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REVERSE inquiries

Structured and market-linked product news for inquiring minds.

The Proposed Volcker Rule Amendments

In late May, the Federal Reserve approved the release for comment of proposed amendments to the Volcker Rule. The other four agencies that share in rulemaking authority for the rule subsequently also approved release of the proposed rulemaking.

In addition to tiering banking entities based on the size of their trading assets and liabilities, which should not affect the most frequent issuers of structured products, there are a fair number of proposed changes relating to proprietary trading that will affect structured product issuers. The proposed revisions would replace the intent-based purpose test of the proprietary trading definition with an objective accounting prong. The accounting prong is intended to capture instruments that are recorded at fair value. While it is clear that the accounting prong would cover derivatives, additional clarification may be required in order to understand how it would apply to any derivative (e.g., a derivative related to a structured note). Certain trading desks are subject only to the accounting prong and not to the market risk and dealer prongs of the proprietary trading definition. Helpfully, compliance with the reasonably expected near-term customer demands (RENTD) requirement would be presumed provided that the banking entity maintains and enforces trading desk limits. The hedging exemption also is proposed to be revised to eliminate the requirement to show that the hedge demonstrably reduces or otherwise significantly mitigates an identifiable risk, which is helpful to structured products market participants.

We discuss the proposed amendments in more detail in our client alert, which is available at https://goo.gl/WfumNu.

In This Issue

EU Provides Clarity on TLAC and MREL

In late May, the European Union reached an agreement to reform certain requirements applicable to European banks relating to total loss-absorbing capacity (TLAC) and the minimum requirement for own funds and eligible liabilities (MREL). The agreement is reflected in a legislative package called "Risk Reduction Measures."

The MREL requirement applies to all banks, not just to banks that are globally systemically important banks (G-SIBs). The agreement clarifies that certain structured notes will qualify for MREL. To the extent that a structured note has a fixed and ascertainable principal amount and only an additional return depends on the performance of a reference asset, the note will count toward MREL. The "embedded derivative" cannot be subject to netting.

For G-SIBs, the EU Council has confirmed that floating rate notes that reference a widely applied benchmark index are eligible liabilities for both TLAC and MREL. This is a helpful confirmation. These notes, often referred to as "lightly structured notes," were thought to qualify but there had been no certainty. Under the Federal Reserve's final TLAC rules, many practitioners had concluded that rate-linked notes would generally qualify as TLAC. While the EU Council's interpretation is not binding in any way on U.S. banks, it does suggest that regulators were focused principally on the ease of valuing a note in resolution and, to the extent that the reference rate is widely known, the valuation should not be problematic.

The Risk Reduction Measures also address other matters, including the calibration of MREL, MREL subordination, and the TLAC and MREL compliance dates.

Deductibility of FINRA Claims

The U.S. federal income tax deductibility of settlements paid to the Financial Industry Regulatory Authority, Inc. ("FINRA") has long been an area of uncertainty in the U.S. federal tax law. Tax reform legislation passed in December 2017, commonly referred to as the Tax Cuts and Jobs Act (the "TCJA"),[1] made FINRA settlements much more difficult to deduct.[2]

FINRA is a private, non-profit organization that is registered with the SEC as the only self-regulatory organization regulating the securities industry, which it does by way of an agreement between its members. FINRA members agree, among other things, to comply with federal securities laws and the rules and regulations thereunder, and to submit to FINRA sanctions if such members break FINRA rules. FINRA is not a part of the United States federal government, and the sanctions and fines imposed by FINRA are not remitted to the United States. The organization is subject to oversight by the Securities and Exchange Commission (the "SEC"), but such oversight is limited.

[1] Pub. L. 115-97, 131 Stat. 2054 (2017).

[2] For detailed coverage of the changes to section 162(f), please see "New Restrictions and Reporting Requirements to Consider During Settlement Negotiations" available at https://goo.gl/RfKMtw.

Before the TCJA, settlement payments to a government were deductible so long as they were not fines or penalties. Section 162(a) of the Internal Revenue Code of 1986, as amended (the "Code"), allows deductions for ordinary and necessary business expenses. Until the TCJA, section 162(f) had disallowed deductions for "fine[s] or similar penalt[ies] paid to a government for the violation of any law." The regulations provided that the term "government" included U.S. federal and state governments, foreign governments and political subdivisions. In addition, they included entities serving as "agencies or instrumentalities" of governments in the definition of "government." Although the regulations did not define "instrumentality," the Tax Court laid out a three-part test to determine whether an entity is an agency or "instrumentality" by examining whether: (i) the entity had been delegated the right to exercise part of the sovereign power, (ii) the entity performed an important governmental function and (iii) the entity had the authority to act with the sanction of government behind it.[3]

The section 162 regulations extended the scope of section 162(f) to settlements by providing that payments to settle "actual or potential liability for a fine or penalty (civil or criminal)" were fines or similar penalties. In addition, the regulations clarified that payments of compensatory damages were not. Because deductions are a "matter of legislative grace," taxpayers bore the burden of proving that settlements were compensatory and thus deductible.

Under these rules, disputes with the IRS often focused on a few types of questions. First, were payments under certain statutes "fines or similar penalties"? Second, where a settlement agreement was unclear and a payment under a particular statute could be either punitive or compensatory, was the settlement payment deductible in whole or in part? And third, were payments made to a government, an agency of the government or an instrumentality of the government?

With respect to FINRA fines, the IRS argued such fines were not deductible under the old section 162(f) because (a) FINRA should be considered a government agency or instrumentality as defined in the section 162 regulations and (b) FINRA fines should be treated the same as SEC-imposed penalties because FINRA is enforcing the Securities Exchange Act of 1934. In response, taxpayers would argue that (a) FINRA is a private, nonprofit organization, not a governmental agency or instrumentality and therefore (b) FINRA fines are not paid to a government.

NEW POST-TAX REFORM LANDSCAPE

The TCJA repealed and replaced old section 162(f) with a new expanded restriction on deductions. While prior section 162(f) applied only to fines or similar penalties, new section 162(f)(1) denies deductions for any amount paid in relation to either "the violation of any law" or even "the investigation or inquiry" into the potential violation of law (unless certain exceptions, discussed below, apply). Deductions are denied regardless of whether they are "fines or similar penalties." In addition, while prior section 162(f) applied to only payments to governments (or agencies or instrumentalities), new section 162(f)(1) also applies to

[3] *Guardian Industries*, 143 T.C. 1 (2014). In *Guardian Industries* the Tax Court had to determine whether the European Commission was a government instrumentality. The extent to which the three-part test laid out in *Guardian Industries* would apply to a self-regulating organization ("SRO") like FINRA has not been decided by any court. This leaves open the possibility for a taxpayer to explore other tests for determining whether an SRO is an instrumentality.

payments "at the direction of" a government or governmental entity. Beyond that, as discussed below, new section 162(f)(5) expands the definition of "government or governmental entity" as well.

If a payment is covered by new section 162(f)(1), it is not deductible unless it fits into one of three exceptions. Of those exceptions, the first—found in new section 162(f)(2)—will require attention in most government settlement negotiations. New section 162(f)(2) provides an exception for "restitution" and amounts paid "to come into compliance with law."

As noted above, under prior law, compensatory amounts were not "fines or similar penalties" and were therefore deductible. New section 162(f)(2), however, replaces "compensatory" with two options. The taxpayer must establish (i) that an amount was restitution for damage or harm that was or may have been caused by the violation (or potential violation) of any law or (ii) that an amount was paid to come into compliance with any law that was either violated or "otherwise involved" in the "investigation or inquiry" mentioned in new section 162(f)(1). While new section 162(f) does not define "restitution," it clarifies that, in a change from prior law, "restitution" will not include amounts that reimburse "the costs of any investigation or litigation."

Beyond requiring the taxpayer to establish that an amount is potentially deductible, new section 162(f) also requires that the settlement agreement itself must identify the payment as restitution or a payment to come into compliance with law. If the settlement agreement fails to do so, the amount is not deductible, regardless of whether the taxpayer establishes that it was restitution or an amount paid to come into compliance with law.

Yet new section 162(f) also provides that identification in the settlement agreement "alone shall not be sufficient" to establish that an amount is deductible as restitution or an amount paid to come into compliance with law. As a result, taxpayers will need to gather additional documentation supporting deductibility (e.g., settlement communications, damages estimates).

New section 162(f) also expands on the concept of what qualifies as a "government." New section 162(f)(5)(A) provides that "[a]ny nongovernmental entity which exercises self-regulatory powers (including imposing sanctions) in connection with a qualified board or exchange" is treated as a "governmental entity" for the purposes of section 162(f). Beyond that, new section 162(f)(5)(B) authorizes the IRS to issue regulations defining any nongovernmental entity that "exercises self-regulatory powers (including imposing sanctions) as part of performing an essential government function."

The TCJA states that the new standards generally apply to amounts paid or incurred on or after December 22, 2017. However, the TCJA provides two exceptions. The new provisions do not apply to (a) amounts paid or incurred under any binding order or agreement entered into before December 22, 2017 and (b) payments to be made under orders or agreements requiring court approval that were pending as of December 22, 2017 but did not receive such approval before that date. Therefore, the deductibility of FINRA fines for the settlements described in (a) and (b) above can still be argued under old section 162(f) and its regulations and relevant case law. However, the deductibility of other FINRA settlements will be decided under the much more stringent rules of new section 162(f).

Short Form Disclosure for Structured Retail Notes – The European PRIIPs Regulation, Experience to Date and Market Impact

BACKGROUND

What is the best way to inform retail clients about the investment objective, and the yield-and-risk profile of a structured note with derivative features linked to underlying reference assets?

The regulatory response to this question is no longer related to a securities prospectus only. With the implementation of the revised EU Prospectus Directive in 2010, lawmakers introduced a new regulated format for prospectus summaries and concluded:

> *The summary of the prospectus should be a key source of information for retail investors. It should be a self-contained part of the prospectus and should be short, simple, clear and easy for targeted investors to understand.*

Meaning in fact that the other parts of the prospectus serve as a pure market-access registration as well as a liability document for issuers. This is why prospectus diligence is and remains a key topic of regulatory compliance measures and should not be the target of cost-savings measures.

However, the regulation in 2010 clearly failed in this regard. The regulated format of the prospectus summary was not simple at all; information was unnaturally split up over several sections of the summary and it was simply too long to serve its intended purpose. The prospectus summaries in the relevant EU countries also did not enable the "*comparison of the summaries of similar products by ensuring that equivalent information always appears in the same position in the summary.*" The regulatory review practice of the various prospectus authorities in the EU was too different, thus resulting in different market practices across the EU.

The EU PRIIPs Regulation ((EU) No 1286/2014) targets product transparency and comparability of products from a new angle and by means of a new regulatory document: the key information document (KID). Lawmakers realized that "*Existing disclosures to retail investors for such PRIIPs are uncoordinated and often do not help retail investors to compare different products, or understand their features*." To overcome and prevent divergence in disclosure standards, a common standard for such KID is regarded as a first step to protect investors. Surprisingly, the recitals to the PRIIPs regulation do not mention the interplay with the securities prospectus at all and, in particular, the prospectus summary. This has now been sorted out by the new EU Prospectus Regulation, which has introduced a new summary format for a securities prospectus with features similar to those of a KID. The question remains why a summary is needed in addition to the KID at all. However, the new EU Prospectus Regulation provides that the information contained in a KID may be used for the prospectus summary, but there remain uncertainties in practice. In particular, the European Securities and Markets Authority (ESMA) in recent consultations required that all relevant contents of the KID shall also be set out in the main part of the prospectus, thereby becoming subject to an additional prospectus liability.

EU PRIIPS REGULATION IN BRIEF

So what is the PRIIPs regulation about? It has been in effect since January 1, 2018 and applies to "packaged retail and insurance-based investment products" ("PRIIPs"). A packaged retail investment product is defined as an investment where, regardless of the legal form of the investment, the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets that are not directly purchased by the retail investor. In short, the PRIIPs Regulation applies to all derivatives offered to retail clients, i.e. securitised derivatives, structured deposits, exchanged-traded derivatives and OTC derivatives. It also covers certain corporate bonds. Moreover, the regulation applies to insurance-based investment products and certain investment funds.

The PRIIPs Regulation requires the PRIIPs' manufacturers (i.e., the issuer of a structured note) to draw up the KID in compliance with the requirements and to publish it on its website before a PRIIP is made available to retail customers. The KID shall be a short document of not more than three pages containing key information on the PRIIP. It has to be provided to the retail customer a good time before the retail customer is bound by any contract or offer relating to that PRIIP.

The mandatory form and content of a KID are set out in detail in a supplemental Delegated Regulation ((EU) 2017/653). Accordingly, a KID must include, *inter alia*:

- a description of the nature and main features of the PRIIP;
- a summary risk indicator supplemented by a narrative explanation;
- the possible maximum loss of invested capital;
- appropriate performance scenarios;
- information on holding periods as well as direct and indirect costs of the investment; and
- contact details in case an investor wants to complain.

The requirements to the form of the KID include, *inter alia*:

- the KID must be written in an official language of each Member State where the PRIIP is distributed; and
- the KID must be easy to read and written in a language and a style that facilitates the understanding of the information.

Many disclosure elements of the KID are preformulated in the Delegated Regulation. Manufacturers are not allowed to change or adapt the strictly regulated wordings to a specific product. The KID is not subject to an approval or filing requirement with any authority. Each KID has to be reviewed and updated on a regular basis (usually daily).

The PRIIPs Regulation empowers the competent authorities of EU Member States to prohibit or suspend the marketing or distribution of a PRIIP, express a public warning that indicates the person responsible for the infringement, prohibit a KID and impose administrative fines. In addition, PRIIPs manufacturers incur civil liability for KIDs that are misleading, inaccurate or inconsistent with relevant documents regarding the PRIIP or with the requirements of the PRIIP Regulation.

EXPERIENCE TO DATE AND MARKET IMPACT

From a practical point of view, it is a real challenge to address so many investment products with different product features into a uniform short format without losing the advantages of such short-form disclosure. It is a good achievement of the PRIIPs Regulation to focus on "plain language" concepts. The first regulatory priority of the PRIIPs Regulation, however, is the comparability of the products and not whether the strictly preformulated wordings are suitable for an investor to understand the product in question. Furthermore, the strict combination of certain mandatory building blocks do not result in language that is easy to read. Moreover, some of the mandatory disclosures use wording that is not commonly used in derivatives disclosure documents.

The European-structured notes issuers successfully implemented the PRIIPs Regulation even though it took a long time to set up the systems; in particular, for automation of the production of the KID and the calculation of the risk indicators and the performance scenarios. Unfortunately, there have been cases where the calculations based on the mandatory methods in the PRIIPs Regulation resulted in rather misleading results. We understand that some regulators requested market participants to inform their clients if the regulated calculations could be misleading.

The focus of the PRIIPs regulation on the risk indicator is a clear deficit of the KID. KIDs are often used as part of the investment advice given by distributors to their clients. For example, in Germany, such distributors are required to inform their clients about the material risks of a product and not only a risk indicator. A short section in the KID that summarizes the risks of an investment in the product in plain language would therefore be most helpful in order to comply with such distribution obligations. In Germany, many structured notes issuers have therefore produced short supplemental risk-disclosure sheets to overcome this liability risk in the distribution chain.

Finally and unfortunately, the PRIIPs regulation could also apply to corporate bond issuers; for example, in case of make-whole amount clauses for early redemptions. Consequently, these corporate bonds are no longer targeted and offered to retail investors, thereby cutting off the retail investor base from these products. Given that corporate bond investments are mainly based on credit risk and not on derivate risks, this asset class should be exempt from the PRIIPs Regulation.

FINRA Hosts 2018 Annual Conference

FINRA hosted its 2018 Annual Conference on May 21-23, 2018 in Washington, DC. The conference provided an opportunity for practitioners and regulators to have an open dialogue and exchange ideas on today's most pertinent compliance and regulatory topics, such as cyber security, senior investors, private securities transactions, advertising, FinTech and issues facing small firms.[4] In addition, the conference provided an inside view of FINRA's new perspectives on the "pillars of compliance": anti-money laundering, supervision and suitability.

[4] Materials from the Conference are available at https://goo.gl/y1wPg4.

FINRA President and CEO, Robert Cook, gave the opening address. Cook's speech highlighted FINRA's continued efforts to accomplish its regulatory goals without unnecessarily hampering market growth and innovation. Cook explained how FINRA aims to ensure that the capital markets industry maintains vibrant and robust markets while also focusing on serving the interests of millions of investors. Cook highlighted three targeted steps that FINRA has taken in the past year to better serve the interests of investors: (1) the introduction of the small firm helpline, (2) enhancements to FINRA's examination framework and (3) development of additional compliance tools.

First, the small firm helpline is a tool for small firms that allows quicker access to answers and information without going to the regulatory coordinator. The helpline has received over 800 calls since the inception in 2017. Second, FINRA has made enhancements to its examination program to better align the program with the risks identified through its ongoing monitoring activities. One substantial change FINRA has implemented is the elimination of historical labels with regards to the frequency of cycle exams (i.e., one-year firm, two-year firm). Instead, FINRA will direct its attention and resources to the highest risk firms, branches and registered representatives, while ensuring that each firm is examined at least once every four years. Third, FINRA made enhancements to its compliance tools, such as the compliance calendar and the vendor directory. A detailed report on FINRA's comprehensive progress over the past year can be found in the FINRA360 report.[5]

In another session, President Cook and SEC Chair Jay Clayton hosted a Q&A session. During the session, Chair Clayton praised the U.S. capital markets, stating, "The way our markets work are the way everyone wishes their markets were." Chair Clayton discussed, how, in his opinion, the most tremendous achievement in the U.S. capital markets is the growing rate of market participation. In the 1950s there was roughly 5% market participation in the United States. Now, that number is closer to 45%.

For Chair Clayton, 45% participation is still not enough. Chair Clayton advocates for more public companies as the solution to further increase market participation from retail investors. He expressed his worry that retail investors do not have access to as broad of a slice of the capital markets as he would like them to have. If the trend continues towards more robust private opportunities rather than public ones, only a select group will participate in the private growth of the economy while excluding retail investors.

Additionally, Chair Clayton provided guidance on the SEC Regulation Best Interest proposal.[6] Chair Clayton explained that when drafting Regulation Best Interest, the SEC looked at work done by the SEC and others over the years to ensure the best proposal. The SEC concluded that an investor should be able to make the assumption that the broker-dealer will not put its own interests over the investor's interests. Chair Clayton further explained that broker-dealers need to have candid conversations with their clients to address fundamental questions of the broker-dealer/investor relationship, such as how the broker-dealer gets paid, the broker dealer's incentives and the obligations owed to a client.

Overall, Cook and Clayton demonstrated a united front in the enhancement and growth of the U.S. capital markets and the protections for retail investors.

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[5] The FINRA360 Progress Report is available at https://goo.gl/sZyXWq.

[6] The full text of Regulation Best Interest is available at https://goo.gl/jLLvkf.

SEC Director Redfearn on Regulation Best Interest

In recent remarks, SEC Director of Division of Trading and Markets Brett Redfearn addressed the SEC's recent rulemaking proposals relating to the standards of conduct for investment professionals. He focused on the Regulation Best Interest proposal. He noted the goals that the SEC is trying to accomplish with this proposal: first, to enhance the quality of broker-dealer recommendations to retail customers and, second, to preserve the brokerage "pay as you go" model as a viable choice for investors. Director Redfearn also discussed the three obligations for the broker-dealer in the proposed Best Interest Rule: the disclosure obligation, the care obligation and the conflict obligation. With regard to the care obligation, a broker-dealer would need to exercise reasonable diligence, care, skill and prudence in making a recommendation. This obligation also incorporates the suitability obligation, which requires a broker-dealer to consider reasonable alternatives. Director Redfearn noted that the biggest change would be the conflict obligation, which allows broker-dealer flexibility to establish, maintain and enforce policies and procedures reasonably designed to identify and address material conflicts of interest, especially conflicts stemming from financial incentives. He concluded his speech by inviting firms to comment on the proposals and provide data on current industry practices. The proposed Regulation Best Interest is subject to a 90-day comment period ending August 7, 2018. The full text of the remarks is available at https://goo.gl/divUyF.

Proposed Regulation Best Interest

Given that the Regulation Best Interest proposing release is well over 1,000 pages, we have summarized in the below chart key aspects of the proposed rule.

Components of Regulation Best Interest[1]

PURPOSE/INTENT		REQUIREMENT	EXAMPLES
1 DISCLOSURE OBLIGATION	To facilitate the retail customer's awareness of certain key information regarding their relationship with the broker-dealer by requiring more explicit disclosure obligations on broker-dealers.	Requires a broker-dealer or "**natural person who is an associated person**" of a broker-dealer to, "**prior to or at the time**" a "**recommendation**" of any securities transaction or investment strategy involving securities to a "**retail customer**" is made, reasonably disclose to the retail customer, in writing, the material facts relating to the scope and terms of the relationship with the retail customer and all material conflicts of interest associated with the recommendation. Form of disclosure: disclosure should be clear and concise, applying plain English principles, using short sentences and active voice, and avoiding legal jargon, technical terms and multiple negatives.	Examples of material facts relating to the scope and terms of the relationship with the retail customer: (i) that the broker-dealer is acting in a broker-dealer capacity with respect to the recommendation; (ii) fees and charges that apply to the retail customer's transactions, holdings and accounts; and (iii) type and scope of services provided by the broker-dealer, including, for example, monitoring the performance of the retail customer's account. Examples of material conflicts of interest associated with a recommendation include conflicts arising from financial incentives such as recommending: • proprietary products; • products of affiliates or a limited range of products; • a specific share class of a mutual fund; • securities underwritten by the broker-dealer's firm or its affiliate; • the rollover or transfer of assets from one type of account to another; and • allocation of investment opportunities among retail customers (e.g., IPO allocation).
2 CARE OBLIGATION	To incorporate and enhance existing suitability requirements applicable to broker-dealers under the federal securities laws by, among other things, imposing a "best interest" requirement that requires the broker-dealer not put its own interest ahead of the retail customer's interest when making recommendations.	Requires a broker-dealer, when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, to exercise reasonable diligence, care, skill and prudence to: (1) understand the potential risks and rewards associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers (i.e., reasonable-basis suitability); (2) have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks and rewards associated with the recommendation (i.e., customer-specific suitability); and (3) have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile (i.e., quantitative suitability). The Care Obligation cannot be satisfied through disclosure alone.	Example factors for assessing reasonable-basis suitability of a security or investment strategy include evaluating the associated costs, investment objectives, characteristics (including any special or unusual features), liquidity, volatility and likely performance of market and economic conditions, the expected return of the security or investment strategy, as well as any financial incentives to recommend the security or investment strategy. Example factors for assessing customer-specific suitability include the retail customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance and any other information the retail customer may disclose to the broker-dealer. Example factors for assessing quantitative suitability by providing a basis for determining that a series of recommended transactions may be excessive include turnover rate, cost-to equity ratio, use of in-and-out trading in a customer's account and any other factors that can be indicative of the magnitude of investor harm caused by the accumulation of high trading costs.
3 CONFLICT OF INTEREST OBLIGATIONS	To enhance the disclosure of material conflicts of interest in order to educate retail customers about such conflicts and help them evaluate recommendations received from broker-dealers, and to establish obligations on broker-dealers to not just disclose, but also mitigate, conflicts of interest arising from financial incentives associated with their recommendations.	Requires broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to: (1) identify and disclose, or eliminate, all "**material conflicts of interest**" that are associated with its recommendations to retail investors; and (2) identify, and disclose and mitigate, or eliminate, "**material conflicts of interest arising from financial incentives**" associated with such recommendations. Broker-dealers cannot comply with the Conflict of Interest Obligations of Regulation Best Interest by simply creating policies and procedures. The policies and procedures must also be effectively maintained and enforced.	There is no one-size-fits-all approach; reasonably designed policies and procedures should be tailored to account for the business practices, size and complexity of the broker-dealer, range of services and products offered and associated conflicts presented. The SEC has stated that it would be reasonable for broker-dealers to use a risk-based compliance and supervisory system to promote compliance (rather than conducting a detailed review of each recommendation). Among the components that broker-dealers should consider including in their programs are: • policies and procedures outlining how the firm identifies its material conflicts (and material conflicts arising from financial incentives) and specifying how the broker-dealer intends to address each conflict; • robust compliance review and monitoring systems; • processes to escalate identified instances of noncompliance to appropriate personnel for remediation; • procedures that clearly designate responsibility for supervision of functions and persons, including determination of compensation; • processes for escalating conflicts of interest; • processes for a periodic review and testing of the adequacy and effectiveness of policies and procedures; and • training on the policies and procedures.

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Components of Regulation Best Interest[1]

KEY DEFINITIONS (IN ALPHABETICAL ORDER)

TERM	DEFINITION
1 MATERIAL CONFLICTS ARISING FROM FINANCIAL INCENTIVES	Material conflicts of interest arising from "financial incentives" associated with a recommendation generally would include, but are not limited to, compensation practices established by the broker-dealer, including fees and other charges for the services provided and products sold; employee compensation or employment incentives (e.g., quotas, bonuses, sales contests, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews); compensation practices involving third parties, including both sales compensation and compensation that does not result from sales activity, such as compensation for services provided to third parties (e.g., sub-accounting or administrative services provided to a mutual fund); receipt of commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer or a third-party; sales of proprietary products or services, or products of affiliates; and transactions that would be effected by the broker-dealer (or an affiliate thereof) in a principal capacity.
2 MATERIAL CONFLICTS OF INTEREST	A conflict of interest that a reasonable person would expect might incline a broker-dealer, consciously or unconsciously, to make a recommendation that is not disinterested.
3 NATURAL PERSON WHO IS AN ASSOCIATED PERSON OF A BROKER-DEALER	A natural person who is an associated person as defined under Section 3(a)(18) of the Securities Exchange Act of 1934: "any partner, officer, director or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial shall not be included in the meaning of such term for purposes of section 15(b) of this title (other than paragraph 6 thereof)."
4 PRIOR TO OR AT THE TIME A RECOMMENDATION IS MADE	The Disclosure Obligation of Regulation Best Interest would apply when a broker-dealer is making a recommendation about any securities transaction or investment strategy to a retail customer. The timing of the disclosure is critically important to whether it may achieve the effect contemplated by the proposed rule. Investors should receive information early enough in the process to give them adequate time to consider the information and promote the investor's understanding in order to make informed investment decisions, but not so early that the disclosure fails to provide meaningful information (e.g., does not sufficiently identify material conflicts presented by a particular recommendation, or overwhelms the retail customer with disclosures related to a number of potential options that the retail customer may not be qualified to pursue). The timing of the required disclosure should also reflect the various ways in which retail customers may receive recommendations and convey orders.
5 RECOMMENDATION	The SEC proposes to apply Regulation Best Interest to recommendations of any securities transaction (sale, purchase, and exchange) and investment strategy (including explicit recommendations to hold a security or regarding the manner in which it is to be purchased or sold) to retail customers. Securities transactions may also include recommendations to roll over or transfer assets from one type of account to another. In determining whether a broker-dealer has made a recommendation, factors that have historically been considered in the context of broker-dealer suitability obligations include whether the communication "reasonably could be viewed as a 'call to action'" and "reasonably would influence an investor to trade a particular security or group of securities." The more individually tailored the communication to a specific customer or targeted group of customers about a security or group of securities, the greater the likelihood that the communication may be viewed as a "recommendation."
6 RETAIL CUSTOMER	A person, or the legal representative of such person, who: (1) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer or a natural person who is an associated person of a broker or dealer and (2) uses the recommendation primarily for personal, family, or household purposes.

[1]The SEC's proposed Regulation Best Interest is available at https://goo.gl/iqm2EC.

Listing Notes on Multiple Exchanges

The national securities exchanges have been in competition for new listings over the past several years. For a long time, the choice was generally between the NYSE and NASDAQ. BATS joined the fray recently, and, as one can see from the BATS listing requirement chart, it does not charge any listing fees for debt securities. For an issuer with its common stock listed on another exchange that wants to list a debt security, a BATS debt listing is an appealing option. If an issuer with its common stock listed on one exchange lists a debt security on another exchange, it should first carefully examine the corporate governance requirements imposed by each exchange to understand any differences in those requirements.

Each exchange's corporate governance rules are lengthy and detailed. While the corporate governance rules of the various securities exchanges are substantively similar, there are some differences. Many of the corporate governance rules implicated by a debt listing will be inapplicable to the debt issuer due to the difference between debt and equity (e.g., no voting rights).

One requirement that will cause a change in the issuer's procedures is the requirement to provide notice of the occurrence of a material event. The issuer should ensure that any notice of a material event required by the issuer's current exchange also be sent to the debt listing exchange.

There are some slight differences among the exchanges for foreign private issuers. Other than the audit committee, certification and disclosure of non-compliance requirements, foreign private issuers are generally permitted to follow home country practice in lieu of the exchange's corporate governance standards. The Nasdaq corporate governance rules require that a foreign private issuer that opts for home country practice in lieu of its corporate governance rules submit a written statement from independent counsel in its home country that the issuer's corporate governance practices are not prohibited by its home country's laws. The BATS corporate governance rules impose the same requirement, but the NYSE's corporate governance rules do not.

Summary of Listing Debt on BATS Exchange

TYPES OF DEBT SECURITIES	ISSUER REQUIREMENTS	THE ISSUE REQUIREMENTS	FEES	CORPORATE GOVERNANCE

SECURITIES LINKED TO THE PERFORMANCE OF INDEXES AND COMMODITIES (INCLUDING CURRENCIES)	• (1) Assets in excess of $100 million and stockholders' equity of at least $10 million and (2) annual income from continuing operations before income taxes of at least $1 million in the most recently completed fiscal year or in two of the three most recently completed fiscal years ("earnings requirement"); OR
	
	(i) Assets in excess of $200 million and stockholders' equity of at least $10 million or (ii) assets in excess of $100 million and stockholders' equity of at least $20 million
	• A minimum tangible net worth in excess of $250 million and to exceed by at least 20% the earnings requirements of annual income from or (ii) a minimum tangible net worth of $150 million and to exceed by at least 20% the earnings requirement and not to have issued securities where the original issue price of all the Company's other index-linked note offerings (combined with index-linked note offerings of the Company's affiliates) listed on a national securities exchange exceeds 25% of the Company's net worth
	• Be in compliance with Rule 10A-3 under the Act relating to Audit Committees upon initial listing and on a continual basis
	• Certain maintenance and dissemination requirements relating to the index and Reference Asset calculations
	• The issuer must be listed on the Exchange, the NYSE or NASDAQ, or must be an affiliate of a Company listed on the Exchange, the NYSE or NASDAQ;
		• Minimum of $4 million of aggregate market value/principal amount of the security
		• A term of not less than one (1) year and not greater than thirty (30) years
		• The issue must be the non-convertible debt
		• The payment at maturity may or may not provide for a multiple of the direct or inverse performance of an underlying index, indexes or Reference Asset; however, in no event will a loss (negative payment) at maturity be accelerated by a multiple that exceeds three times the performance of an underlying index, indexes or Reference Asset
		• A minimum of 400 holders of the security or 100 holders if the instrument is traded in $1,000 denominations.
		• If the security is traded in $1,000 denominations or redeemable at the holder's option on at least a weekly basis, no minimum holder or minimum public distribution of trading units is required
			No fees	• Majority Independent Board
				• Regularly scheduled Executive Sessions of independent directors
				• Independent Audit Committee of at least three members
				• Compensation Committee
				• Independent Director Oversight of Executive Compensation
				• Independent Director Oversight of Director Nominations
				• Code of Conduct
				• Meetings of Shareholders
				• Review of Related Party Transactions
				• Prior shareholder approval for the following under certain circumstances:
				  • the acquisition of the stock or assets of another company;
				  • change of control;
				  • equity-based compensation of officers, directors, employees or consultants; and private placements

DERIVATIVE SECURITIES — INDEX-LINKED EXCHANGEABLE NOTES	• (1) Assets in excess of $100 million and stockholders' equity of at least $10 million and (2) annual income from continuing operations before income taxes of at least $1 million in the most recently completed fiscal year or in two of the three most recently completed fiscal years; OR
	
	(i) Assets in excess of $200 million and stockholders' equity of at least $10 million or (ii) assets in excess of $100 million and stockholders' equity of at least $20 million
	• A minimum tangible net worth in excess of $250 million and to substantially exceed the earnings requirement or a minimum tangible net worth of $150 million and to substantially exceed the earnings requirement and not to have issued Index-Linked Exchangeable Notes where the original issue price of all the issuer's other index-linked exchangeable note offerings (combined with other index-linked exchangeable note offerings of the issuer's affiliates) listed on a national securities exchange exceeds 25% of the issuer's net worth
	• Be in compliance with Rule 10A-3 under the Act relating to Audit Committees upon initial listing and on a continual basis
	• Certain maintenance and dissemination requirements relating to the index and Reference Asset calculations
	• The issuer must be listed on the Exchange, the NYSE or NASDAQ, or must be an affiliate of a Company listed on the Exchange, the NYSE or NASDAQ;
		• Minimum of $4 million of aggregate market value/principal amount of the security
		• Minimum public distribution shall be 150,000 notes with a minimum of 400 public noteholders except, if traded in thousand dollar denominations or redeemable at the option of the holders thereof on at least a weekly basis, then no minimum public distribution and no minimum number of holders is required
		• The issue has a minimum term of one year
		• Certain requirements for Indices to which an exchangeable note is linked
		• The Intraday Indicative Value of the subject Index-Linked Exchangeable Notes must be calculated and widely disseminated by the Exchange or one or more major market data vendors on at least a 15-second basis during Regular Trading Hours
		• Beginning twelve months after the initial issuance of a series of index-linked exchangeable notes, the Exchange will consider the suspension of trading in and will commence delisting proceedings for that series of Index-Linked Exchangeable Notes if:
		  o the series has fewer than 50,000 notes issued and outstanding; or
		  o the market value of all Index-Linked Exchangeable Notes of that series issued and outstanding is less than $1,000,000		

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Summary of Listing Debt on BATS Exchange

DERIVATIVE SECURITIES — SELECTED EQUITY-LINKED DEBT SECURITIES (“SEEDS”)	• Issuer is listed on the Exchange as a Tier I issuer, the NYSE, NASDAQ or is an affiliate of a Company listed on the Exchange, the NYSE or NASDAQ • Minimum net worth of $150 million • The market value of a SEEDS offering, when combined with the market value of all other SEEDS offerings previously completed by the Company and traded on the Exchange or another national securities exchange, may not be greater than 25% of the Company’s net worth at the time of issuance	• Minimum public distribution of one million SEEDS • Minimum of 400 holders of the SEEDS; provided, however, that if the SEEDS are traded in $1,000 denominations or are redeemable at the option of holders thereof on at least a weekly basis, there is no minimum number of holders and no minimum public distribution • Minimum market value of $4 million • Minimum term of one year • Minimum Standards Applicable to the Linked Security o Have a market value of listed securities of: ▪ at least $3 billion and a trading volume in the United States of at least 2.5 million shares in the one-year period preceding the listing of the SEEDS; ▪ at least $1.5 billion and a trading volume in the United States of at least 10 million shares in the one-year period preceding the listing of the SEEDS; or ▪ at least $500 million and a trading volume in the United States of at least 15 million shares in the one-year period preceding the listing of the SEEDS. o Be issued by a Company that has a continuous reporting obligation under the Act and the security must be listed on the Exchange as a Tier I security or another national securities exchange and be subject to last sale reporting o Be issued by a: ▪ US Company ▪ Foreign Company under certain conditions • The issuance of SEEDS relating to any underlying U.S. security may not exceed five percent of the total outstanding shares of such underlying security • The issuance of SEEDS relating to any underlying non-U.S. security or sponsored ADR may not exceed: o 2% of the total shares outstanding worldwide if at least 30% of the worldwide trading volume in such security occurs in the U.S. market during the six-month period preceding the date of listing (the 2% limit, based on 20% of the worldwide trading volume in the non-U.S. security or sponsored ADR, applies only if there is a comprehensive surveillance sharing agreement in place with the primary exchange in the country where the security is primarily traded or, in the case of an ADR, the primary exchange on which the security underlying the ADR is traded. If there is no such agreement, the combined trading volume of such security and other related securities occurring in the U.S. market must represent (on a share equivalent basis for any ADRs) at least 50% of the combined worldwide trading volume in such security, other related securities, and other classes of common stock related to such security over the six month period preceding the date of listing) o 3% of the total shares outstanding worldwide if at least 50% of the worldwide trading volume in such security occurs in the U.S. market during the six-month period preceding the date of listing; or o 5% of the total shares outstanding worldwide if at least 70% of the worldwide trading volume in such security occurs in the U.S. market during the six-month period preceding the date of listing		
OTHER SECURITIES NOT SPECIFIED	• The Company shall have (i) assets in excess of $100 million and stockholders’ equity of at least $10 million or (ii) (a) assets in excess of $200 million and stockholders’ equity of at least $10 million or (b) assets in excess of $100 million and stockholders’ equity of at least $20 million • Minimum of 400 holders of the security; provided, however, that if the instrument is traded in $1,000 denominations, there must be a minimum of 100 holders • At least $4 million in aggregate market value/principal amount of the security • Issuer must be listed on the Exchange, the NYSE or NASDAQ, or must be an affiliate of a company listed on the Exchange, the NYSE or NASDAQ			

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Announcements

Save the Date.

Date & Time: **Thursday**, **September 27**, 2018; 8:00 a.m. – 3:30 p.m.
Location: Harvard Club of New York City, 35 West 44th Street, New York, NY 10036

The Summit will cover updates on the latest legal, regulatory and compliance issues and topics including:

- The Best Interest Rule, State Fiduciary Rules and Structured Products;
- Tax Developments Affecting Issuers of Structured Products;
- Regulatory Developments Affecting Structured Products, including MiFID, PRIIPs and Benchmark Regulation;
- LIBOR and Other Benchmark Indices;
- Other Regulatory Developments, including Canadian Bail-In and TLAC Requirements, Proposed Changes to the Volcker Rule; Proposed Changes to FINRA's Quantitative Suitability Rule; and
- Market Trends, Product Developments and Growth Opportunities.

CLE credit for this program is pending.

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

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. Please email your questions or topics to: reverseinquiries@mayerbrown.com.

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