2021, Mayer Brown hosted with TEI Silicon Valley Chapter the second part of the Ethics for the In-House Tax Professional seminar. Partners Paul DiSangro and Marjorie Margolies discussed "Common Ethical Issues Faced by the In-House Tax Professional" and associate Anthony Pastore participated in a panel discussion titled "Records Management for Tax Professionals (Including Privilege Policies)".

- A New Era for Qualified Mortgages: CFPB Finalizes QM Rules. On December 17, 2020, Kris Kully and Laurence Platt participated in a Global Financial Markets Initiative teleconference to give insight and an analysis on the finalized rules by the Consumer Financial Protection Bureau (CFPB) that reshaped boundaries for Qualified Mortgages (QMs).

- Mortgage Market Developments and Becoming a Public Company. Hosted by Mortgage Bankers Association (MBA) on December 14, 2020, Brian Hirshberg, Anna Pinedo and Remmelt Reigersman joined Michael Fratantoni of MBA to speak to mortgage originator and servicers that joined the ranks of SEC reporting companies. They discussed the 2020 US IPO market and its expectations; US IPO dynamics, aftermarket performance and IPO trends; assessing IPO readiness and IPO considerations; disclosure and governance; SPAC IPOs and what's been driving the trend; merging with a SPAC to become a public company; and mortgage market developments and learnings from recent deals.

- Time to Get Ready: Preparing for the 2021 US Proxy & Annual Reporting Season. On December 9, 2020, Intelligize invited Candace Jackson, Christine McDevitt, Anna Pinedo and Christina Thomas to discuss prep for success in proxy and annual report season. They covered SEC COVID-19 guidance and disclosures; changes affecting 2020's 10-K, including MD&A and other Regulation S-K changes; virtual meetings; pay ratio and say-on-pay; human capital and ESG disclosures; shareholder proposals; and proxy voting advice amendments.

- Becoming a US Public Company: The New Three-Track Process. On December 1, 2020, following IFLR's publication of *A Deep Dive into Capital Raising Alternatives*, IFLR partnered with us for a webinar to discuss the US IPO market in 2020. Anna Pinedo and John Ablan were joined by Brian DiCaprio and Zachary Dombrowski of BMO Capital Markets, Jennie Dong of the NYSE and Greg

McDowell of ICR Strategic Communications & Advisory to speak to the significant increase in SPAC IPOs and high-profile mergers of unicorns with SPACs. Due to popular demand, panelists discussed US IPO dynamics, aftermarket performance, and IPO trends; foreign private issuers, and potential actions affecting PRC-based companies; how direct listings work, and which types of issuers should consider a direct listing; how merging with a SPAC to become a public company works; and SEC developments that may facilitate capital formation.

- Every 10 Years I Have to Relearn Section 382. On November 16, partners Thomas Humphreys and Remmelt Reigersman with members of TEI New York Chapter discussed the net operating loss carryover provisions of Internal Revenue Code Section 382. They reviewed Section 382's basic rules and explored how its limitations on NOLs and NOL usage operate. They then applied the rules to examples, walking through some interesting current structures and transactions.

- Interesting Transactions of the Past Year. On October 15, Mayer Brown tax partner Thomas Humphreys participated on a panel for PLI's Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings virtual conference. Tom discussed the federal income tax issues surrounding special purpose acquisition companies.

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SPA
Structured Products Association

2021 STRUCTURED PRODUCTS LEGAL, REGULATORY AND MARKET BRIEFING

SUPPLEMENTAL MATERIALS | MAY 13, 2021

Panel 3

Update on the LIBOR Transition, ARCC Developments, the IBOR Protocol and the New York State Legislature

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March 05
2021

IBA Sets LIBOR Publication Cessation Dates and Triggers a LIBOR Transition Event

Eye On IBOR Transition Blog

Authors David K. Duffee J. Paul Forrester Mary Jo N. Miller

On 5 March 2021, ICE Benchmark Administration ("IBA"), the administrator of LIBOR, released the much anticipated feedback statement ("Cessation Statement") reporting the results of its 4 December 2020 Consultation on Potential Cessation. IBA consulted on the issue of LIBOR publication cessation because "a majority of LIBOR panel banks had communicated to IBA that they would not be willing to continue contributing to the relevant LIBOR settings after [the proposed cessation] dates." Pursuant to the Cessation Statement, IBA intends to cease publication of (i) all GBP, EUR, CHF and JPY LIBOR settings, and the 1 Week and 2 Month USD LIBOR settings immediately following the LIBOR publication on 31 December 2021, and (ii) the Overnight and 1, 3, 6 and 12 Month USD LIBOR settings immediately following the LIBOR publication on 30 June 2023, subject to any rights of the UK Financial Conduct Authority ("FCA"), the regulatory supervisor of IBA, to compel IBA to continue publication using a changed methodology. Individual non-confidential responses to the consultation, of the 55 responses received, can be viewed on the IBA website.

IBA highlighted that FCA has advised, pursuant to a related announcement on future cessation and loss of representativeness of the LIBOR benchmarks ("FCA Announcement"), that it does not intend to use its proposed new powers (included in Financial Services Bill 200 and supplemented by explanatory notes published by HM Treasury in its Policy Statement – Amendments to the Benchmarks Regulation to support LIBOR transition) to compel publication of any EUR or CHF tenors, nor the less common tenors of USD, GBP and JPY LIBORs, beyond the proposed publication cessation dates. FCA stated, however, that it does intend to consult on using those powers to "require IBA to continue the publication on a "synthetic" basis of the 1 Month, 3 Month and 6 Month GBP and JPY LIBOR," and will consider doing so in the future with respect to those same more common tenors of USD LIBOR. FCA emphasized that publication of LIBOR settings on a synthetic basis "would be intended to assist legacy contract holders" and "*new use* of synthetic LIBOR by UK regulated firms in regulated financial instruments *would be prohibited* under the Benchmarks Regulation as amended by the Financial Services Bill…." (*emphasis added*).

As a result of its assessment of the Cessation Statement in the context of its proposed new powers, FCA advised that *publication* of 26 of the existing 35 LIBOR tenors *will permanently cease* as of the cessation dates announced by IBA. The remaining 9 LIBOR *tenors* (1-, 3-, and 6-month GBP, JPY and USD LIBOR) *will "no longer be representative and representativeness will not be restored*" as of the cessation dates announced by IBA. IBA notes in the Cessation Statement that FCA has confirmed to it that, based on undertakings from existing panel banks, it does not expect any LIBOR setting to become "unrepresentative" before the applicable intended cessation date.

A number of additional statements and resources also were published on 5 March 2021 in support of the Cessation Statement and FCA Announcement:

1. Bank of England – Announcements on the end of LIBOR – "Today's announcements confirm the importance of those preparations [for a smooth transition in advance of LIBOR ceasing] for all users of LIBOR. Regulated firms should expect further engagement from their supervisors at both the Prudential Regulation Authority and the FCA to ensure these timelines are met."
2. International Swaps and Derivatives Association ("ISDA") – ISDA Statement on UK FCA LIBOR Announcement – "Today's announcement [by the FCA] constitutes an index cessation event under the IBOR Fallbacks Supplement and the ISDA 2020 IBOR Fallbacks Protocol for all 35 LIBOR settings. As a result, the fallback spread adjustment published by Bloomberg is fixed as of the date of the announcement for all euro, sterling, Swiss franc, US dollar and yen LIBOR settings."
3. ISDA – Future Cessation and Non-Representativeness Guidance – "The purpose of this Guidance is … to describe how the terms of the ISDA 2020 IBOR Fallbacks Protocol … and Supplement number 70 to the 2006 ISDA Definitions … [as well as the 2018 ISDA Benchmarks Supplement] apply to the FCA LIBOR Announcement," and includes a Summary Table of relevant dates and information.
4. Bloomberg – IBOR Fallbacks: Technical Notice – Spread Fixing Event for LIBOR – Setting forth "every LIBOR Tenor, Ticker and associated fixed Spread Adjustment" for the five key LIBOR currencies.
5. U.S. Alternative Reference Rates Committee – ARRC Commends Decisions Outlining the Definitive Endgame for LIBOR – "We now know when a representative USD LIBOR will end and what its associated spread adjustments will be in no uncertain terms," and noting that "supervisors will focus on ensuring that firms are managing the remaining transition risks." The statement acknowledged additional support from the Federal Reserve Board and Commodity Futures Trading Commission.
6. Structured Finance Association – LIBOR Cessation Dates Officially Announced – the SFA noted that it is "especially pleased with the adoption of an extension for USD LIBOR for legacy contracts – and continues to support a legislative solution allowing time for USD

LIBOR transactions executed before January 1, 2022 to mature…."

The Cessation Statement is "a public statement … by … the administrator of [LIBOR] … announcing that such administrator … *will cease* to provide all Available Tenors of such Benchmark … permanently or indefinitely,"[1] and, as such, constitutes a "Transition Event" or "Cessation Event" under most recommended forms of LIBOR fallback language, including the ISDA 2020 IBOR Fallbacks Protocol published by ISDA. As a result, borrowers and other market participants can expect their lenders and other credit providers to begin to implement applicable fallback provisions.

It is important to understand that the immediate effect of the Cessation Statement will be to set the fallback rate spread adjustment (the 5-year historical median difference between the relevant LIBOR and its applicable fallback rate) but will not result in an immediate move from LIBOR to applicable fallback rates. However, fallbacks that are not in such recommended forms will need to be evaluated to see if the Cessation Statement has the same or substantially similar effect under such fallbacks.

Most global working groups have stated a preference for implementing the spread adjustment methodology set by ISDA in order to avoid basis mismatches between various cash products and the derivatives used to hedge related interest rate risk. According to the IBOR Fallback Rate Adjustments Rule Book jointly published by ISDA and Bloomberg Index Services Limited, which is the organization chosen by ISDA to calculate and publish benchmark fallback adjustments pursuant to a methodology based on industry consultation feedback, the Cessation Statement constitutes a "Spread Adjustment Fixing Date" (a component of which is defined substantially similarly to "Transition Event" or "Cessation Event" under most fallback provisions). The occurrence of the Spread Adjustment Fixing Date fixes the spread adjustment calculation (i.e., the five-year period used to calculate the historical median), but does not cause the related fallback rate to be applied. The application of the relevant fallback rate will not occur until "the first date on which [LIBOR] is no longer provided."[2] The ARRC has provided helpful guidance on these mechanics in its Guide on the Endgame for USD LIBOR.

Because the "Index Cessation Effective Date" has not occurred yet, transition to alternative rates (e.g., SOFR) is not triggered under hardwired fallback provisions as a result of the Cessation Statement, nor is there generally (depending on the wording of applicable contractual fallback provisions) any immediate obligation for credit providers following the amendment approach to benchmark replacement to propose a new reference rate (although, pursuant to the ARRC's Best Practices for Completing Transition from LIBOR, anticipated fallback rates should be chosen by the applicable determining party at least "six months prior to reset after LIBOR's end"). So, for now, recommended practice is that lenders and other credit providers provide notice to their borrowers and other counterparties of the occurrence of the "Transition Event"/"Cessation Event" and resultant "Spread Adjustment Fixing Date" and intensify their efforts to be prepared, contractually and operationally, for the impending transition from LIBOR to replacement rates.

Trade organizations, including the LSTA, have published model language that can be used by market participants to give notice of this trigger event and the effectiveness of contractual fallback provisions.

Please contact your Mayer Brown Finance lawyer for assistance in implementing your IBOR fallbacks protocol.

[1] From the definition of "Benchmark Transition Event" set forth in ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Syndicated Loans (Alternative Reference Rates Committee, 30 June 2020)

[2] *See* definition of "Index Cessation Effective Date" under Supplement No 70 to the 2006 ISDA Definitions for legacy contracts and "Fallback Index Cessation Effective Date" under the ISDA Protocol for new originations.

The post IBA Sets LIBOR Publication Cessation Dates and Triggers a LIBOR Transition Event appeared first on Eye on IBOR Transition.

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IBOR Fallbacks

Technical Notice – Spread Fixing Event for LIBOR

IBOR Cessation Trigger Date

On 5 March 2021, the UK Financial Conduct Authority (FCA) issued an announcement on the future cessation and loss of representativeness of the LIBOR benchmarks. As confirmed via the announcement by the International Swaps and Derivatives Association, Inc. (ISDA), today (5 March 2021) is the 'Spread Adjustment Fixing Date' for all LIBOR Tenors across all LIBOR currencies.

Each LIBOR Tenor, Ticker and associated fixed Spread Adjustment are set forth below. Going forward, the 'Fallback Rate' calculated for each 'Rate Record Day' (as such terms are defined in the Rule Book) from and including 5 March 2021 will use the fixed Spread Adjustments set forth below. All Fallback Rates calculated for a Rate Record Day prior to 5 March 2021 will use the Spread Adjustment previously published for such Rate Record Day. Users are referred to applicable ISDA documentation as to the effectiveness of the Fallback Rates in their contracts.

Figure 1
List of impacted IBOR Fallbacks

LIBOR	Tenor	Ticker	Spread Adjustment (%)
CHF	Spot/Next	SSF00SN Index	-0.0551
CHF	1 Week	SSF0001W Index	-0.0705
CHF	1 Month	SSF0001M Index	-0.0571
CHF	2 Months	SSF0002M Index	-0.0231
CHF	3 Months	SSF0003M Index	0.0031
CHF	6 Months	SSF0006M Index	0.0741
CHF	12 Months	SSF0012M Index	0.2048
EUR	Overnight	SEE00ON Index	0.0017
EUR	1 Week	SEE0001W Index	0.0243

EUR	1 Month	SEE0001M Index	0.0456
EUR	2 Months	SEE0002M Index	0.0753
EUR	3 Months	SEE0003M Index	0.0962
EUR	6 Months	SEE0006M Index	0.1537
EUR	12 Months	SEE0012M Index	0.2993
GBP	Overnight	SBP00ON Index	-0.0024
GBP	1 Week	SBP0001W Index	0.0168
GBP	1 Month	SBP0001M Index	0.0326
GBP	2 Months	SBP0002M Index	0.0633
GBP	3 Months	SBP0003M Index	0.1193
GBP	6 Months	SBP0006M Index	0.2766
GBP	12 Months	SBP0012M Index	0.4644
JPY	Spot/Next	SJY00SN Index	-0.01839
JPY	1 Week	SJY0001W Index	-0.01981
JPY	1 Month	SJY0001M Index	-0.02923
JPY	2 Months	SJY0002M Index	-0.00449
JPY	3 Months	SJY0003M Index	0.00835
JPY	6 Months	SJY0006M Index	0.05809
JPY	12 Months	SJY0012M Index	0.16600
USD	Overnight	SUS00ON Index	0.00644
USD	1 Week	SUS0001W Index	0.03839
USD	1 Month	SUS0001M Index	0.11448
USD	2 Months	SUS0002M Index	0.18456
USD	3 Months	SUS0003M Index	0.26161
USD	6 Months	SUS0006M Index	0.42826
USD	12 Months	SUS0012M Index	0.71513

Article 18-C

Libor Discontinuance

General Obligations (GOB)

Section 18-400

Definitions

General Obligations (GOB)

As used in this article the following terms shall have the following meanings:

1. "LIBOR" shall mean, for purposes of the application of this article to any particular contract, security or instrument, U.S. dollar LIBOR (formerly known as the London interbank offered rate) as administered by ICE Benchmark Administration Limited (or any predecessor or successor thereof), or any tenor thereof, as applicable, that is used in making any calculation or determination thereunder.

2. "LIBOR discontinuance event" shall mean the earliest to occur of any of the following:

a. a public statement or publication of information by or on behalf of the administrator of LIBOR announcing that such administrator has ceased or will cease to provide LIBOR, permanently or indefinitely, provided that, at the time of the statement or publication, there is no successor administrator that will continue to provide LIBOR;

b. a public statement or publication of information by the regulatory supervisor for the administrator of LIBOR, the United States Federal Reserve System, an insolvency official with jurisdiction over the administrator for LIBOR, a resolution authority with jurisdiction over the administrator for LIBOR or a court or an entity with similar insolvency or resolution authority over the administrator for LIBOR, which states that the administrator of LIBOR has ceased or will cease to provide LIBOR permanently or indefinitely, provided that, at the time of the statement or publication, there is no successor administrator that will continue to provide LIBOR; or

c. a public statement or publication of information by the regulatory supervisor for the administrator of LIBOR announcing that LIBOR is no longer representative. For purposes of this subdivision two, a public statement or publication of information that affects one or more tenors of LIBOR shall not constitute a LIBOR discontinuance event with respect to any contract, security or instrument that (i) provides for only one tenor of LIBOR, if such contract, security or instrument requires interpolation and such tenor can be interpolated from LIBOR tenors that are not so affected, or (ii) permits a party to choose from more than one tenor of LIBOR and any of such tenors (A) is not so affected or (B) if such contract, security or instrument requires interpolation, can be interpolated from LIBOR tenors that are not so affected.

3. "LIBOR replacement date" shall mean:

a. in the case of a LIBOR discontinuance event described in paragraph a or b of subdivision two of this section, the later of (i) the date of the public statement or publication of information referenced therein; and (ii) the date on which the administrator of LIBOR permanently or indefinitely ceases to provide LIBOR; and

b. in the case of a LIBOR discontinuance event described in paragraph c of subdivision two of this section, the date of the public statement or publication of information referenced therein. For purposes of this subdivision, a date that affects one or more tenors of LIBOR shall not constitute a LIBOR replacement date with respect to any contract, security or instrument that (i) provides for only one tenor of LIBOR, if such contract, security or instrument requires interpolation and such tenor can be interpolated from LIBOR tenors that are not so affected, or (ii) permits a party to choose from more than one tenor of LIBOR and any of such tenors (A) is not so affected or (B) if such contract, security or instrument requires interpolation, can be interpolated from LIBOR tenors that are not so affected.

4. "Fallback provisions" shall mean terms in a contract, security or instrument that set forth a methodology or procedure for determining a benchmark replacement, including any terms relating to the date on which the benchmark replacement becomes effective, without regard to whether a benchmark replacement can be determined in accordance with such methodology or procedure.

5. "Benchmark" shall mean an index of interest rates or dividend rates that is used, in whole or in part, as the basis of or as a reference for calculating or determining any valuation, payment or other measurement under or in respect of a contract, security or instrument.

6. "Benchmark replacement" shall mean a benchmark, or an interest rate or dividend rate (which may or may not be based in whole or in part on a prior setting of LIBOR), to replace LIBOR or any interest rate or dividend rate based on LIBOR, whether on a temporary, permanent or indefinite basis, under or in respect of a contract, security or instrument.

7. "Recommended benchmark replacement" shall mean, with respect to any particular type of contract, security or instrument, a benchmark replacement based on SOFR, which shall include any recommended spread adjustment and any benchmark replacement conforming changes, that shall have been selected or recommended by a relevant recommending body with respect to such type of contract, security or instrument.

8. "Recommended spread adjustment" shall mean a spread adjustment, or method for calculating or determining such spread adjustment, (which may be a positive or negative value or zero) that shall have been selected or recommended by a relevant recommending body for a recommended benchmark replacement for a particular type of contract, security or instrument and for a particular term to account for the effects of the transition or change from LIBOR to a recommended benchmark replacement.

9. "Benchmark replacement conforming changes" shall mean, with respect to any type of contract, security or instrument, any technical, administrative or operational changes, alterations or modifications that are associated with and reasonably necessary to the use, adoption, calculation or implementation of a recommended benchmark replacement and that:

a. have been selected or recommended by a relevant recommending body; and

b. if, in the reasonable judgment of the calculating person, the benchmark replacement conforming changes selected or recommended pursuant to paragraph a of this subdivision do not apply to such contract, security or instrument or are insufficient to permit administration and calculation of the recommended benchmark replacement, then benchmark replacement conforming changes shall include such other changes, alterations or modifications that, in the reasonable judgment of the calculating person:

(i) are necessary to permit administration and calculation of the recommended benchmark replacement under or in respect of such contract, security or instrument in a manner consistent with market practice for substantially similar contracts, securities or instruments and, to the extent practicable, the manner in which such contract, security or instrument was administered immediately prior to the LIBOR replacement date; and

(ii) would not result in a disposition of such contract, security or instrument for U.S. federal income tax purposes.

10. "Determining person" shall mean, with respect to any contract, security or instrument, in the following order of priority:

a. any person specified as a "determining person"; or

b. any person with the authority, right or obligation to:

(i) determine the benchmark replacement that will take effect on the LIBOR replacement date,

(ii) calculate or determine a valuation, payment or other measurement based on a benchmark, or

(iii) notify other persons of the occurrence of a LIBOR discontinuance event, a LIBOR replacement date or a benchmark replacement.

11. "Relevant recommending body" shall mean the Federal Reserve Board, the Federal Reserve Bank of New York, or the Alternative Reference Rates Committee, or any successor to any of them.

12. "SOFR" shall mean, with respect to any day, the secured overnight financing rate published for such day by the Federal Reserve Bank of New York, as the administrator of the benchmark (or a successor administrator), on the Federal Reserve Bank of New York's website.

13. "Calculating person" shall mean, with respect to any contract, security or instrument, any person (which may be the determining person) responsible for calculating or determining any valuation, payment or other measurement based on a benchmark.

14. "Contract, security, or instrument" shall include, without limitation, any contract, agreement, mortgage, deed of trust, lease, security (whether representing debt or equity, and including any interest in a corporation, a partnership or a limited liability company), instrument, or other obligation.

UP ONE LEVEL
ARTICLE 18-C
Libor Discontinuance (/Legislation/Laws/GOB/A18-C)

NEXT
SECTION 18-401
Effect Of LIBOR Discontinuance On Agreements (/Legislation/Laws/GOB/18-401/)

Section 18-401

Effect of LIBOR discontinuance on agreements

General Obligations (GOB)

1. On the LIBOR replacement date, the recommended benchmark replacement shall, by operation of law, be the benchmark replacement for any contract, security or instrument that uses LIBOR as a benchmark and:

a. contains no fallback provisions; or

b. contains fallback provisions that result in a benchmark replacement, other than a recommended benchmark replacement, that is based in any way on any LIBOR value.

2. Following the occurrence of a LIBOR discontinuance event, any fallback provisions in a contract, security, or instrument that provide for a benchmark replacement based on or otherwise involving a poll, survey or inquiries for quotes or information concerning interbank lending rates or any interest rate or dividend rate based on LIBOR shall be disregarded as if not included in such contract, security or instrument and shall be deemed null and void and without any force or effect.

3. This subdivision shall apply to any contract, security, or instrument that uses LIBOR as a benchmark and contains fallback provisions that permit or require the selection of a benchmark replacement that is:

a. based in any way on any LIBOR value; or

b. the substantive equivalent of paragraph a, b or c of subdivision one of section 18-402 of this article.

A determining person shall have the authority under this article, but shall not be required, to select on or after the occurrence of a LIBOR discontinuance event the recommended benchmark replacement as the benchmark replacement. Such selection of the recommended benchmark replacement shall be:

(i) irrevocable;

(ii) made by the earlier of either the LIBOR replacement date, or the latest date for selecting a benchmark replacement according to such contract, security, or instrument; and

(iii) used in any determinations of the benchmark under or with respect to such contract, security or instrument occurring on and after the LIBOR replacement date.

4. If a recommended benchmark replacement becomes the benchmark replacement for any contract, security, or instrument pursuant to subdivision one or subdivision three of this section, then all benchmark replacement conforming changes that are applicable (in accordance with the definition of benchmark replacement conforming changes) to such recommended benchmark replacement shall become an integral part of such contract, security, or instrument by operation of law.

5. The provisions of this article shall not alter or impair:

a. any written agreement by all requisite parties that, retrospectively or prospectively, a contract, security, or instrument shall not be subject to this article without necessarily referring specifically to this article. For purposes of this subdivision, "requisite parties" means all parties required to amend the terms and provisions of a contract, security, or instrument that would otherwise be altered or affected by this article;

b. any contract, security or instrument that contains fallback provisions that would result in a benchmark replacement that is not based on LIBOR, including, but not limited to, the prime rate or the federal funds rate, except that such contract, security or instrument shall be subject to subdivision two of this section;

c. any contract, security, or instrument subject to subdivision three of this section as to which a determining person does not elect to use a recommended benchmark replacement pursuant to subdivision three of this section or as to which a determining person elects to use a recommended benchmark replacement prior to the occurrence of a LIBOR discontinuance event, except that such contract, security, or instrument shall be subject to subdivision two of this section; or

d. the application to a recommended benchmark replacement of any cap, floor, modifier, or spread adjustment to which LIBOR had been subject pursuant to the terms of a contract, security, or instrument.

6. Notwithstanding the uniform commercial code or any other law of this state, this title shall apply to all contracts, securities and instruments, including contracts, with respect to commercial transactions, and shall not be deemed to be displaced by any other law of this state.

PREV
SECTION 18-400
Definitions (/Legislation/Laws/GOB/18-400/)

NEXT
SECTION 18-402
Continuity Of Contract And Safe Harbor (/Legislation/Laws/GOB/18-402/)

Section 18-402

Continuity of contract and safe harbor

General Obligations (GOB)

SHARE

1. The selection or use of a recommended benchmark replacement as a benchmark replacement under or in respect of a contract, security or instrument by operation of section 18-401 of this article shall constitute:

a. a commercially reasonable replacement for and a commercially substantial equivalent to LIBOR;

b. a reasonable, comparable or analogous term for LIBOR under or in respect of such contract, security or instrument;

c. a replacement that is based on a methodology or information that is similar or comparable to LIBOR; and

d. substantial performance by any person of any right or obligation relating to or based on LIBOR under or in respect of a contract, security or instrument.

2. None of: a. a LIBOR discontinuance event or a LIBOR replacement date, b. the selection or use of a recommended benchmark replacement as a benchmark replacement; or c. the determination, implementation or performance of benchmark replacement conforming changes, in each case, by operation of section 18-401 of this article, shall:

(i) be deemed to impair or affect the right of any person to receive a payment, or affect the amount or timing of such payment, under any contract, security, or instrument; or

(ii) have the effect of (A) discharging or excusing performance under any contract, security or instrument for any reason, claim or defense, including, but not limited to, any force majeure or other provision in any contract, security or instrument; (B) giving any person the right to unilaterally terminate or suspend performance under any contract, security or instrument; (C) constituting a breach of a contract, security or instrument; or (D) voiding or nullifying any contract, security or instrument.

3. No person shall have any liability for damages to any person or be subject to any claim or request for equitable relief arising out of or related to the selection or use of a recommended benchmark replacement or the determination, implementation or performance of benchmark replacement conforming changes, in each case, by operation of section 18-401 of this article, and such selection or use of the recommended benchmark replacement or such determination implementation or performance of benchmark replacement conforming changes shall not give rise to any claim or cause of action by any person in law or in equity.

4. The selection or use of a recommended benchmark replacement or the determination, implementation, or performance of benchmark replacement conforming changes, by operation of section 18-401 of this article, shall be deemed to:

a. not be an amendment or modification of any contract, security or instrument; and

b. not prejudice, impair or affect any person's rights, interests or obligations under or in respect of any contract, security or instrument.

5. Except as provided in either subdivision one or subdivision three of section 18-401 of this article, the provisions of this article shall not be interpreted as creating any negative inference or negative presumption regarding the validity or enforceability of:

a. any benchmark replacement that is not a recommended replacement benchmark;

b. any spread adjustment, or method for calculating or determining a spread adjustment, that is not a recommended spread adjustment; or

c. any changes, alterations or modifications to or in respect of a contract, security or instrument that are not benchmark replacement conforming changes.

PREV
SECTION 18-401
Effect Of LIBOR Discontinuance On Agreements (/Legislation/Laws/GOB/18-401/)

NEXT
SECTION 18-403
Severability (/Legislation/Laws/GOB/18-403/)

Section 18-403

Severability

General Obligations (GOB)

If any provision of this article or application thereof to any person or circumstance is held invalid, the invalidity shall not affect other provisions or applications of this article that can be given effect without the invalid provision or application, and to this end the provisions of this article shall be severable.

The New York LIBOR Legislative Solution Becomes Law

By Bradley Berman & J. Paul Forrester on April 9, 2021

On April 7, 2021, the proposed New York "legislative solution" for legacy USD LIBOR contracts became Article 18-C of the New York General Obligations Law. Article 18-C is primarily aimed at USD LIBOR contracts, securities or instruments (e.g., floating rate notes ("FRNs"), loans, securitizations and mortgages) with the 2006 ISDA Definitions LIBOR fallbacks, or no fallback provisions at all, and which are governed by New York law. This article focuses on the law's effect on USD LIBOR FRNs.

Article 18-C has no effect on USD LIBOR FRNs that have the Alternative Reference Rate Committee's ("ARRC") recommended fallback provisions to the secured overnight financing rate ("SOFR"), nor does it have any effect on non-USD LIBOR FRNs.

For USD LIBOR FRNs that have a discretionary replacement fallback to an industry-accepted replacement rate standard, Article 18-C confirms that the choice of SOFR to replace USD LIBOR under the terms of the FRN is a commercially reasonable substitute for USD LIBOR, a reasonable, comparable or analogous term for USD LIBOR under the terms of the FRN, a replacement that is based on a methodology similar to LIBOR and substantial performance by any person of any right or obligation under such FRN.

On March 5, 2021, ICE Benchmark Administration Limited, the LIBOR administrator, and the U.K. Financial Conduct Authority, the LIBOR regulator, announced dates for the cessation of LIBOR. Under Article 18-C, a "LIBOR discontinuance event," as defined, occurred with respect to all USD LIBOR tenors. Consequently, once Article 18-C came into law, the polling provisions in USD LIBOR FRNs were deemed null and void and without any force or effect. This will have no practical effect on legacy USD LIBOR FRNs because the polling provisions would only be looked to once USD LIBOR ceases (December 31, 2021 for 1-week and 2-month USD LIBOR, and June 30, 2023 for all other USD LIBOR tenors) and, at that point, Article 18-C would automatically change the USD LIBOR provisions to the ARRC recommended fallback provisions to SOFR.

With the New York legislative solution now effective, similar federal legislation is advancing, which would address FRNs governing by non-New York law.

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Legislating LIBOR: New York State Poised to Enact LIBOR Transition Assistance Law to Facilitate "Tough Legacy" Contract Transition

Authors J. Paul Forrester Mary Jo N. Miller David K. Duffee

In a flurry of legislative activity on March 24, 2021, the New York State Senate and Assembly passed bills (collectively, "LIBOR Legislation")[1] that, once signed by New York Governor Andrew Cuomo (expected because the legislation was included in the governor's 2021 budget proposal), will facilitate the transition from LIBOR of "tough legacy" contracts that are governed by New York law and that do not include adequate interest rate fallback provisions that contemplate a permanent cessation of LIBOR.

The LIBOR Legislation aims to address the consequences of the permanent cessation of LIBOR for specified contracts, securities, and other agreements that are economically linked to LIBOR, and does so via an amendment to the New York General Obligations Law that adds a new Article 18-C. Key provisions of the amendment include:

1. replacement of LIBOR, by operation of law, in any contract, security or instrument that (a) uses LIBOR as a benchmark and contains no fallback provisions or (b) contains fallback provisions that result in a benchmark replacement (other than a recommended benchmark replacement) that is based in any way on any LIBOR value (including by way of a poll or survey of lending rates), with the benchmark replacement based on SOFR and spread adjustment recommended by a Relevant Recommending Body,[2] on the date that LIBOR permanently ceases to be published or is announced to no longer be representative;
2. prohibition on parties from refusing to perform contractual obligations or declaring a breach of contract as a result of the discontinuance of LIBOR or the use of a replacement;
3. statement establishing that the legislative benchmark replacement is a commercially reasonable substitute for, and a commercially substantial equivalent to, LIBOR; and
4. provision of a safe harbor from litigation for the use of the recommended benchmark replacement.

The ARRC acknowledged this important development in a related press release, describing the legislation as "crucial in minimizing legal uncertainty and adverse economic impacts associated with the transition."

The timing is also propitious because the day before, on March 23, 2021, the Federal Reserve released a Progress Report ("Progress Report") finding that there are approximately $2 trillion[3] of potential "tough legacy" contracts—approximately $1.6 trillion in securitization transactions and $400 billion in other cash products. The Progress Report discussed[4] the proposed New York legislation as an important part of addressing legacy products.

Our March 12, 2020 Legal Update *US ARRC Proposes a New York State Legislative "Solution" for Legacy LIBOR Contracts Without Adequate Fallbacks—But What Does It Actually "Solve"?* reviewed the proposed New York legislation and raised concerns regarding potential conflict with the unanimous consent requirements of the Trust Indenture Act ("TIA").

The New York City Bar Association recently released a detailed Report on Legislation ("NYCBA Report") in support of the enactment of the proposed New York legislation that also concluded that the law may violate the TIA[5] (and supported federal action "to remove this concern") and discussed the implicated Constitutional considerations.[6]

While there is more work to be done to resolve potential challenges, there is no doubt that the LIBOR Legislation is an important step in the process and may accelerate the approval of companion legislation at the federal level, which might not face the same potential inconsistencies with the TIA and which has the recent support of FRB Chair Jerome Powell.

[1] The Senate bill is designated S297B, and the bill version passed by the Senate was adopted as A164B in the Assembly.

[2] "Relevant Recommending Body" is defined in the LIBOR Legislation as "the Federal Reserve Board, the Federal Reserve Bank of New York, or the Alternative Reference Rates Committee, or any successor to any of them."

[3] See fn1 (on p.3), which states: "Of the estimated $90 trillion in USD LIBOR exposures outstanding beyond June 2023, the majority are derivatives which can be addressed through adherence to the ISDA Protocol. An estimated $1.9 trillion in exposures will remain in bonds and securitizations, many of which may have no effective means to transition away from LIBOR upon its cessation. See discussion around legislation and 'tough legacy' contracts below."

[4] Progress Report at pp. 11-12.

[5] NYCBA Report at pp.16-17 and Appendix C-7.

[6] NYCBA Report at pp.14-15 and Appendices C-1 – C-6.

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March 12
2020

US ARRC Proposes a New York State Legislative "Solution" for Legacy LIBOR Contracts Without Adequate Fallbacks—But What Does It Actually "Solve"?

Authors J. Paul Forrester Christopher J. Houpt

On March 6, 2020, the Alternative Reference Rates Committee (ARRC) released its "Proposed Legislative Solution to Minimize Legal Uncertainty and Adverse Economic Impact Associated with LIBOR Transition," which the ARRC intends to minimize legal uncertainty and adverse economic impacts associated with LIBOR transition.

The ARRC noted, in connection with the release of the proposal, that many financial contracts referencing LIBOR do not envision a permanent or indefinite cessation of LIBOR. Therefore, existing contracts[1] either do not have fallback language that adequately addresses a permanent LIBOR cessation or have language that could dramatically alter the economics of contract terms if LIBOR is discontinued. Although existing contracts may be amended, such an amendment process might be challenging, if not impossible, for certain products. The ARRC proposes New York State legislation to address this issue because a substantial number of financial contracts that reference US dollar LIBOR are governed by New York law.

In summarizing the proposal, the ARRC stated that the proposed legislation would:

- prohibit a party from refusing to perform its contractual obligations or declaring a breach of contract as a result of LIBOR discontinuance or the use of the legislation's recommended benchmark replacement;
- establish that the recommended benchmark replacement is a commercially reasonable substitute for and a commercially substantial equivalent to LIBOR; and
- provide a safe harbor from litigation for the use of the recommended benchmark replacement.

Specifically, the proposed legislation, on a **mandatory** basis, automatically would:

- override existing fallback language that references a LIBOR-based rate (such as last-available LIBOR) and instead would require the use of the legislation's recommended benchmark replacement;
- nullify existing fallback language that requires polling for LIBOR or other interbank funding rates; and
- insert the recommended benchmark replacement as the LIBOR fallback in contracts that do not have any existing fallback language.

The proposed legislation also, on a **permissive** basis, would allow:

- parties who have the contractual right to exercise discretion or judgment regarding the fallback rate to avail themselves of the litigation safe harbor if they select the recommended benchmark replacement as the fallback rate; and
- parties to mutually opt out of any mandatory application of the proposed legislation, at any time.

However, while this legislative solution is obviously well-intentioned, one cannot help but wonder whether, if enacted as proposed, it would actually serve to "minimize legal uncertainty and adverse economic impact associated with LIBOR transition." Unfortunately, there are several reasons why it might not or may not for a significant number of cases realize such intent.

One possible reason why the legislation may not be effective, especially at avoiding litigation entirely, is the possible conflict between such legislation and federal law contained in section 316(b) of the Trust Indenture Act of 1939, as amended (TIA)[2]. Holders of notes that are subject to the TIA may argue that changes in interest rates are precisely the sort of modification that requires unanimous consent under the statute.

Another similar conflict may exist for other legacy LIBOR-based transactions that require the consent of all holders for a change in the related interest rate or of holders that are "adversely affected" by such change, as is a common standard for many non-TIA qualified indentures.

Taking the second of these first, the NYS legislation proposed by the ARRC would provide that the use of a Recommended Benchmark Replacement or the implementation or performance of Benchmark Replacement Conforming Changes shall be deemed to (a) not be an amendment or modification of any contract, security or instrument and (b) not impair or have a material or adverse effect on any person's rights or obligations under or in respect of any contract, security or instrument. While we understand that the ARRC proposal is based on a NYS law passed in 1998 to deal with similar issues arising from the introduction of the Euro[3], this is an unusual exercise of legislative power. Can the NYS legislature so change actual reality? To illustrate this point and reframe the provision in more neutral terms (and assuming that it wanted to do so), could the legislature similarly declare that borrowers may pay half of the contractual interest rate? Might this litigation "safe harbor" generate litigation over such issue?

The possible TIA conflict is at least more concrete. For TIA-qualified indentures that include section 316(b) language, the question becomes this: Is a change in rate effected by the proposed law an impermissible "impairment" or "affect" upon the contractual rate and, further, that if it is or might be, is the replacement of the contractual rate with the replacement benchmark rate an impermissible "impairment" or "affect" under the TIA? Of course, the ARRC proposal applies only for a Recommended Replacement Benchmark and only protects Benchmark Replacement Conforming Changes. As defined in the proposal, these are:

> "Recommended Benchmark Replacement" shall mean a Benchmark Replacement, which shall include any Recommended Spread Adjustment and any Benchmark Replacement Conforming Changes, that shall have been selected or recommended by a Relevant Recommending Body.
>
> "Benchmark Replacement Conforming Changes " shall mean, with respect to any contract, security or instrument, any changes, alterations or modifications that are associated with and reasonably necessary to the use, adoption or implementation of a Recommended Benchmark Replacement and that (a) have been selected or recommended by a Relevant Recommending Body to reflect the use, adoption or implementation of a Recommended Benchmark Replacement under or in respect of such contract, security or instrument or (b) would not, in the reasonable judgment of the Determining Person, result in a disposition of such contract, security or instrument for U.S. federal income tax purposes.

Importantly, both of these terms require action (selection or recommendation, as applicable) by the Relevant Recommending Body, which is defined in the proposal as:

> "Relevant Recommending Body" shall mean the Federal Reserve Board, the Federal Reserve Bank of New York, or the Alternative Reference Rates Committee or any successor to any of them.

However, the potential for dispute regarding whether the conforming changes are covered or whether the judgment of the Determining Person was reasonable would remain unless the Relevant Recommending Body makes such selection or recommendation and only those conforming changes are made.

Since it appears likely that the ARRC will only recommend SOFR-based Benchmark Replacements and only specific Benchmark Replacement Conforming Changes (which at least to date have not been taken up by the market for all products), any other replacement rates or other changes may not avoid the need for otherwise required consents to, or approvals of, such changes.

We note that, at this point, a companion federal legislative solution is not envisaged. *Compliance Week* reports that in a speech to the House Committee on Financial Services on February 11, 2020, Federal Reserve Chair Jerome Powell stated that he does not believe that a federal law change is needed.

While the ARRC proposal is an important step to manage the significant economic and related legal risks to LIBOR replacement, it may not necessarily be sufficient to accomplish the stated intent to minimize legal uncertainty and adverse economic impacts associated with LIBOR transition.

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[1] An estimated $2.5 trillion of LIBOR-based legacy transactions are expected to be still outstanding at the end of 2021, when publication of LIBOR will no longer be required by applicable regulators and many current providers of the underlying estimates for LIBOR are expected to cease providing such estimates.

[2] TIA §316(b) provides (emphasis added):

(b) *Prohibition of impairment of holder's right to payment*. Notwithstanding any other provision of the indenture to be qualified, **the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security**, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, **shall not be impaired or affected without the consent of such holder**, except as to a postponement of an interest payment consented to as provided in paragraph (2) of subsection (a), and except that such indenture may contain provisions limiting or denying the right of any such holder to institute any such suit, if and to the extent that the institution or prosecution thereof or the entry of judgment therein would, under applicable law, result in the surrender, impairment, waiver, or loss of the lien of such indenture upon any property subject to such lien.

[3] See New York's General Obligation Law Article 5 Title 16 (available at: http://public.leginfo.state.ny.us/lawssrch.cgi?NVLWO).

[DISCUSSION DRAFT]

117TH CONGRESS
1ST SESSION

H. R. ____

To deem certain references to LIBOR as referring to a replacement benchmark rate upon the occurrence of certain events affecting LIBOR, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

Mr. SHERMAN introduced the following bill; which was referred to the Committee on ______________________________

A BILL

To deem certain references to LIBOR as referring to a replacement benchmark rate upon the occurrence of certain events affecting LIBOR, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the ''Adjustable Interest Rate (LIBOR) Act of 2021''.

SEC. 2. FINDINGS AND PURPOSE.

(a) FINDINGS.—The Congress finds that—

(1) the U.S. dollar LIBOR is used as a benchmark rate in more than $200 trillion of contracts worldwide;

(2) a significant number of existing contracts that reference the U.S. dollar LIBOR do not provide for the use of a clearly defined fallback benchmark rate if the U.S. dollar LIBOR is discontinued; and

(3) the cessation or non-representativeness of the U.S. dollar LIBOR could result in disruptive litigation related to existing contracts that do not provide for the use of a clearly defined fallback benchmark rate.

(b) PURPOSE.—It is the purpose of this Act—

(1) to establish a clear and uniform process, on a nationwide basis, for replacing LIBOR in existing contracts that do not provide for the use of a clearly defined fallback benchmark rate;

(2) to preclude litigation related to existing contracts that do not provide for the use of a clearly defined fallback benchmark rate; and

(3) to allow existing contracts that reference LIBOR but provide for the use of a clearly defined fallback benchmark rate to operate according to the terms of such contracts.

SEC. 3. DEFINITIONS.

As used in this Act, the following terms shall have the following meanings:

(1) ''Benchmark'' shall mean an index of interest rates or dividend rates that is used, in whole or in part, as the basis of or as a reference for calculating or determining any valuation, payment or other measurement.

(2) ''Benchmark Replacement'' shall mean a Benchmark, or an interest rate or dividend rate (which may or may not be based in whole or in part on a prior setting of LIBOR), to replace LIBOR or any interest rate or dividend rate based on LIBOR, whether on a temporary, permanent, or indefinite basis, under or in respect of a LIBOR Contract.

(3) ''Benchmark Replacement Conforming Changes'' shall mean, with respect to any LIBOR Contract, any technical, administrative, or operational changes, alterations, or modifications that, in the reasonable judgment of a Calculating Person, are necessary to permit the administration and calculation of the Board-Selected Benchmark Replacement under or in respect of such LIBOR Contract in a manner consistent with standard or recommended market practice and, to the extent practicable, the manner in which such LIBOR Contract

was administered immediately prior to the LIBOR Replacement Date.

(4) ‘‘Board’’ means the Board of Governors of the Federal Reserve System.

(5) ‘‘Board-Selected Benchmark Replacement’’ shall mean a Benchmark Replacement identified by the Board that is based on SOFR. The Board-Selected Benchmark Replacement for each category of LIBOR Contract shall be adjusted to—

(A) apply to each LIBOR tenor; and

(B) account for the median historical difference between LIBOR and SOFR.

(6) ‘‘Calculating Person’’ shall mean, with respect to any LIBOR Contract, any person (which may be the Determining Person) responsible for calculating or determining any valuation, payment, or other measurement based on a Benchmark.

(7) ‘‘Determining Person’’ shall mean, with respect to any LIBOR Contract, any person with the authority, right, or obligation to determine the Benchmark Replacement that will take effect on the LIBOR Replacement Date.

(8) ‘‘Fallback Provisions’’ shall mean terms in a LIBOR Contract that set forth a methodology or procedure for determining a Benchmark Replace-

ment, including any terms relating to the date on which the Benchmark Replacement becomes effective.

(9) ‘‘LIBOR’’ shall mean U.S. dollar LIBOR (formerly known as the London interbank offered rate) as administered by ICE Benchmark Administration Limited (or any predecessor or successor thereof), including any tenor thereof.

(10) ‘‘LIBOR Contract’’ shall mean, without limitation, any contract, agreement, mortgage, deed of trust, lease, security (whether representing debt or equity, and including any interest in a corporation, a partnership, or a limited liability company), instrument, or other obligation that uses LIBOR as a Benchmark.

(11) ‘‘LIBOR Replacement Date’’ shall mean, unless the Board determines that any LIBOR tenor will cease to be published or cease to be representative on a different date, January 1, 2022 (in the case of the 1-week and 2-month LIBOR tenors) and July 1, 2023 (in the case of the overnight and 1-, 3-, 6-, and 12-month LIBOR tenors); provided, however, that a LIBOR Replacement Date for one or more LIBOR tenors shall not constitute a LIBOR

Replacement Date with respect to any LIBOR Contract that—

(A) provides for only one LIBOR tenor, if the terms of such LIBOR Contract require interpolation and such tenor can be interpolated from other LIBOR tenors that have a later LIBOR Replacement Date; or

(B) permits a party to choose from more than one LIBOR tenor and any such LIBOR tenor—

(i) has a later LIBOR Replacement Date; or

(ii) can, if the contract requires interpolation, be interpolated from other LIBOR tenors that have a later LIBOR Replacement Date.

(12) "SOFR" shall mean, with respect to any day, the Secured Overnight Financing Rate published by the Federal Reserve Bank of New York (or a successor administrator).

SEC. 4. LIBOR CONTRACTS.

(a) On the LIBOR Replacement Date, the Board-Selected Benchmark Replacement shall, by operation of law, be the Benchmark Replacement for any LIBOR Contract that—

(1) contains no Fallback Provisions; or

(2) contains Fallback Provisions that result in a Benchmark Replacement that is based in any way on any LIBOR value (except to account for the difference between LIBOR and the Benchmark Replacement).

(b) Following the effective date of this Act, any Fallback Provisions in a LIBOR Contract that provide for a Benchmark Replacement based on or otherwise involving a poll, survey, or inquiries for quotes or information concerning interbank lending rates or any interest rate or dividend rate based on LIBOR shall be disregarded as if not included in such LIBOR Contract and shall be deemed null and void and without any force or effect.

(c) A Determining Person shall have authority under this Act, but shall not be required, to select on or after the effective date of this Act the Board-Selected Benchmark Replacement as the Benchmark Replacement; provided, however, that a Determining Person shall not have such authority if the LIBOR Contract requires the Determining Person to select another specified Benchmark Replacement (including, but not limited to, the prime rate or the Effective Federal Funds Rate) that is not based on LIBOR and does not involve a poll, survey, or inquiries for quotes or information concerning interbank lending rates.

(d) Any selection by a Determining Person of the Board-Selected Benchmark Replacement pursuant to subsection (c) shall be—

(1) irrevocable;

(2) made by the earlier of the LIBOR Replacement Date and the latest date for selecting a Benchmark Replacement according to the terms of such LIBOR Contract; and

(3) used in any determinations based on LIBOR under or in respect of such LIBOR Contract occurring on and after the LIBOR Replacement Date.

(e) If a Board-Selected Benchmark Replacement becomes the Benchmark Replacement for a LIBOR Contract pursuant to subsection (a) or (c), then all Benchmark Replacement Conforming Changes shall become an integral part of such LIBOR Contract by operation of law.

(f) The provisions of this Act shall not alter or impair—

(1) any written agreement specifying that a LIBOR Contract shall not be subject to this Act;

(2) any LIBOR Contract that contains Fallback Provisions that would result in a Benchmark

Replacement that is not based on LIBOR (including, but not limited to, the prime rate or the Effective Federal Funds Rate), except that such LIBOR Contract shall be subject to subsection (b);

(3) any LIBOR Contract subject to subsection (c) as to which a Determining Person does not elect to use a Board-Selected Benchmark Replacement pursuant to subsection (c), except that such LIBOR Contract shall be subject to subsection (b);

(4) the application to a Board-Selected Benchmark Replacement of any cap, floor, modifier, or spread adjustment to which LIBOR had been subject pursuant to the terms of a LIBOR Contract;

(5) any LIBOR Contract that provides for a special allowance payment to be calculated in accordance with a Federal statute that explicitly names LIBOR; or

(6) any provision of the Real Estate Settlement Procedures Act or the regulations issued thereunder.

SEC. 5. CONTINUITY OF CONTRACT AND SAFE HARBOR.

(a) The selection or use of a Board-Selected Benchmark Replacement as a Benchmark Replacement under or in respect of a LIBOR Contract by operation of section 4 shall constitute—

(1) a commercially reasonable replacement for and a commercially substantial equivalent to LIBOR;

(2) a reasonable, comparable, or analogous term for LIBOR;

(3) a replacement that is based on a methodology or information that is similar or comparable to LIBOR; and

(4) substantial performance by any person of any right or obligation relating to or based on LIBOR.

(b) None of—

(1) a LIBOR Replacement Date;

(2) the selection or use of a Board-Selected Benchmark Replacement as a Benchmark Replacement; or

(3) the determination, implementation, or performance of Benchmark Replacement Conforming Changes, in each case by operation of section 4, shall—

(A) be deemed to impair or affect the right of any person to receive a payment, or affect the amount or timing of such payment, under any LIBOR Contract; or

(B) have the effect of—

(i) discharging or excusing performance under any LIBOR Contract for any reason, claim, or defense (including, but not limited to, any force majeure or other provision in any LIBOR Contract);

(ii) giving any person the right to unilaterally terminate or suspend performance under any LIBOR Contract;

(iii) constituting a breach of any LIBOR Contract; or

(iv) voiding or nullifying any LIBOR Contract.

(c) No person shall be subject to any claim or cause of action in law or equity or have liability for damages, arising out of or related to the selection or use of a Board-Selected Benchmark Replacement or the determination or performance of Benchmark Replacement Conforming Changes, in each case by operation of section 4.

(d) The selection or use of a Board-Selected Benchmark Replacement or the determination, implementation, or performance of Benchmark Replacement Conforming Changes, in each case by operation of section 4, shall not be deemed to—

(1) be an amendment or modification of any LIBOR Contract; or

(2) prejudice, impair, or affect any person's rights, interests, or obligations under or in respect of any LIBOR Contract.

(e) Except as provided in either subsection (a) or (c) of section 4, the provisions of this Act shall not be interpreted as creating any negative inference or negative presumption regarding the validity or enforceability of—

(1) any Benchmark Replacement (including any method for calculating or determining a spread adjustment) that is not a Board-Selected Benchmark Replacement; or

(2) any changes, alterations, or modifications to or in respect of a LIBOR Contract that are not Benchmark Replacement Conforming Changes.

SEC. 6. TAX TREATMENT.

None of—

(1) the selection or use of a Board-Selected Benchmark Replacement as a Benchmark Replacement;

(2) the determination, implementation or performance of Benchmark Replacement Conforming Changes; or

(3) the application to any LIBOR Contract of, or the agreement by parties thereto to terms consistent with, section 4 of this Act, shall be treated

as a sale, exchange or other disposition of property for purposes of the Internal Revenue Code of 1986.

SEC. 7. PREEMPTION.

(a) This Act and the regulations hereunder shall supersede any and all laws of any State, the District of Columbia, or any territory or possession of the United States, insofar as such laws provide for the selection or use of a Benchmark Replacement.

(b) No provision of any State or local law that expressly limits the manner of calculating interest, including the compounding of interest, shall apply to the selection or use of a Board-Selected Benchmark Replacement by operation of section 4, and any State or local law to the contrary is hereby preempted.

SEC. 8. TRUST INDENTURE ACT OF 1939.

Section 316 of the Trust Indenture Act of 1939 (15 U.S.C. 77ppp) is amended—

(1) by striking ‘‘and’’ after ‘‘of subsection (a),’’ in subsection (b); and

(2) by inserting ‘‘, and except that the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security shall not be deemed to be impaired or affected by any change occurring by the application of section 4 of the Adjustable Interest Rate

(LIBOR) Act of 2021 to any indenture security'' after ''subject to such lien'' in subsection (b).

SEC. 9. RULEMAKING.

The Board is authorized to issue such regulations as may be necessary to enable it to administer and carry out the purposes of this Act; provided, however, that the Secretary of the Treasury is authorized to issue such regulations as may be necessary to enable it to administer and carry out the purposes of section 6 of this Act.

MAYER | BROWN

April 19
2021

Recent Congressional Hearing Indicates that Federal LIBOR Transition Assistance Law Increasingly Likely

Eye On IBOR Transition Blog

Testimony at a virtual hearing on Thursday, April 15, 2021, of the Subcommittee on Investor Protection, Entrepreneurship and Capital Markets of the US House Committee on Financial Services reinforced regulatory support for federal legislation to facilitate the transition from LIBOR.

A replay of the full hearing is available here, the committee memorandum in support of the proposed legislation is here, and written testimony by representatives of five panel witnesses are here (Federal Housing Finance Authority), here (Securities and Exchange Commission), here (US Department of the Treasury), here (US Federal Reserve Board ("FRB")), and here (Office of the Comptroller of the Currency).

Significantly, the General Counsel of the FRB stated in his written testimony:

"The end of LIBOR may result in significant litigation. For example, if a legacy contract converts to a fixed rate when LIBOR ends, a party disadvantaged by that conversion might request that a court reform the contract by substituting an alternative floating rate for LIBOR. Parties also might request that a court reform or void a legacy contract that lacks any fallback language if the parties cannot agree bilaterally on a successor rate. Similarly, in instances where a legacy contract allows a person to select a replacement rate when LIBOR ends, a party disadvantaged by the replacement rate might argue that the manner in which another person—for example, a bond trustee—selected the replacement rate violates the implied covenant of good faith and fair dealing. Chair Powell and Vice Chair Quarles have publicly stated their support for federal legislation to mitigate risks related to legacy contracts. Federal legislation would establish a clear and uniform framework, on a nationwide basis, for replacing LIBOR in legacy contracts that do not provide for an appropriate fallback rate. Federal legislation should be targeted narrowly to address legacy contracts that have no fallback language, that have fallback language referring to LIBOR or to a poll of banks, or that convert to fixed-rate instruments. Federal legislation should not affect legacy contracts with fallbacks to another floating rate, nor should federal legislation dictate that market participants must use any particular benchmark rate in future contracts. Finally, to avoid conflict of laws problems, federal legislation should pre-empt any outstanding state legislation on legacy LIBOR contracts."

While the text of the proposed legislation remains as a draft, this testimony is further evidence of the important regulatory support for federal legislation to facilitate the LIBOR transition for "tough legacy" contracts.

The post Recent Congressional Hearing Indicates that Federal LIBOR Transition Assistance Law Increasingly Likely appeared first on Eye on IBOR Transition.

MAYER | BROWN

January 14
2021

Update on the Proposal for a Governmental IBOR Transition in the European Union

Eye On IBOR Transition Blog

Authors Ann-Kathrin Balster Dr. Patrick Scholl

Following the discussion and status set out in our September 2020 blog post, Proposal for a Governmental IBOR Transition in the European Union, the proposed amendment to the EU Benchmark Regulation ("BMR") has been developed further and a consolidated version published reflecting the text agreed by the Council of the European Union and the European Parliament.

As has been contemplated from the first draft, the BMR Amendment addresses European "tough legacy contracts" on a directly applicable level. It aims to avoid a significant disruption in the functioning of the financial markets in the EU by adding a new Article 23 (a) to the BMR. This new article grants new powers of the European Commission ("EC Powers") to designate a mandatory replacement benchmark and, by operation of law, replace all references to the benchmark that has ceased to be published in specified contracts covered by the regulation ("BMR Covered Contracts"). The European Commission exercises these powers by adopting implementing acts. Equivalent powers are introduced for national legislators in a new Article 23 (b) for member states where a majority of contributors to a relevant benchmark are located.

The scope of BMR Covered Contracts in the current draft of the amendment, however, has been extended since the prior draft beyond financial instruments, financial contracts and funds that are within the scope of the BMR, and clarifications have been added in respect of the governing laws that are within the scope of the EC Powers. The final version now applies to:

"(a) any contract or any financial instrument as defined in Directive 2014/65/EU that is governed by the law of one of the Member States and that references a benchmark; and

(b) any contract that is subject to the law of a third country but the parties to which are all established in the Union and where the law of that third country does not provide for an orderly wind-down of a benchmark."

Unchanged is the stipulation that the EC Powers relate to BMR Covered Contracts not providing for a suitable fallback. The BMR Amendment explicitly states that a fallback provision shall be deemed unsuitable if : (i) the fallback provision does not cover the permanent cessation of a reference benchmark; or (ii) the application of the fallback provision requires further consent from third parties that has been denied; or (iii) the application of the fallback provision no longer, or only with a significant difference, reflects the underlying market or the economic reality that the ceasing benchmark is intended to measure, and could have an adverse impact on financial stability.

As a result of this suitability condition, for example, a German law LIBOR floating rate note that does not provide for a suitable fallback can be amended by operation of law to a successor rate selected by the European Commission by way of the EC Powers.

Therefore, existing fallback provisions in BMR Covered Contracts will have to be scrutinized as to their suitability and ability to meet the criteria set out above. These criteria also should be taken into account in drafting new fallback provisions.

Even in light of these changes to the BMR Amendment, our initial analysis and conclusion still stand and the BMR Amendment should, in our view, not be regarded as the primary solution to the challenges relating to the cessation of LIBOR. While the BMR Amendment provides an additional tool to deal with certain affected contracts, for the time being, legal certainty should primarily be achieved by market participants proactively amending all affected financial instruments and contracts. In the case of OTC derivatives, adherence to the ISDA 2020 IBOR Fallbacks Protocol, which will become effective 25 January 2021, is one example of an available amendment option.

One of the issues the we pointed out previously has not been resolved and remains a source of uncertainty that we would like to see addressed: the use in the BMR Amendment of the term "contract". Unlike the reference to "financial instruments," the term "contract" is not defined. Fortunately, previous uncertainties arising from the unclear applicability of the BMR Amendment to contracts with only one EU-domiciled party, or to those governed by a third-party country's law, have been reduced greatly.

For contracts governed by the laws of a third country, the BMR Amendment only applies if (i) all parties are established in the EU and (ii) the relevant third country law does not provide for an orderly wind-down of a benchmark. For example: a NY law governed loan agreement between an Italian borrower and a German lender could be amended pursuant to the BMR Amendment if neither the agreement nor any NY law addresses the permanent cessation of LIBOR. The EC Powers would not extend to a NY law contract of a German borrower with a bank in the United States. While the second prong of this requirement could raise some uncertainties in practice as to what constitutes "provisions for an orderly wind-down of a benchmark," we view these new restrictions as a vast improvement, as the requirement for all parties to be established in the EU clarifies the scope immensely. We expect opinions to be formed and guidance to be published in the near future on the benchmark wind-down procedure for the most common third-country jurisdictions.

The market is still speculating about the policy that the European Commission will implement to make use of its newly granted EC Powers, apply adjustment spreads and respond to different market approaches or different product-specific fallbacks. The same is true for Member States that now also have the power to designate a replacement benchmark rate, which raises the additional question of potential conflicts between a European approach and a solution on a national basis. During the most recent roundtable discussion hosted by the ECB working group on risk free rates, it was mentioned that the European Commission could apply its EC Powers in several ways taking into account the nature and markets of the relevant contracts (bonds, derivatives, commercial loans, retail loans, etc.) if required to align the respective BMR Covered Contracts with amendments agreed in the respective product area or market.

The BMR Amendment is expected to enter into force without further changes as soon as the procedural requirements allow. The next step, the first reading, is currently scheduled to take place on 18 January 2021.

The post Update on the Proposal for a Governmental IBOR Transition in the European Union appeared first on Eye on IBOR Transition.

MAYER | BROWN

October 29
2020

Promised UK 'Tough Legacy' Legislation Released; HM Treasury Issues Supporting Policy Statement

Eye On IBOR Transition Blog

Authors Ravi Amin J. Paul Forrester Ashley McDermott

The UK Government released its promised[1] draft legislation, Financial Services Bill 200, on October 20, 2020,[2] to assist the 'tough legacy' issue for certain LIBOR-referencing contracts by providing the UK's Financial Conduct Authority with new and enhanced powers to oversee the orderly wind-down of critical benchmarks, such as LIBOR. The legislation includes the authority for the FCA to direct a change in the methodology of a critical benchmark and extend its publication for a limited time period.

Contemporaneously, HM Treasury issued a policy statement supporting the proposed amendments to the Benchmark Regulation and encouraging firms to continue to prioritize active transition away from LIBOR to alternative benchmarks.

[1] Described in our prior Perspective*Sunak's Solution to LIBOR Transition in 'Tough Legacy' Contracts*.

[2] See sections 8-21 and Schedule 5.

The post Promised UK 'Tough Legacy' Legislation Released; HM Treasury Issues Supporting Policy Statement appeared first on Eye on IBOR Transition.

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Resources

- FAQ
- IOSCO Compliance Statement
- Benchmark Statement
- Methodology
- Oversight Committee
- Finance and Economic Discussion Series
- CME Clearing's SOFR OIS Curve
- ARRC Term SOFR Key Principles

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Daily updated Term SOFR values

DATE	TERM SOFR (%)		
	1 MONTH	3 MONTH	6 MONTH
12 May 2021	0.0167	0.0280	0.0342
11 May 2021	0.0159	0.0261	0.0340
10 May 2021	0.0170	0.0288	0.0355
07 May 2021	0.0172	0.0303	0.0372
06 May 2021	0.0205	0.0347	0.0412

Last Updated: 12 May 2021 05:48 CT

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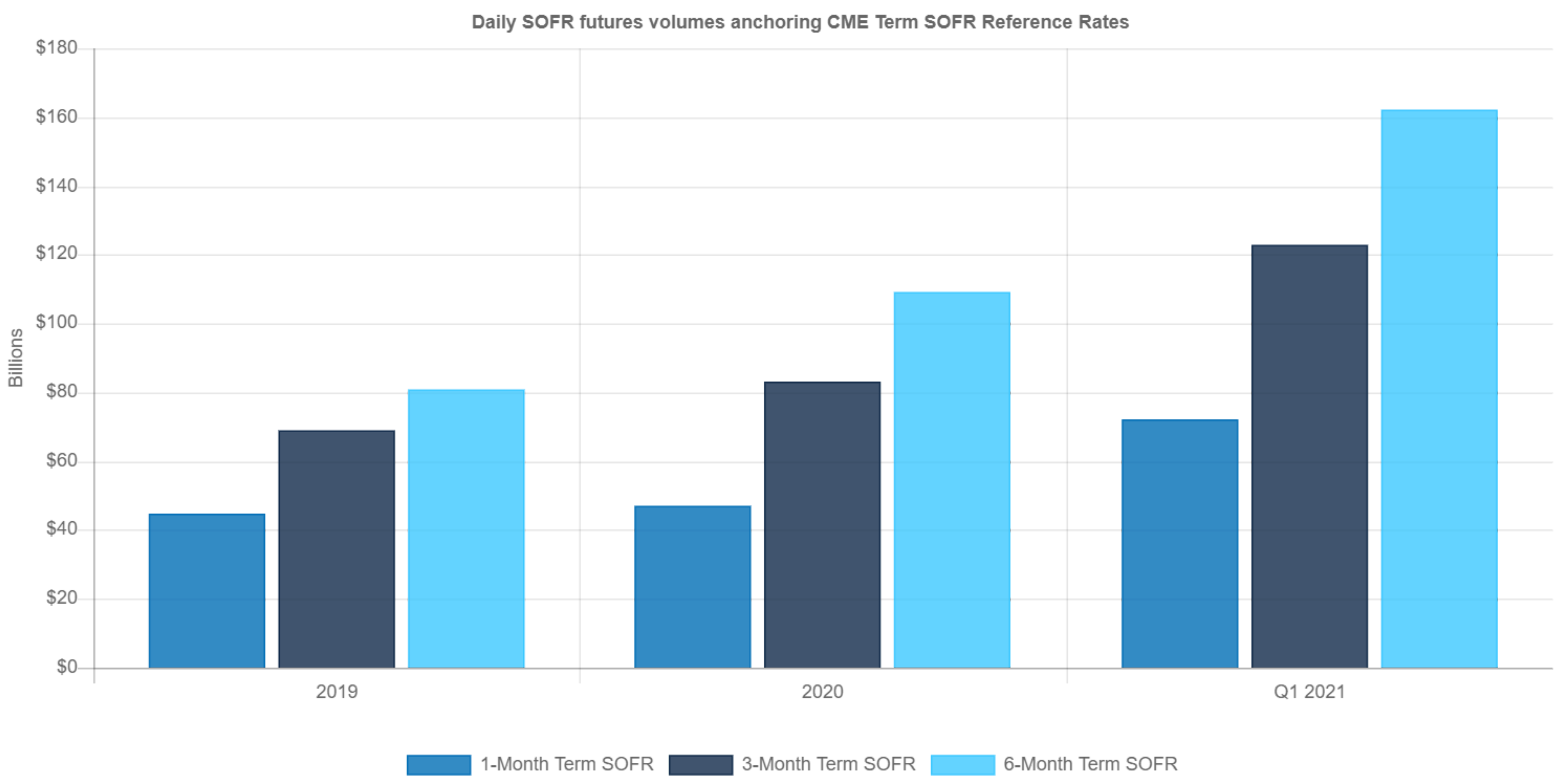

*Notional shown for illustrative purposes only, computed based on the value of an equivalent money market instrument with the same dollar-value-of-basis-point (DV01)

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MAYER | BROWN

March 30
2021

US Alternative Reference Rates Committee Proposes Using a 30-Day Average of the SOFR in Advance for Certain Asset-Backed Securities

Authors J. Paul Forrester Mary Jo N. Miller

On March 29, 2021, the US Alternative Reference Rates Committee (ARRC) issued a white paper (White Paper) proposing a 30-day average of the secured overnight financing rate (SOFR), with a monthly reset, in advance of the related interest accrual period for use in certain asset-backed securities (ABS) products, including non-CLO ABS and mortgage-backed securities and commercial mortgage-backed securities.

While noting that some market participants had expressed interest in an ***in arrears*** rate method (on which the ARRC continues to work), the ***in advance*** rate was designed and recommended by the ARRC's Securitization Working Group (SWG). SWG members—including representatives of issuers, underwriters, arrangers, trustees, services, calculation agents, note administrators, trust administrators and investors—participated in a months-long process of sharing insights and perspectives on current ABS market operations, market participant preferences and market trends before reaching a consensus on this option for the use of SOFR in securitized products.

In addition, to the extent possible, approaches for using SOFR in new ABS products were developed by the SWG giving due consideration to the benefit of aligning the recommendations with existing practices. SWG members viewed having a limited number of market standards for using SOFR to be a necessary step for adoption. By looking to existing, thoroughly vetted practices for using SOFR in ABS, the SWG seeks to minimize confusion and complexity and maintain consistency within the market, thereby facilitating its adoption by market participants in ABS products. Also, the ABS market has begun to show nascent signs of accepting a SOFR-based rate, with recent issuances by Freddie Mac of ABS using 30-day average SOFR set in advance.

While some investors may prefer the interest rate to reset at the end of an interest period in order to align more with the interest rate environment that existed during the actual interest accrual period, SWG members noted that doing so presents significant operational challenges for market participants. Knowing the interest rate in advance of the interest accrual period is an important aspect of a stable and liquid market because it allows trades in ABS to occur without adjustment during the month.

The White Paper concludes by noting that the widespread adoption of average SOFR in ABS transactions will help stabilize the market during the London Interbank Offered Rate (LIBOR) cessation and reduce systemic risk. The ***in advance*** model described in the White Paper is not a binding directive nor exhaustive of all other acceptable possibilities but a consensus-based example of how a successful SOFR-based ABS product could be created using average SOFR, with interest rates determined prior to the commencement of the interest accrual period.

MAYER | BROWN

November 04
2020

ARRC Provides Recommendations to US Prudential Banking Regulators to Facilitate USD LIBOR Transition to SOFR

Authors J. Paul Forrester Matthew Bisanz Jeffrey P. Taft

On November 2, 2020, the Alternative Reference Rates Committee ("ARRC") sent a detailed memorandum ("Memorandum") to the Board of Governors of the Federal Reserve System ("FRB"), the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC" and, together with the FRB and FDIC, the "Agencies") that summarizes the ARRC's preliminary findings and recommendations on the potential regulatory considerations with the application of current and anticipated capital and liquidity requirements in the context of the market transition from the use of the London Interbank Offered Rate ("LIBOR") to the Secured Overnight Financing Rate ("SOFR") as a contractual reference rate in the United States (the "Transition").

The Memorandum notes that a key policy goal of the Transition is to reduce overall risk in the financial system. The treatment of SOFR-based exposures under prudential capital and liquidity standards during and after the Transition should recognize this policy goal and ensure that prudential treatment of these exposures does not dis-incentivize timely and voluntary transition to SOFR. In general, if the Transition were to lead to unintended increases in capital and liquidity requirements, this would be at cross-purposes with the macro-prudential goal of mitigating risk of the financial system as a whole. To that end, the Basel Committee on Banking Supervision ("BCBS") has issued guidance in the form of FAQs ("BCBS June 2020 FAQs") that clarify application of certain international capital and liquidity standards in light of the transitions in many of its member jurisdictions from IBORs to risk-free rates ("RFRs").

The ARRC states in the Memorandum that it believes US regulators should similarly address these principles with respect to current US capital and liquidity regulatory requirements, as well as to future such requirements, such as quantitative impact studies of the implementation of the Fundamental Review of the Trading Book ("FRTB") because past studies may not have included a robust *pro forma* analysis reflecting the impact of the Transition and because the BCBS June 2020 FAQs are not legally operative in the United States.

The 25-page Memorandum is organized into four parts:

- Part I provides background on the Transition and the actions market participants may be expected to take to help effect the Transition.
- Part II discusses the capital and liquidity considerations related to the Transition for which the ARRC currently recommends that regulators take appropriate actions to avoid potential unintended and temporary effects of the Transition on regulatory capital and liquidity requirements that may discourage a timely Transition.
- Part III discusses other general effects of the Transition on regulatory capital and liquidity requirements that the ARRC believes merit discussion and monitoring but for which the ARRC does not have a specific regulatory recommendation in this initial analysis.
- Part IV highlights how unintended increases in capital and liquidity requirements related to the Transition would ultimately increase costs to end users of products such as derivatives.

Importantly, the ARRC considered effects beyond those arising from its recommended best practices as part of its Paced Transition Plan, including an increased volume effect (e.g., higher derivative notionals due to basis risk hedging) and reduced liquidity effect (e.g., due to both LIBOR- and SOFR-referencing instruments being outstanding and reducing liquidity for each other) from the Transition, effects that are likely to directly impact current capital and liquidity requirements.

In the Memorandum, the ARRC makes recommendations related to three types of considerations:

- Model-related considerations;
- Recalibration-related considerations; and
- Amendment-related considerations.

Model-Related Considerations

Model-related considerations noted in the Memorandum include the comprehensive capital analysis and review ("CCAR") process, stress testing and stress capital buffers. The ARRC recommends that the Agencies should consult with the industry to develop more streamlined model approval requirements applicable to Transition-related model changes and effective for a temporary period during the Transition, and should otherwise make reasonable accommodations for Transition-related issues that may arise in existing market risk and counterparty credit risk models that banks may rely on during the Transition. After this period, models could be revisited and assessed on an ex-post basis, which would help mitigate time and resource constraints for both banks and supervisors. The ARRC also recommends that the Agencies consult with the industry to issue guidance on (i) the use of historical proxy data published by the Federal Reserve Bank of New York for purposes of the CCAR and (ii) expectations for the impact of the Transition on financial projections under modeled stress scenarios.

Recalibration-Related Considerations

The ARRC's recalibration-related recommendations include, for implementing the FRTB in the United States, that the Agencies (i) clarify that, consistent with the BCBS June 2020 FAQs, banks be permitted during the Transition to use the new benchmark rates for expected shortfall calculations for the reduced set of risk factors in the current period, while using the old benchmark rates as proxies in the historical stress period if the new benchmark rate is not available; (ii) clarify that banks be permitted during the Transition to capitalize desks via the internal models approach of the FRTB, even if desk-level models fail back-testing or the profit and loss attribution test, if such failure was a result of the Transition, on the basis that the Transition constitutes a "major regime shift"; and (iii) issue guidance addressing the impact of the Transition under the existing market risk and counterparty credit risk capital frameworks. Similar unintended consequences could also affect the existing market risk framework. For example, stressed Value-at-Risk and the stressed Effective Expected Positive Exposure measure under the internal models methodology may be difficult to model. In particular, regulators have not yet clarified how they expect firms to proxy such time series given that in some cases RFRs did not exist during the 2008–2009 financial crisis.

Also, the ARRC recommends that the Agencies (a) provide guidance confirming that, during the Transition, the lack of liquidity of certain collateral securities and/or derivatives will not result in an increase in the standardized or modelled exposure amounts for derivatives and securities financing transactions via an extended assumed holding period or margin period of risk; (b) in conjunction with the industry, monitor whether the Transition could cause certain collateral securities to fail to meet the "readily marketable" standard for financial collateral under the collateral recognition requirements and (c) issue guidance providing that, during the Transition, supervisors can take into account anticipated increases in the liquidity of replacement instruments for purposes of assessing whether those instruments qualify as high-quality liquid assets under the liquidity coverage ratio rule.

Finally, the ARRC recommends that the FRB engage with the ARRC to discuss, and provide modifications to, the G-SIB surcharge computation and FR Y-15 reporting instructions to avoid dis-incentivizing participation by global systemically important banks ("G-SIBs") in the Transition.

Amendment-Related Considerations

Amendment-related considerations prompted the ARRC generally to recommend that the FRB issue guidance confirming that amending an instrument from LIBOR to SOFR (i) would not call into question its grandfathered status for purposes of the total loss-absorbing capacity ("TLAC") rule and (ii) would not trigger the need for re-approval of a contractual conversion feature. The ARRC recommends that the FRB also confirm that the TLAC rule would not prohibit using tender or exchange offers to transition the index rate of debt or equity securities.

Specifically, the clean holding company requirements in the FRB's TLAC rule could limit some firms' flexibility to use tender offers or exchange offers to replace debt and preferred equity securities indexed to LIBOR with securities indexed to SOFR.

In connection with a tender offer or exchange offer for its own debt or equity securities, a bank holding company typically enters into binding securities contracts to repurchase securities from third-party investors. These securities contracts are qualified financial contracts ("QFCs") for purposes of the TLAC rule and would be prohibited by the TLAC rule's clean holding company requirements if a covered bank holding company enters into a QFC (other than a credit enhancement) directly with an unaffiliated third party. Absent clarification from the FRB, the ARRC notes that this provision of the TLAC rule could limit some holding companies' ability to use tender offers or exchange offers to effect Transition-related transactions related to their debt and preferred equity securities.

The ARRC also recommends that the Agencies confirm that an amendment to a capital instrument to reference SOFR rather than LIBOR would not (i) be treated as a redemption and replacement for purposes of the regulatory capital rule or the CCAR or (ii) trigger a reassessment of whether the instrument has an incentive to redeem. These confirmations would be consistent with BCBS guidance regarding capital qualification of instruments amended to effectuate the Transition.

Conclusion

The ARRC addresses a wide array of concerns in the Memorandum that touch on almost every capital or liquidity standard. While each recommendation addresses a well-articulated concern, it remains to be seen how the industry and the Agencies will respond. In some instances, the industry may develop well-reasoned, practical conclusions that negate the need for action by the Agencies. For example, even the ARRC states that its assumption about amending an instrument from LIBOR to SOFR will not create an incentive to redeem.

However, other issues, such as excluding transition-related hedging basis swaps from the G-SIB surcharge, are likely to require intervention by the Agencies. Given the limited number of banks affected by many of these standards, and the burden of engaging in formal rulemaking, it is possible that the Agencies will act through interpretive letters, supervisory guidance and enforcement discretion. Accordingly, banks should be working with legal counsel and the trade associations to identify approaches to their issues and planning engagement strategies with the Agencies.

2021 STRUCTURED PRODUCTS LEGAL, REGULATORY AND MARKET BRIEFING

SUPPLEMENTAL MATERIALS | MAY 13, 2021

Panel 4

SEC, FINRA and CFTC Regulatory Announced Priorities & Enforcement Expectations Under the Biden Administration

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November 1, 2019

Legal Update

FINRA Provides New Reg. BI and Form CRS Resource

On October 8, 2019, the Financial Industry Regulatory Authority (FINRA) published a new resource to assist its member firms in their efforts to comply with the US Securities and Exchange Commission's (SEC) Regulation Best Interest (Reg. BI) and Form CRS by the June 30, 2020 compliance date.[1] FINRA's Reg. BI and Form CRS Firm Checklist[2] (the "Checklist") provides a Q&A outlining the major requirements of the recent rulemaking package and explains some key differences between FINRA rules and the SEC's Reg. BI and Form CRS to help member firms assess their obligations under each.

Reg. BI

Firms will be expected to update their policies and procedures in light of changes provided for in Reg. BI. The application of Reg. BI's "best interest" standard to recommendations used by retail customers[3] will require that firms establish and implement policies and procedures designed to fulfill the four "Component Obligations" of Reg. BI: (1) Disclosure, (2) Care, (3) Conflict of Interest and (4) Compliance. The Checklist provides guidelines for firms seeking to fulfill these obligations and warns of potential pitfalls where Reg. BI has created new obligations.

DISCLOSURE

The Checklist instructs that firms should be prepared to give full and fair disclosure of all material facts relating to the scope and terms of their relationship with retail customers and relating to conflicts of interest. As a part of "full and fair" disclosure, firms should be sure to provide sufficient information to enable a retail customer to make an informed decision with regard to a recommendation. The Checklist notes several items that should be the focus of a firm's disclosure, including:

1. the capacity in which the firm is acting (*i.e.*, as a broker-dealer or investment adviser);
2. material fees and costs that apply to a retail customer's transactions, holdings and accounts;
3. the type and scope of services provided (including whether account monitoring is included);[4]
4. minimum account size;
5. material limitations on the securities or investment strategy that may be recommended to a customer;
6. the general basis for a firm's recommendation;
7. risks associated with a recommendation; and

8. conflicts of interest relating to a recommendation.

CARE

Reg. BI's standard of care incorporates and enhances FINRA's suitability requirements for reasonable-basis, customer-specific and quantitative suitability.[5] The Checklist notes that care, skill and costs are new express elements for consideration when making recommendations to retail customers. A firm should look to these elements, among others, when determining whether it has a reasonable basis for its recommendations. To effectively conduct this analysis, a broker-dealer should establish a process for establishing and understanding the scope of "reasonably available alternatives" that would be considered as a part of fulfilling its standard of care.

Additionally, in a change from FINRA's suitability requirement, Reg. BI applies the best interest standard to a series of recommended transactions, irrespective of whether the broker-dealer exercises actual or de facto control over a customer's account. Firms should therefore safeguard against excessive trading, irrespective of whether it or its associated person "controls" the account.

Although not a requirement, the Checklist notes that firms should consider, as a best practice, applying heightened scrutiny to recommendations of high-risk or complex investments. It is also important to note that firms are not expected to recommend a single "best" product, but need only be able to form the reasonable basis that a recommendation is in the best interest of the customer.

CONFLICTS OF INTEREST

The Checklist advises firms that they must establish policies and procedures to identify and address the firm's conflicts of interest,[6] disclosing or eliminating them where required. Conflicts that create an incentive for an associated person to place the firm's or such associated person's interest ahead of the retail customer's interest must be mitigated, and certain other conflicts of interest must be eliminated entirely. Reg. BI prohibits certain practices deemed to create too great of a conflict of interest to disclose away or mitigate, such as sales contests, bonus, non-cash compensation and quotas based on the sale of specific securities or specific types of securities within a limited time. Firms should be certain that their policies and procedures have been updated to reflect the Reg. BI standards for identifying and addressing these conflicts of interest, whether they are required to disclose, mitigate or eliminate them.

COMPLIANCE

Firms should update their policies and procedures to account for Reg. BI updates, such as new defined terms. Additionally, current recordkeeping practices will not fully satisfy Reg. BI, so firms will need to address their recordkeeping policies to ensure they can meet their new obligations. Firms should also implement training to ensure that all associated persons are aware of Reg. BI's requirements and prepared to comply with them upon the compliance date. Although the requirements will vary depending on a firm's size and complexity, a reasonably designed compliance program generally would include: controls, remediation of non-compliance, training, and periodic review and testing. The Checklist provides a helpful "cheat sheet" for firms to look to when establishing these new policies and procedures.

Form CRS

Registered broker-dealers and registered investment advisers (RIAs) who provide services to retail investors[7] are required to complete a relationship summary on Form CRS. The relationship summary is intended to inform retail investors about the services provided by the broker-dealer or RIA and describe the relationship between the retail investor and the firm. The Checklist highlights several important items relating to Form CRS to ensure that firms are prepared to complete, file and deliver Form CRS when the compliance date arrives.

The Checklist advises firms of the format and content requirements of Form CRS. Firms should be aware of the page limit (two for a broker-dealer or RIA, four for a dual registrant) and ensure that all required content is available in their relationship summary in plain English. The use of visual aids is also encouraged.

Firms are expected to provide retail investors with:

1. an introduction to the firm;
2. a description of services provided to the retail investor;
3. a description of fees and costs, the applicable standard of conduct, conflicts of interest and examples of how the firm makes money;
4. relevant disciplinary history;
5. a method to obtain additional information; and
6. certain prescribed "conversation starters" for investors to ask their financial professionals.

The Checklist also advises firms to establish processes so they are equipped to file, deliver and update Form CRS when needed. Filers should ensure they are prepared to:

- file Form CRS through Web CRD (or IARD for RIAs – dual registrants will be required to file relationship summaries through both IARD and Web CRD);
- update Form CRS within 30 days of any information becoming materially inaccurate and communicate any changes to retail investor clients or customers within 60 days after updates are required to be made;
- deliver a relationship summary to new or prospective customers who are retail investors before or at the beginning of their relationship;
- deliver a relationship summary to existing customers;
- post a current version of the relationship summary prominently on the firm's public website; and
- maintain and preserve a record of each relationship summary and the date it was provided to each retail investor for a period of at least six years.

Conclusion

Although by no means exhaustive, the Checklist provides a useful summary of a broker-dealer's obligations under Reg. BI and Form CRS. Firms should already be preparing to address how they will update their policies and procedures and otherwise comply with the requirements of Reg. BI and Form CRS by June 30, 2020. Reviewing the Checklist should be an important first step in this process.

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Endnotes

[1] Other available resources include the SEC's Regulation Best Interest, A Small Entity Compliance Guide, available at http://bit.ly/2NqBNlb and Form CRS Relationship Summary; Amendments to Form ADV, A Small Entity Compliance Guide, available at http://bit.ly/36mPZEn.

[2] The Checklist is available at http://bit.ly/36lv44M.

[3] Reg. BI only applies to recommendations to "retail customers" and their non-professional legal representatives. Reg. BI defines a "retail customer" as a natural person, or the legal representative of such person, who: (a) receives a recommendation for any securities transaction or investment strategy from a broker-dealer or associated person; and (b) uses the recommendation primarily for personal, family or household purposes.

[4] Although Reg. BI imposes no duty to monitor a customer's account, if a firm agrees to do so, it takes on an obligation to review and make recommendations regarding the account on the specified, periodic basis it has agreed with the customer. In such circumstances, Reg. BI will infer an "implicit" hold recommendation subject to the obligations of other recommendations under Reg. BI.

[5] *See* FINRA Rule 2111 (Suitability).

[6] A "conflict of interest" is an interest that might incline a broker-dealer or associated person – consciously or unconsciously – to make a recommendation that is not disinterested.

[7] A "retail investor" is a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes. This definition mirrors the definition of "retail customer" in Reg. BI.

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March 1, 2021

Legal Update

SEC Division of Examinations Risk Alert: New SEC Leadership Continues Focus on Examinations Related to Digital Asset Securities

On February 26, 2021, the US Securities and Exchange Commission's ("SEC") Division of Examinations published a risk alert in connection with the offer, sale, and trading of digital assets that are securities.[1] The risk alert provides observations made by Division of Examinations staff during examinations of broker-dealers, investment advisers, exchanges, and transfer agents. The risk alert also highlights areas of focus for the Division of Examinations' future examinations.

The Division of Examinations notes that activities relating to digital asset securities "present unique risks to investors."[2] Market participants should reflect upon their own practices, policies and procedures in light of the considerations highlighted by the risk alert to develop and enhance their compliance programs.

Key Takeaways

- ***New leadership continues focus on exams.*** The SEC, including the Division of Examinations, appear poised to continue to focus on enforcement and examination of issues related to dealings in digital assets or the use of distributed ledger technology by capital markets participants and the securities markets themselves.
- ***"That which we call a rose by any other name would smell as sweet."*** Some things from the times of Shakespeare's *Romeo and Juliet* remain true to this day. The risk alert is a signal to market participants that just because an asset is purported to be a "digital asset," it does not mean it is not a security. The SEC maintains jurisdiction over digital asset securities and over SEC registrants, so firms should be aware of the uncertain status of many of these instruments and consider how their activities (or the activities of their affiliates) may implicate SEC registration requirements and otherwise be subject to SEC rules and regulations.

- ***What makes you unique?*** The SEC views activities in digital assets as involving unique risks, which require unique policies and procedures, due diligence and investor disclosures to address and mitigate those risks. Firms should be aware of the key differences among digital assets with which they engage and ensure that they understand the key risks that may be idiosyncratic to such assets and their underlying technologies. These unique factors should be considered when developing and enhancing firm policies, procedures, and compliance programs. We are working to develop a separate chapter in the Written Supervisory Procedures dedicated to digital assets, for example.

Considerations Highlighted by the Risk Alert

BROKER-DEALERS

The risk alert highlights a number of considerations for broker-dealers operating a digital assets business that the Division of Examinations has noted will be a focus in examinations going forward:

- ***Safekeeping of Funds and Operations:*** Division of Examinations staff will examine broker-dealers to understand operational activities, including operations that are unique to the safety and custody of digital asset securities.
- ***Registration Requirements***: Examinations will include broker-dealers' and any affiliated entities' compliance with registration requirements, particularly where an affiliate may assist in effecting transactions in digital asset securities.
- ***Anti-Money Laundering ("AML"):*** The pseudonymous nature of distributed ledger technology presents unique challenges to firm AML programs. Division of Examinations staff observed inadequate AML procedures, controls, and documentation regarding digital asset securities and will continue to examine for compliance with AML obligations.
- ***Offerings:*** Underwriting and private placements of digital asset securities may implicate "unique disclosure and due diligence obligations." Examinations will include a review of the due diligence performed by broker-dealers, and the disclosures made by broker-dealers to customers related to the offering of digital asset securities.
- ***Disclosure of Conflicts of Interest:*** Division of Examinations staff observed circumstances where firms operate in multiple capacities, including as trading platforms or proprietary traders of Digital Asset Securities on their own and other platforms. Future examinations will include a review of the existence and disclosures of conflicts of interest and the compliance policies and procedures to address them.
- ***Outside Business Activities ("OBAs"):*** Division of Examinations staff observed instances of registered representatives of broker-dealers offering services related to digital assets apart from their employer. FINRA Rule 3270 requires that FINRA-member firms evaluate OBAs to determine whether they should be subjected to the approval, supervision, and

recordation of the broker-dealer. Division of Examinations staff will continue to review these activities and their treatment under FINRA-member firm compliance programs.

INVESTMENT ADVISERS

Examinations of investment advisers managing digital asset securities, as well as other digital assets and derivative products, have identified several key risks for future examination based on Division of Examinations staff's observations. The Division of Examinations has noted that future examinations will focus on the following:

- ***Custody*:** Examinations will review the risks and practices related to custody of digital assets and examine for compliance with the custody rule (Rule 206(4)-2) under the Investment Advisers Act of 1940, where applicable. Regardless of how digital assets are stored, Division of Examinations staff will review:
    - Occurrences of unauthorized transactions, including theft of digital assets;
    - Controls around safekeeping of digital assets;
    - Business continuity plans where key personnel have exclusive access to private keys;
    - How the adviser evaluates harm due to the loss of private keys;
    - Reliability of software used to interact with relevant digital asset networks;
    - Storage of digital assets on trading platform accounts and with third party custodians; and
    - Security procedures related to software and hardware wallets.
- ***Books and Records:*** Digital asset trading platforms vary in reliability and consistency with regard to order execution, settlement methods, and post-trade recordation and notification, which an adviser should consider when designing its recordkeeping practices.
- ***Disclosures:*** Examinations will include a review of investor disclosure relating to the risks associated with digital assets. Division of Examinations staff will assess disclosures regarding specific risks, including the complexities of the products and technology underlying such assets, technical, legal, market, and operational risks (including custody and cybersecurity), price volatility, illiquidity, valuation methodology, related-party transactions, and conflicts of interest.
- ***Portfolio Management*:** A review of policies, procedures, and practices of investment advisers investing client assets in digital asset securities and other digital assets will focus in particular on the following areas:
    - Classification of digital assets managed on behalf of their clients, including whether they are classified as securities;
    - Due diligence on digital assets;

- Evaluation and mitigation of risks related to trading venues and trade execution or settlement facilities;
- Management of risks and complexities associated with "forked" and "airdropped" digital assets; and
- Fulfillment of their fiduciary duty with respect to investment advice – across all client types.

- ***Pricing Client Portfolios:*** Investment advisers may face valuation challenges for digital assets due to market fragmentation, illiquidity, volatility, and the potential for manipulation. Examinations will include a review of, among other things, the valuation methodologies utilized, including those used to determine principal markets, fair value, valuation after significant events, and recognition of forked and airdropped digital assets, as well as disclosures relating to valuation methodologies, and advisory fee calculations and the impact valuation practices have on these fees.
- ***Registration Issues:*** Examinations will include a review of compliance matters related to appropriate registration, including calculation of regulatory assets under management, characterization of digital assets, status of clients, and understanding applicable exemptions from registration for investment companies.

NATIONAL SECURITIES EXCHANGES

Distributed ledger technology has created new, innovative methods for facilitating electronic trading in digital asset securities. Firms that operate digital asset trading platforms need to consider whether those assets may be securities such that the firm meets the definition of "exchange" in Section 3(a)(1) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 3b-16(a) thereunder and must therefore register as a national securities exchange or operate pursuant to an exemption. Division of Examinations staff will examine platforms that facilitate trading in digital asset securities and review whether they meet the definition of an exchange.

The Division of Examinations will also review the conduct of firms that act as an alternative trading system ("ATS"). Examinations will include a review of whether an ATS that trades digital asset securities is operating in compliance with Regulation ATS, including, among other things, whether the ATS has accurately and timely disclosed information on Form ATS and Form ATS-R, and has adequate safeguards and procedures to protect confidential subscriber trading information.

TRANSFER AGENTS

Although distributed ledger technology may impact the way firms perform various shareholder administrative functions on behalf of issuers, including recordation of ownership, it does not obviate the need to comply with existing registration requirements for transfer agents or conduct requirements for transfer agent activities.[3] Examinations will include a review of whether registered transfer agents servicing digital asset securities are operating in compliance with rules for transfer agents promulgated by the SEC.

For more information about topics raised in this Legal Update, please contact any of the lawyers listed below.

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Endnotes

[1] The term "digital asset," as used by the Division of Examinations, refers to an asset that is issued and/or transferred using distributed ledger or blockchain technology, including, but not limited to, so-called "virtual currencies," "coins," and "tokens."

[3] SEC, Division of Examinations, Announcement, *The Division of Examinations' Continued Focus on Digital Asset Securities* (Feb. 26, 2021). https://www.sec.gov/ocie/announcement/risk-alert-digital-assets.

[4] Section 17A(c) of the Exchange Act requires transfer agents to register with the SEC. See Exchange Act Rules 17Ad-1 to 17Ad-7.

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April 2, 2021

Legal Update

SEC Division of Examinations Publishes Risk Alert on Broker-Dealer AML Practices

On March 29, 2021, the staff of the Division of Examinations ("EXAMS") of the US Securities and Exchange Commission ("SEC") published a Risk Alert regarding the anti-money laundering ("AML") obligations of broker-dealers.[1] The Risk Alert highlights compliance issues related to suspicious activity monitoring and reporting observed by EXAMS over the course of its examinations of broker-dealers.

For the past several years, AML compliance has been top-of-mind for the SEC (as well as other financial industry regulators) on an agency-wide basis. The US Department of Justice brought the first criminal charges against a broker-dealer for violations of the Bank Secrecy Act ("BSA") in 2018, and just last year, the SEC, in cooperation with the Financial Industry Regulatory Authority ("FINRA") and the US Commodity Futures Trading Commission, assessed a total of $38 million in penalties to one broker-dealer for AML violations, including violations relating to suspicious activity monitoring and reporting. FINRA has also been active in its enforcement of AML compliance, issuing fines into the multimillion-dollar range for AML compliance failures.

In this Legal Update, we highlight key observations relating to suspicious activity monitoring and reporting made by EXAMS staff.

Background on AML Framework for Broker-Dealers

The BSA and its implementing regulations establish the basic framework for AML obligations imposed on financial institutions. The Financial Crimes Enforcement Network ("FinCEN"), a bureau of the Department of the Treasury, adopted requirements that financial institutions, including broker-dealers, establish and implement AML programs that include suspicious activity monitoring and reporting policies and procedures.[2]

A broker-dealer is required to establish and implement a risk-based AML program that includes policies, procedures and internal controls reasonably designed to, among other things, identify and report suspicious transactions, as required by the BSA and its implementing regulations. A broker-dealer should tailor its AML program to address the risks facing its particular business in order to identify "red flags" for suspicious activity and should adopt and implement policies and procedures to appropriately manage those red flags.[3]

As a part of its AML program, a broker-dealer is required to file reports with FinCEN of suspicious transactions (a "suspicious activity report" or "SAR") that may relate to potential violations of law or that have no apparent business purpose.[4] Broker-dealers are further instructed by FinCEN to identify five "essential elements" (*i.e.*, who? what? when? where? why?) regarding the suspicious activity in their SARs.

EXAMS Key Observations

The Risk Alert articulates several key observations by EXAMS staff that primarily address the adoption of adequate AML policies, procedures and internal controls or their implementation. The risks posed by low-priced securities or "penny stocks," which can be susceptible to market manipulation, are also heavily featured in the Risk Alert as a type of security producing an outsized number of AML compliance failures.

The Risk Alert divides EXAMS staff observations into two parts: (1) AML Policies and Procedures and Internal Controls and (2) Suspicious Activity Monitoring and Reporting.

AML POLICIES AND PROCEDURES AND INTERNAL CONTROLS

Inadequate policies and procedures. EXAMS observed that some broker-dealers did not establish reasonably designed policies and procedures and internal controls to adequately identify and report suspicious activity as required under the BSA. Examples included:

- Failure to include red flags in their policies and procedures to assist with identifying suspicious activity for further due diligence or failure to tailor the red flags in their policies and procedures to address risks associated with the type of activity in which their customers regularly engaged.
- Some firms with large volumes of daily trading failed to establish and implement automated systems to monitor and report suspicious activity associated with trading in large volumes.
- Where firms incorporated penny stock transactions into their automated monitoring, some firms set the threshold for generating an alert at securities worth less than $1 per share, failing to monitor penny stocks priced between $1 and $5 per share.
- Setting the SAR reporting thresholds at amounts significantly higher than the $5,000 threshold specified in the SAR Rule.
- Inappropriately deferring to clearing firms to identify and report suspicious transactions in customer accounts and failing to adopt procedures that take into account the high-risk nature of certain customers' activity (*e.g.*, penny stock transactions).

Failure to implement procedures. EXAMs also noted that some firms that had reasonably designed written policies and procedures did not implement their procedures adequately and did not conduct adequate due diligence on or report suspicious activity that, per their own procedures, appeared to trigger a SAR filing requirement. Examples included firms' failure to:

- File SARs on transactions that appeared identical in nature to transactions for which the firm had routinely filed SARs without distinguishing such transactions.
- Reasonably use available transaction reports and systems to monitor for suspicious activity.
- Follow up on red flags identified in their procedures, such as prearranged or non-competitive trading, including wash or cross trades or potential insider trading.
- Comply with firm prohibitions on accepting trades for securities priced at less than one penny per share and conduct due diligence to determine whether to file SARs on those transactions.

SUSPICIOUS ACTIVITY MONITORING AND REPORTING

Failure to respond to suspicious activity. EXAMS observed that weak policies, procedures, and internal controls, or the failure to implement existing policies and procedures, ultimately resulted in firms not conducting or documenting adequate due diligence in response to red flags. Examples of such red flags included:

- Large deposits of low-priced securities, followed by the near-immediate liquidations of those securities and then wiring out the proceeds.
- Patterns of trading activity common to several customers including, but not limited to, the sales of large quantities of low-priced securities of multiple issuers by the customers.
- Trading in thinly traded, low-priced securities that resulted in sudden spikes in price or that represented most, if not all, of the securities' daily trading volumes.
- Trading in stock of issuers that were shell companies, were subject to trading suspensions or who had affiliates, officers, or other insiders with a history of securities law violations.
- Questionable background of customers, including those subject to criminal, civil, or regulatory actions relating to, among other things, securities law violations.
- Trading in the stock of issuers for which over-the-counter stock quotation systems had published warnings because the issuers had ceased to comply with their SEC financial reporting obligations or for which the firms relied on a "freely tradeable" legal opinion that was inconsistent with publicly available information.

EXAMS also observed that firms often did not reasonably account for information that was publicly available or in the firms' possession when evaluating activity in customer accounts.

Filing inaccurate or incomplete SARs. EXAMS observed that some broker-dealers did not include details known to the firm of individual customer trades or issuers that were suspicious or did not make use of specific structured data fields on the SAR. Examples included:

- Not including or inaccurately capturing key information despite having such information available in the firm's own internal records.
- Reporting the deposit of low-priced securities but failing to report the liquidation of the same securities shortly thereafter and the disposition of the proceeds, or reporting that a customer deposit of low-priced securities was an "initial" deposit, despite firm records indicating one or more previous deposits of the same security.
- For cyber-intrusions, not including details known at the time of reporting regarding the method and manner of cyber-intrusions and schemes to "take over" customer accounts.

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Takeaways

The implementation and maintenance of an AML program is not a static exercise. Regulators, including the SEC, expect broker-dealers to identify, assess and understand their money laundering risk in terms of the products, customers and geographies they are exposed to, and to adapt their AML programs to align with their unique risk profiles.

Suspicious activity monitoring and reporting are critical components of an effective, risk-based AML program, and the failure to implement adequate suspicious activity monitoring and reporting has been a source of several high-profile regulatory enforcement actions, as well as a DOJ action. Monitoring systems that identify unusual or suspicious activity and support the filing of a SAR should be properly calibrated to a firm's risk profile. Typically, such monitoring systems include manual, transaction-based systems and/or automated surveillance systems. The sophistication of a broker-dealer's monitoring systems should reflect the firm's risk profile, with particular emphasis on higher-risk products, services, customers, entities, and geographies.

The Risk Alert also highlights penny stocks as a product that carries increased risk of money laundering. Broker-dealers that deal with such securities should expect that EXAMS staff will be attentive to the risks posed by penny stocks and the steps taken to guard against those risks. Any broker-dealer with exposure to penny stocks should ensure its AML program accounts for the heightened risks described in the Risk Alert through enhanced risk mitigation measures.

We expect AML requirements, including suspicious activity monitoring and reporting, to remain of significant interest to the SEC and other financial regulators. Given the abundance of recent guidance in this space and increased attention in both examinations and enforcement, particularly with respect to penny stock transactions, financial regulators are sending a clear message to the industry that they will be actively monitoring for AML compliance. Broker-dealers should therefore review the Risk Alert in order to assess their supervisory, compliance and/or other risk management systems related to these risks and make appropriate changes to address or strengthen their systems.

Endnotes

[1] AML compliance is frequently a stated examination priority for EXAMS (formerly, the Office of Compliance Inspections and Examinations) and continues to be an important focus for broker-dealer examinations. *See* SEC, Division of Examinations, *2021 Examination Priorities*, https://www.sec.gov/files/2021-exam-priorities.pdf.

[2] *See* 31 C.F.R. § 1023.210; 31 C.F.R. § 1023.320; *see also* 17 C.F.R. § 240.17a-8. Self-regulatory organizations' rules also contain AML requirements. *See, e.g.*, FINRA Rule 3310.

[3] *See* FINRA, Regulatory Notice 19-18, *FINRA Provides Guidance to Firms Regarding Suspicious Activity Monitoring and Reporting Obligations* (May 6, 2019), https://www.finra.org/rules-guidance/notices/19-18; *see also* SEC, *Anti-Money Laundering (AML) Source Tool for Broker-Dealers*, https://www.sec.gov/about/offices/ocie/amlsourcetool.htm (last updated Jan. 5, 2021).

[4] Generally, a broker-dealer must file a SAR for any transaction involving funds or other assets of at least $5,000 that are conducted or attempted by, at, or through the broker-dealer and for which the broker-dealer knows, suspects, or has reason to suspect that, among other things, the transaction (or pattern of transactions of which the transaction is a part): (1) involves funds derived from illegal activity or is intended or conducted to hide or disguise funds or assets derived from illegal activity as part of a plan to violate or evade any federal law or regulation; (2) is designed to evade any requirements set forth in regulations implementing the BSA; (3) has no business purpose or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the broker-dealer knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction; or (4) involves use of the broker-dealer to facilitate criminal activity.

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April 8, 2020

Legal Update

SEC's OCIE Risk Alerts – Examination Focus on Compliance with Regulation Best Interest and Form CRS

On April 7, 2020, the U.S. Securities and Exchange Commission's ("SEC") Office of Compliance Inspections and Examinations ("OCIE") issued two companion risk alerts on compliance with Regulation Best Interest ("Reg. BI") and Form CRS.[1] These risk alerts provide broker-dealers and investment advisers with advance information about the expected scope and content of the initial examinations for compliance with Reg. BI and Form CRS, both of which have an upcoming compliance date of June 30, 2020.

The timing of these risk alerts is particularly interesting given the April 2, 2020 statement by SEC Chairman Jay Clayton regarding, among other matters, the June 30 compliance date amidst the COVID-19 pandemic. His statement not only affirms the compliance date but also appears to acknowledge the challenges presented by COVID-19:

> Over the past ten months, the Commission and the staff have engaged extensively with broker-dealers, investment advisers, retail investors and other market participants, as well as FINRA and other regulatory partners, regarding the implementation of Reg BI and Form CRS. We believe firms with account relationships comprising a substantial majority of retail investor assets have made considerable progress . . . .
>
> Based on that engagement—and because the continued implementation of these conduct and transparency initiatives, individually and collectively, will significantly benefit Main Street investors—we believe that the June 30, 2020 compliance date for Reg BI and other requirements, including the requirement to file and begin delivering Form CRS, remains appropriate.
>
> [F]irms should continue to make good faith efforts around operational matters to ensure compliance by June 30, 2020, including devoting resources as necessary and available in light of the circumstances. To the extent that a firm is unable to make certain filings or meet other requirements because of disruptions caused by COVID-19, including as a result of efforts to comply with national, state or local health and safety directives and guidance, the firm should engage with us. I expect that the Commission and the staff will take the firm-specific effects of such unforeseen circumstances (and related operational constraints and resource needs) into account in our examination and enforcement efforts.[2]

Reg. BI Risk Alert

OCIE is set to begin examinations to assess implementation of Reg. BI. Initial examinations will likely occur during the first year after the compliance date and will be primarily intended to evaluate whether firms have:

- Established policies and procedures reasonably designed to achieve compliance with Reg. BI
- Have made "reasonable progress" in implementing those policies and procedures as necessary or appropriate, including making modifications as may be necessary or appropriate in light of information gained from the implementation process and other facts and circumstances

On a more cooperative note, OCIE staff noted that it stands ready to work with firms and other SEC staff on issues that may arise in the course of examinations and understands that COVID-19 has created challenges for firms. In a footnote, however, OCIE staff highlights that while the SEC and staff across divisions and offices continue to monitor the effects of COVID-19 on market participants, including broker-dealers, the SEC has not extended the compliance date and warns that OCIE staff remains fully operational nationwide and continues to execute its investor protection mission (echoing Chairman Clayton's statement regarding the importance of Reg. BI to investor protection).

The risk alert then explains that initial examinations will focus on assessing whether firms have made a good faith effort to implement policies and procedures reasonably designed to comply with Reg. BI, including the operational effectiveness of broker-dealers' policies and procedures. The alert breaks down the primary topics of OCIE's examination focus by the four component obligations of Reg. BI's general obligation to make a recommendation in a retail customer's best interest. The primary areas of focus are outlined in the chart below.

Disclosure Obligation	*OCIE may assess how the firm has met the requirement to disclose material facts relating to the scope and terms of its relationship with a retail customer, including (i) capacity in which a recommendation is made, (ii) fees and costs and (iii) limitations on securities or investment strategies that may be recommended.* *In order to assess content and timing of disclosures, OCIE may review:* • Schedules of fees and charges and related disclosures • Compensation methods for registered personnel and related conflicts of interest • Disclosures related to account monitoring • Disclosures on material limitations on accounts or services recommended to retail customers • Lists of proprietary products sold to retail customers
Care Obligation	*To assess whether a broker-dealer is acting in accordance with the appropriate standard of care, OCIE may review:* • Information collected to create retail customer investment profiles • Processes for determining a recommendation is in the best interest of a retail customer, including consideration of the related risks, rewards, costs and conflicts of interest • Processes related to recommendations for significant investment decisions (such as rollovers or account recommendations) and complex, risky or expensive products

Conflict of Interest Obligation	*OCIE may review whether and how a broker-dealer's policies and procedures and related documentation address:* • Structures put in place to identify conflicts for the broker-dealer or its associated persons • Conflicts associated with material limitations on the securities or strategies that may be recommended to a retail customer • Identification and assessment of conflicts as the broker-dealer's business evolves • Disclosure, mitigation and elimination of conflicts and the related processes for making that determination, particularly where certain conflicts are required to be eliminated by Reg. BI
Compliance Obligation	*OCIE may review a broker-dealer's policies and procedures to assess Reg. BI compliance, with a particular focus on:* • Any controls, remediation of noncompliance, training, and periodic review and testing

Form CRS Risk Alert

The Form CRS risk alert begins by setting what we hope to be a cooperative tone by stating that initial examinations will focus on assessing whether firms have made a good faith effort to implement Form CRS. Like the Reg. BI risk alert, this risk alert states that OCIE is ready to work with firms and other SEC staff on issues that may arise in the course of examinations and understands that COVID-19 has created challenges for firms. But it also includes a similar warning: "While the Commission and staff across Commission divisions and offices continue to monitor the effects of COVID-19 on market participants, including investment advisers and broker-dealers, the Commission has not extended the compliance date for Form CRS. OCIE staff remains fully operational nationwide and continues to execute its investor protection mission."

With that in mind, we explore the risk alert's important considerations related to the content of the relationship summary and the processes firms will need to undertake in order to meet the associated requirements.

- **Filing:** OCIE will review whether a firm has filed its relationship summary, including any amendments, with the appropriate depository and posted it on the firm's website for public access.
- **Delivery:** OCIE will also evaluate delivery processes and review policies and procedures for whether and how they address required delivery processes and dates, with special attention toward whether firms have complied with their initial delivery obligation as Form CRS compliance gets off the ground. OCIE staff may review records of dates on which each relationship summary was provided to validate whether existing and new retail investors properly received their relationship summary.
  - ***Existing Retail Investors:*** Firms must complete initial delivery to existing retail investors **by July 30, 2020,** and before or at the time of (i) a new account opening, (ii) a rollover recommendation or (iii) a recommendation of a new brokerage or investment advisory service or investment that would not be held in an existing account.
  - ***New Retail Investors:*** Delivery to a new retail investor must occur before or at the

earliest of (i) entering into an investment advisory contract, (ii) making a securities transaction, account or investment strategy recommendation, (iii) placing an order or (iv) opening a new brokerage account.

- **Content:** Firms should ensure that their relationship summary includes all required information and that it is true, accurate and not misleading. OCIE may review for information regarding:
  - Descriptions of relationships and services offered, including monitoring and investment authority
  - Fees and costs, including the principal fees and costs and other fees relating to services and investments paid by retail investors directly or indirectly (OCIE may review fee schedules, advisory agreements and brokerage agreements and compare the fees listed in those documents against the fees listed in the relationship summary)
  - Compensation of financial professionals, cash or non-cash, and related conflicts of interest
  - Conflicts of interests of the firm, including incentives relating to proprietary products, third-party payments, revenue sharing and principal trading
  - Legal or disciplinary history of the firm or its financial professionals
- **Formatting:** Form CRS should be formatted in accordance with the Form CRS instructions. Firms should consider whether they have followed each instruction, e.g., the plain English requirement or requirements for particular wording or text features.
- **Updates:** OCIE may review policies and procedures for updating the relationship summary. A firm should consider (i) how and whether it updates Form CRS within 30 days of information becoming materially inaccurate or communicates such changes to retail investors within 60 days and (ii) the processes for highlighting or summarizing recent material changes.
- **Recordkeeping:** To assess compliance with delivery and recordkeeping obligations, OCIE may review (i) records related to relationship summary delivery and (ii) policies and procedures regarding creation and maintenance of records.

Takeaways

The risk alerts provide a useful framework detailing the primary high-level concerns for broker-dealers and investment advisers when gauging their Reg. BI and Form CRS preparedness. However, OCIE does not provide an exhaustive list of potential examination targets, and the required compliance measures may vary from firm to firm. Additionally, SEC staff do not appear to yield to certain current challenges, particularly those of an operational nature, that firms are experiencing as a result of COVID-19 related disruptions.

As mentioned above, in a recent public statement, Chairman Clayton reiterated the SEC's dedication to Reg. BI and Form CRS as important investor protection measures. Although acknowledging the challenges caused by COVID-19, the SEC is prepared to move forward with Reg. BI and Form CRS as of the scheduled compliance date of June 30, 2020. OCIE is expected to begin examinations to assess firms' Reg. BI and Form CRS implementation not long after the compliance date, so firms should prepare now for their implementation of these programs. We hope that SEC staff will act in accordance with Chairman Clayton's words and take firms' "good faith efforts" and firm-specific effects of these unforeseen circumstances (and related operational constraints and resource needs) into account in SEC examination (and enforcement) efforts.

For more information on the SEC's Reg. BI and Form CRS initiatives or if you would like to engage Mayer Brown to assess your firm's Reg. BI and Form CRS preparedness or to contact SEC staff on your behalf, please contact any of the following Mayer Brown attorneys.

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If you wish to receive regular updates on the range of the complex issues confronting businesses in the face of the novel coronavirus, please subscribe to our COVID-19 "Special Interest" mailing list.

And for any legal questions related to this pandemic, please contact the authors of this Legal Update or Mayer Brown's COVID-19 Core Response Team at FW-SIG-COVID-19-Core-Response-Team@mayerbrown.com.

Endnotes

[1] Sec. & Exch. Comm'n, OCIE Risk Alert, *Examinations that Focus on Compliance with Regulation Best Interest* (Apr. 7, 2020), https://www.sec.gov/files/Risk%20Alert-%20Regulation%20Best%20Interest%20Exams.pdf; Sec. & Exch. Comm'n,, OCIE Risk Alert, *Examinations that Focus on Compliance with Form CRS* (Apr. 7, 2020), https://www.sec.gov/files/Risk%20Alert%20-%20Form%20CRS%20Exams.pdf

[2] Chairman Jay Clayton, *Investors Remain Front of Mind at the SEC: Approach to Allocation of Resources, Oversight and Rulemaking; Implementation of Regulation Best Interest and Form CRS* (Apr. 2, 2020), https://www.sec.gov/news/public-statement/statement-clayton-investors-rbi-form-crs

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US SEC Announces the Creation of a Climate and ESG Task Force

Eye on ESG Blog

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The past few weeks have seen a flurry of ESG-related announcements coming from the US Securities and Exchange Commission (**SEC**) Acting Chair and staff. The most recent press release announced that the SEC has created a Climate and ESG Task Force in the Division of Enforcement:

"[T]he Climate and ESG Task Force will develop initiatives to proactively identify ESG-related misconduct. The task force will also coordinate the effective use of Division resources, including through the use of sophisticated data analysis to mine and assess information across registrants, to identify potential violations.

The initial focus will be to identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules. The task force will also analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies."

SEC registrants may be wondering if these announcements change their legal obligations and what actions they should take in response in order to ensure compliance. We discuss the implications for registrants in this Blog Post.

This announcement, like the others, does not relate to any new rules for which registrants need to prepare. Instead, these statements should be viewed as a reminder to registrants that existing statutes and regulations are applicable when it comes to ESG. As such, registrants may wish to evaluate the effectiveness of their disclosure controls and procedures as it relates to climate and other ESG disclosure. To the extent that ESG information—like any other information—is material to investors and clients, it must be disclosed. This, of course, means that securities law violations can occur in the ESG space. And if the new Climate and ESG Task Force recommends action against market participants, those alleged to have broken the law will, as always, need to carefully consider whether to settle with the SEC or litigate and let the courts decide whether a violation has occurred.

It is worth noting that Commissioners Peirce and Roisman, who together make up one half of the current Commission, issued their own statement in response to this press release expressing confusion with respect to the recent announcements and asking: "Do these announcements represent a change from current Commission practices or a continuation of the status quo with a new public relations twist?" The skepticism indicates that there will not likely be a noticeable change in Commission action until a new SEC Chairman is sworn into office. Gary Gensler, President Biden's nominee to chair the SEC, testified before the Senate Committee on Banking, Housing, and Urban Affairs on March 2, 2021, and is expected to be confirmed by the Senate as early as this month and sworn in soon as SEC Chairman. In that role, he will determine the SEC's agenda for the administration. Mr. Gensler has not yet commented on these newly announced policy initiatives, but has indicated that he believes that investors consider ESG disclosures material to their investment decisions. Hence, the question going forward is not whether Mr. Gensler, if confirmed, will advance new ESG policies, but how he will do so.

For more information on previous ESG announcements, please see our Legal Update on Acting Chair Lee's announcement that the agency will enhance its focus on public companies' climate change disclosures, as well as our Blog Post on ESG expertise in the US government more broadly.

The post US SEC Announces the Creation of a Climate and ESG Task Force appeared first on Eye on ESG.