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REVERSE inquiries

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LIBOR Replacement Mechanisms: Where Are We Now?

With the clock ticking down to the cessation of LIBOR in 2021, many issuers are addressing their LIBOR fallback provisions so that floating rate notes issued with a maturity extending past 2021 will not default into fixed rate notes.

To summarize briefly, the current LIBOR mechanism included in many floating rate debt instruments, including fixed to floating rate notes, provides that if LIBOR is not published on the appropriate Reuters screen page, then, under the first fallback provision, the calculation agent will, in the case of U.S. dollar LIBOR, poll banks in the London interbank market for rates for deposits of the same tenor and in the same currency. If that poll fails to yield at least two quotations, then, under the second fallback provision, the calculation agent would poll major banks in New York City for quotes for loans of the same tenor and in the same currency offered to leading European banks. If the second poll fails to yield at least two quotations, then, under the final fallback provision, the LIBOR rate will remain at the rate set in the previous interest rate period. The result of the current LIBOR mechanism is that, without publication of LIBOR, the floating rate note will become a fixed rate note.

With minor variations, issuers are beginning to replace the current LIBOR fallback mechanism with disclosure that allows the use of an alternative reference rate after the cessation of LIBOR. There are a number of issues arising from these new disclosures:

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- Cessation of LIBOR – Some disclosures use the phrase "permanent discontinuance" with respect to LIBOR, without defining exactly what that means. We note here that the LIBOR fallback proposal in the Credit Roundtable letter had a precise waterfall of events which, taken together, constituted a LIBOR cessation.[1] Without a precise definition of the "permanent discontinuance" of LIBOR, the issuer or the calculation agent (whichever party is tasked with making the determination) may open themselves up to liability.

- Using a LIBOR substitute – The new LIBOR fallback disclosures contemplate that the calculation agent choose and use a LIBOR substitute, with appropriate adjustments (including a spread), once LIBOR ceases. Some disclosures refer to this rate as one that is generally accepted in the industry, while others have a more precise requirement ("the alternative reference rate selected by the central bank, reserve bank, monetary authority or any similar institution (including any committee or working group thereof) that is consistent with accepted market practice"). To the extent that the calculation agent is an affiliate of an issuer that is a financial institution, there seems to be less concern about calculation agent liability for its choice of a successor rate. There also are examples in which the calculation agent is an unaffiliated third party and the issuer is not a financial institution; in that case, in the event that a substitute for LIBOR has to be picked, the issuer would appoint an independent financial institution to decide whether the replacement rate is generally accepted by the industry.

- Adjustments to the LIBOR substitute – The new disclosures contemplate that the calculation agent may have to adjust the business day convention, interest determination dates, day count conventions and other terms of the LIBOR floating rate note for the replacement rate. One form of such disclosure contemplates that the calculation agent will adjust the spread between the replacement rate and LIBOR (see the discussion below). In some cases, there is a requirement that the calculation agent consult with the issuer before making any of these adjustments.

- The dark at the end of the tunnel – What happens if, in the last analysis, there is no agreement on a replacement rate for LIBOR? Some alternatives have total calculation agent discretion for choosing a substitute or successor base rate that is most comparable to LIBOR. Another choice is to have the issuer appoint an investment bank of national standing in the United States (including an affiliate of the issuer) to determine an appropriate alternative rate.

It seems that issuers are comfortable that there will be an industry-accepted LIBOR replacement rate by 2021. The current front-runner for the replacement rate is the Secured Overnight Financing Rate ("SOFR"). Because SOFR is a secured, backward-looking overnight financing rate and LIBOR is a forward-looking, unsecured rate with various tenors, the industry anticipates adjustments to SOFR in the form of a risk spread and a forward-looking term structure quoted by the Federal Reserve Bank of New York ("FRBNY") or another entity designated by the Alternative Rates Reference Committee ("ARRC") or ISDA.

The FRBNY began publishing SOFR on April 3, 2018. On April 16, 2018, the FRBNY announced that it had "mistakenly included certain repo transactions in the settings for April 2 to April 12 …." In other words, almost the first two weeks of SOFR publication were wrong.

[1] The Credit Roundtable letter, dated January 2018, can be found at https://goo.gl/2zNv3m.

Another concern is that the risk-spread and forward-looking term structure required to adjust SOFR to LIBOR has not appeared yet. This, despite SOFR being known to market participants for at least one year. Without this adjustment, issuers and calculation agents will be casting about for a LIBOR replacement in 2021. According to the ARRC, the adjustment will not be ready until 2021 – uncomfortably close to the anticipated LIBOR cessation. Perhaps as SOFR is used more and establishes liquidity, the adjustment will become clearer.

Also, none of these disclosures will apply to existing LIBOR floating rate notes that mature past 2021 – at least, without a consent solicitation. Generally, a debt indenture requires 100% consent of the noteholders to change the interest rate – a costly and difficult exercise.

The uncertainty with respect to the timing of a LIBOR replacement and the current absence of an adjustment for SOFR call out for clear risk factor disclosure. Risk factors have been, and should be, updated to reflect the uncertainty and to highlight the potential conflicts of interest between the calculation agent, which may be an affiliate of the issuer, and the noteholders if the calculation agent has to pick a replacement rate in an environment where there is no agreement in the market on a LIBOR replacement.

SEC Denies Extension of Markup Disclosures Deadline; Rule Effective

In April 2018, the Securities and Exchange Commission (SEC) announced to market groups that it would not grant an extension of the May 14, 2018 effective date for the new markup disclosure requirements for broker-dealers under Financial Industry Regulatory Authority, Inc. (FINRA) Rule 2232 (Customer Confirmations). The amendment, which was approved by the SEC on November 17, 2016, requires the disclosure by broker-dealers to retail customers of additional transaction-related information, such as the dealer's markup or markdown as a total dollar amount and as a percentage of the prevailing market price (PMP), for secondary trades in certain fixed income securities.

Market participants had been pushing for an extension of the May 14 date, with concerns that they may not be ready in time to implement the changes that would allow their automated systems to comply with the new requirements, especially with regards to determining the PMP. Third-party vendors have developed products designed to calculate PMP, but brokerage firms must still adapt their automated trade processes to integrate with these vendor tools. Trade organizations such as the Securities Industry and Financial Markets Association had repeatedly urged regulators to implement a conformance period beyond the May 14 deadline to provide dealers with additional time to come into full compliance with the amendment. Many in the market believed that the SEC would grant the extension given the significant concerns in the dealer community regarding their ability to be in compliance by the deadline. FINRA released updated FAQs to assist dealers with compliance; these are available at https://goo.gl/unNCfe.

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Clayton Speech on Proposed Regulation Best Interest

In a speech delivered on May 2, 2018, SEC Chair Jay Clayton emphasized protecting "Main Street" retail investors and summarized the recently published proposed Regulation Best Interest. Chair Clayton discussed multiple concerns, which the proposed regulation is intended to address, including:

- Investor confusion and lack of clarity – Most customers are not sure whether they are dealing with a broker-dealer or an investment adviser;
- Different professional obligations of broker-dealers and investment advisers, disclosure and mitigation of conflicts – Broker-dealers are not required to recommend a security that the broker-dealer believes is in the customer's best interest, while an investment adviser's advice is governed by a federal fiduciary duty; and
- Too many regulators with overlapping or inconsistent standards – An investor's portfolio may be subject to regulation by the SEC, FINRA, the Department of Labor, state insurance and securities regulators, state attorneys general and federal or state banking regulators.

Chair Clayton then summarized how proposed Regulation Best Interest and related proposed changes would help retail investors, including Form CRS and the new SALI tool (discussed below). Chair Clayton also signaled that the SEC intends to harmonize regulation across federal and state levels to achieve "consistency and cohesion …."

SEC Announces New Investor Protection Tool

Investors have always had the ability to check, through FINRA's BrokerCheck system, whether a registered broker-dealer, investment adviser or firm has a disciplinary history. Investors will now have another tool to determine whether an individual, whether or not registered with the SEC or FINRA, has settled, defaulted or contested an enforcement action brought by the SEC, provided that a final judgment or order was entered against that person in a federal court or administrative proceeding. The SEC Action Lookup for Individuals, or SALI, will be available on the SEC's Investor.gov website.

FINRA Requests Comment on Proposed Amendments to the Quantitative Suitability Obligation under FINRA Rule 2111

Timed to coincide with the release of proposed Regulation Best Interest, FINRA opened comment on proposed rule amendments that would revise the quantitative suitability obligation under FINRA Rule 2111.[2]

[2] See FINRA Regulatory Notice 18-03 at https://goo.gl/VH1d7N.

With the proposed amendments, FINRA aims to address instances of excessive trading in customer accounts. The proposed rule amendments would remove the element of control that currently must be proven in order to demonstrate a Rule 2111 violation, but would not change the obligation to prove that the transactions were recommended and that the level of trading was excessive and unsuitable in light of the customer's investment profile. Comments must be received by June 19, 2018.

In 2010, when FINRA amended the suitability rule, it codified the line of cases on excessive trading, or "churning," as the quantitative suitability obligation. Under current Rule 2111, a broker who has control over a customer's account is required to have a reasonable basis for believing that a series of transactions the broker recommends is not excessive and unsuitable for the customer, even if the individual transactions are suitable when viewed in isolation. However, absent an element of control by the broker over the customer's account, the quantitative suitability obligation does not apply when the broker recommends a series of transactions, even if that series of transactions is excessive and unsuitable for the customer. As noted above, FINRA is reconsidering the appropriateness of the control element.

FINRA proposes to remove the phrase *"who has actual or de facto control over a customer account"* from the quantitative suitability obligation under Supplementary Material .05(c) of Rule 2111. FINRA claims the original basis for requiring the control element is no longer necessary and may impede investor protection by acting as an unintended shield for unscrupulous brokers engaging in excessive trading. Whether trading activity in a customer's account is excessive would still depend on the facts and circumstances of a particular case and would continue to be assessed in light of the customer's investment profile.

Removing the control element would likely increase FINRA's ability to hold brokers responsible for recommendations resulting in excessive trading and serve as a deterrent to possible future misconduct.

FINRA's New Guidance on Implementing Heightened Supervision for Associated Persons with a History of Past Misconduct

On April 30, 2018, FINRA issued Regulatory Notice 18-15, in which it provided additional guidance on its supervision rule, FINRA Rule 3110.[3] FINRA previously issued guidance regarding heightened supervisory plans for associated persons with a history of industry- or regulatory-related incidents in Notice to Members 97-19 and Notice to Members 98-39.

This notice describes procedures a member firm may implement with respect to certain associated persons in order to reduce future customer harm by brokers. Heightened supervisory plans should be applied by member firms in relation to (a) associated persons who are statutorily disqualified under the Securities

[3] FINRA Regulatory Notice 18-15 is available at https://goo.gl/Sf7KPT.

Exchange Act of 1934 during their FINRA eligibility review process and (b) persons whose litigated disciplinary case is on appeal to the National Adjudicatory Council. FINRA also provided a number of measures that a member firm might incorporate into the member firm's heightened supervision plan, including, at a minimum, designating a principal to implement and enforce the plan, requiring appropriate additional training for the associated person, requiring the written acknowledgement of the heightened supervisory plan by the associated person, and periodically reviewing the heightened supervisory plan. FINRA cautions that implementation of the recommendations in and of themselves would not necessarily satisfy a member firm's compliance with applicable securities laws and FINRA rules.

SEC Proposes to Tighten Regulations on High-Risk Brokers and the Firms That Hire Them

On the same day, FINRA solicited comments in Regulatory Notice 18-16 on proposed rule amendments that would impose additional restrictions or requirements on high-risk brokers and firms that hire them.[4] The proposed amendments are summarized below:

INTERIM ORDER AND MANDATORY HEIGHTENED SUPERVISION IN DISCIPLINARY PROCEEDINGS

The proposed amendments to the Rule 9200 Series (Disciplinary Proceedings) and the Rule 9300 Series (Review of Disciplinary Proceedings by National Adjudicatory Council and FINRA Board; Application for SEC Review) would allow FINRA to impose interim conditions or restrictions on a respondent firm or broker while the administrative appeal is pending. These restrictions, once imposed, would remain effective until the appellate body of FINRA issues a final decision. A broker subject to the restrictions would be able to request an expedited review to modify or remove these restrictions. In addition, the broker who appeals the initial decision would be subject to heightened supervision during the administrative appeal.

AUTOMATIC HEIGHTENED SUPERVISION IN ELIGIBILITY PROCEEDINGS

Pursuant to the proposed amendments to the Rule 9520 Series (Eligibility Proceedings), a member firm that files an application seeking approval to hire brokers who are the subject of statutory disqualification (SD) would be required to place those brokers on heightened supervision when the application is pending review by FINRA. Currently there is no explicit rule requirement that individuals that are the subject of SDs be placed on heightened supervision during the pendency of the review.

GENERAL DISCLOSURE OF "TAPING FIRM" THROUGH BROKERCHECK

The proposed amendment to Rule 8312 (FINRA BrokerCheck Disclosure) would permit FINRA to release information through BrokerCheck, regarding whether a particular member is a taping firm. The existing rule provides that a member firm that hires a specified percentage of registered persons from disciplined firms is

[4] FINRA Regulatory Notice 18-16 is available at https://goo.gl/nFju4Y.

designated as a "taping firm." A taping firm must establish, maintain and enforce special written procedures to supervise the telemarketing activities of all of its registered persons.

MATERIALITY CONSULTATION IN MEMBERSHIP PROCEEDINGS

The proposed amendments to the NASD Rule 1010 Series would also require member firms to seek a materiality consultation from FINRA if certain high-risk brokers are to become an owner, control person, principal or registered person of a member firm. Currently, the materiality consultation is a voluntary proceeding used by member firms to seek guidance from FINRA on a contemplated change in business operations that may not fall squarely within one of the categories or definitions that would require a Continuing Member Application.

FINRA360 Progress Report

On April 24, 2018, FINRA released a progress report summarizing the major actions and changes enacted as a result of FINRA360 over the past year. FINRA360 is FINRA's self-examination initiative, focused on improving the efficiency and effectiveness of FINRA by interacting with FINRA member firms, the investing public, industry officials, investor advocates and other regulators to learn about their experiences with FINRA and to receive input on how it can improve.

Some of the major actions noted in the progress report include:

- the integration of FINRA's two enforcement programs into one unified structure to eliminate duplication of efforts and inconsistency of results;
- the release of an Examinations Findings Report to the public detailing FINRA's observations from its prior year examinations to educate firms and facilitate compliance;
- the publication of a summary of FINRA's 2018 budget and its financial guiding principles to provide greater transparency to FINRA stakeholders regarding sources and uses of revenues from fines;
- the launch of the Small Firm Helpline to provide small firms with a resource to get answers to general questions and direct them to the appropriate regulatory staff or department;
- the creation of the Innovation Outreach Initiative to address the growing activity in the financial technology-related (FinTech) industry that has embraced new technologies such as cloud storage, machine learning and blockchain and that is changing the landscape for broker-dealer operations;
- the advancement and acceleration of FINRA's retrospective rule review to ensure that FINRA's rules are meeting their intended investor protection objectives;
- improvements to FINRA's qualification exam for broker-dealers;
- increased funding for training of FINRA's examiners and regulatory coordinators;
- updates to the roles of FINRA's advisory and governance committees to enhance transparency on what those committees do and how interested parties can become involved; and

- further advancement of FINRA's risk-based approach to better direct and align examination resources to the risk profile and complexity of each FINRA member firm rather than a "one-size-fits-all" examination program.

The full report is available at https://goo.gl/U7Ge1q.

Index Providers as Publishers

During the keynote address at the ICI 2018 Mutual Funds and Investment Management Conference, the director of the Division of Investment Management, Dalia Blass, discussed the evolution of index mutual funds and ETFs. Specifically, Blass noted that due to the maturing market for index products, funds now track indices in a variety of strategies. While index providers have long relied on the publisher's exclusion from the definition of "investment adviser" under the Investment Advisers Act of 1940 (the "Advisers Act"), Blass pointed out that it may be time to revisit the status of certain index providers as investment advisers in light of changing market practices.

Under Section 202(a)(11)(D) of the Advisers Act, a publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation is excluded from the definition of an investment adviser and, therefore, is not subject to the provisions of the Advisers Act. In order to qualify for the Section 202(a)(11)(D) exclusion, the publication must be: (1) of a general and impersonal nature, in that the advice provided is not adapted to any specific portfolio or any client's particular needs; (2) "bona fide" or genuine, in that it contains disinterested commentary and analysis as opposed to promotional material; and (3) of general and regular circulation, in that it is not timed to specific market activity or to events affecting, or having the ability to affect, the securities industry.[5]

The Advisers Act reflects Congressional recognition of the fiduciary nature of the advisory relationship, as well as Congress's desire to eliminate, or at least expose, all conflicts of interest that might cause advisers, either consciously or unconsciously, to render advice that is not disinterested.[6] In keeping with the purpose of the Advisers Act, determining whether a person qualifies for an exclusion from the definition of an investment adviser is a factual determination.[7] Blass raised several questions that may come up when analyzing a narrow index, including:

- How should we treat an index that the provider maintains for only one single fund?
- What if the provider takes significant input from the fund's sponsor or board regarding the creation, composition or rebalancing of that index?

[5] Jonathon Hendricks, SEC Staff No-Action Letter (avail. Jan. 26, 2015).

[6] "Regulation of Investment Advisers by the U.S. Securities and Exchange Commission," Staff of the Investment Adviser Regulation Office Division of Investment Management U.S. Securities and Exchange Commission, dated March 2013 (citing *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180, 189, 191-192 (1963)).

[7] Alfred A. Zurl, SEC Staff No-Action Letter (avail. Aug. 7, 1995).

- Should affiliation between the index provider and the sponsor affect the conclusion?

As index products continue to develop, practitioners must refresh their analysis and focus on the specific facts and circumstances of each index, rather than reaching a determination based on the index sponsor's characterization of itself as an index provider.

DOL Field Assistance Bulletin

Following the decision of the Fifth Circuit Court of Appeals vacating the Department of Labor's ("DOL") fiduciary rule and the confusion regarding the status of the rule, the DOL recently issued Field Assistance Bulletin (FAB) 2018-02. The FAB states that the DOL will not bring enforcement actions against firms for non-exempt prohibited transactions arising from providing investment advice to retirement accounts provided that they exercise reasonable diligence and act in good faith to comply with the impartial conduct standards.

Announcements

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