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REVERSEinquiries

Structured and market-linked product news for inquiring minds.

A New ARRC Consultation Addresses LIBOR Fallbacks for Floating Rate Notes

In September, the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York's Alternative Reference Rates Committee (the "ARRC") released a consultation proposing fallback language to be used in floating rate notes ("FRNs") linked to LIBOR if LIBOR ceases publication in 2021 (the "Consultation").[1] As discussed in a prior issue of this publication, in its July 2018 Guiding Principles, the ARRC chose the secured overnight financing rate ("SOFR") as the "risk-free" replacement rate to be used when LIBOR is no longer available.[2] The Consultation covers a number of areas, but this article focuses on proposed definitions of a LIBOR cessation and the proposed waterfalls of fallback rates and spread adjustments.

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Because LIBOR is an unsecured forward-looking term rate (overnight, one week, one month, three months, six months and one year) and SOFR is a backward-looking overnight secured rate, drafting a LIBOR floating rate note with a built-in replacement rate based on SOFR is not easy. As noted in the Consultation, LIBOR may tend to be higher than SOFR during times of severe credit market stress, due to LIBOR including an element of bank credit risk. SOFR, an almost risk-free rate, is expected to be lower than LIBOR and, during those times of severe credit risk, may stay flat or even tighten. The Consultation addresses proposed adjustments that are intended to mitigate the differences between LIBOR and SOFR.[3]

Defining cessation triggers. The International Swaps and Derivatives Association ("ISDA") has proposed two triggers, each based on a permanent cessation of LIBOR:[4]

- a public statement or publication of information by or on behalf of the administrator of [the relevant IBOR] announcing that it has ceased or will cease to provide [the relevant IBOR] permanently or indefinitely, provided that, at that time, there is no successor administrator that will continue to provide [the relevant IBOR]; or

[1] The Consultation is available at: https://goo.gl/u8686g.
[2] REVERSEinquiries, Vol. 1, No. 4: https://goo.gl/LhBygw.
[3] See the Consultation at 4.
[4] The ARRC is consulting with ISDA on the LIBOR transition.

- a public statement or publication of information by the regulatory supervisor for the administrator of [the relevant IBOR], the central bank for the currency of [the relevant IBOR], an insolvency official with jurisdiction over the administrator for [the relevant IBOR], a resolution authority with jurisdiction over the administrator for the [the relevant IBOR] or a court or an entity with similar insolvency or resolution authority over the administrator for [the relevant IBOR], which states that the administrator of [the relevant IBOR] has ceased or will cease to provide [the relevant IBOR] permanently or indefinitely, provided that, at that time, there is no successor administrator that will continue to provide [the relevant IBOR].

These fallbacks would be triggered at the actual time of cessation if it were later than the time of announcement.

The Consultation adds additional pre-cessation triggers, which allow for a transition from LIBOR to a replacement rate without a permanent discontinuance of LIBOR:

- An unannounced stop to LIBOR, or a permanent or indefinite discontinuance not meeting the ISDA triggers:
    - a Benchmark rate is not published by the administrator of such Benchmark for five consecutive business days and such failure is not the result of a temporary moratorium, embargo or disruption declared by the administrator of such Benchmark or by the regulatory supervisor for the administrator of such Benchmark and the Benchmark cannot be determined by reference to an Interpolated Period;
- A material change to LIBOR – too few submissions from the panel banks:
    - a public statement or publication of information by the administrator of such Benchmark that it has invoked or will invoke, permanently or indefinitely, its insufficient submissions policy; or
- LIBOR becomes useless:
    - a public statement by the regulatory supervisor for the administrator of such Benchmark announcing that such Benchmark is no longer representative or may no longer be used.

The last two bullet points above refer to the "Zombie LIBOR" scenario. Currently, there are 16 panel banks submitting quotes for US dollar LIBOR to the Intercontinental Exchange, Inc. ("ICE"), the LIBOR administrator. ICE has a minimum submission number of four panel banks. If ICE were to continue to publish LIBOR with only six submissions from the panel banks, one or both of the last two cessation events above could be invoked.

Defining a waterfall of fallback replacement rates. Once one of the cessation events has occurred, the next step would be to go to a fallback replacement rate. The Consultation proposes the following waterfall of replacement rates:

- Step 1: Term SOFR recommended by the Relevant Governmental Body (ARRC) plus a spread
    - This would be a forward-looking term rate (e.g., 3-month SOFR)
    - Term SOFR does not yet exist
- Step 2: Compounded SOFR plus a spread

- "In arrears" – forward-looking - the rate is calculated over the interest period for the FRN with a lockup period at the end; the rate will not be known at the start of the interest period[5]
- "In advance" – backward-looking – calculated at the start of the interest period using the historic Compound SOFR rate for the period that ends immediately prior to that date (the rate will not change even if it deviates during the relevant interest period)

- Step 3: Spot SOFR plus a spread
  - Locks in the overnight rate for the duration of the interest period, and will not change during the interest period
  - This option uses an overnight rate for the whole term with no adjustment
- Step 4: Replacement rate recommended by Relevant Governmental Body (ARRC) plus a spread
- Step 5: Replacement rate in ISDA Definitions at such time plus a spread
  - This option uses the fallbacks in ISDA Supplement No. 57 for USD-SOFR-COMPOUND[6]
  - This would look first to the ARRC replacement rate for SOFR, then to the Overnight Bank Funding Rate and then to the Federal Open Markets Committee (FOMC) Target Rate
- Step 6: Replacement rate determined by issuer or its designee plus a spread
  - Issuer/calculation agent discretion model

Defining a waterfall of spread adjustments. Once a replacement benchmark rate is determined, then a spread adjustment will be needed to make the LIBOR and SOFR rates more comparable.

- Step 1: Spread recommended by Relevant Governmental Body
  - ARRC for USD FRNs
- Step 2: Spread in fallbacks for derivatives in ISDA definitions
  - But ISDA has not analyzed whether its spread adjustments would be appropriate for non-derivatives
  - This will apply only if using the ISDA fallback replacement benchmark
  - ISDA anticipates this spread will be available through a vendor screen
- Step 3: Spread determined by issuer or its designee
  - Using an "industry accepted" adjustment

For each cessation trigger and the steps in the two waterfalls above, the Consultation requests input from market participants as to their feasibility and other aspects. The deadline for market participants to respond to those questions is November 8, 2018. The Consultation also includes draft fallback language to be used in new issuances of FRNs. The Consultation is an important step forward for draftspersons. Although the actual spreads have not yet been determined, once the ARRC receives feedback from market participants and releases its final disclosures, issuers of FRNs will have a good starting point for their LIBOR replacement disclosures.

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[5] Recent compounded SOFR FRN offerings have used the in arrears calculation, without a spread, as they are standalone SOFR FRNs and do not have to address LIBOR transition issues.

[6] We discuss ISDA Supplement No. 57 in REVERSEinquiries, Vol. 1, No. 6, available at: https://goo.gl/wLZvsM.

SEC Director Blass's Congressional Testimony

In her recent testimony before Congress, Dalia Blass, the Director of the Division of Investment Management (the "Division") of the Securities and Exchange Commission ("SEC"), reported on the SEC's recent efforts to improve the retail investor experience. Director Blass highlighted the proposed Relationship Summary that is part of the proposed Regulation Best Interest ("Regulation BI"). The Relationship Summary would require broker-dealers and investment advisers to disclose in a succinct manner their relationships with retail investors. The Relationship Summary would highlight key differences between broker-dealers and investment advisers, including: (1) the principal types of services offered; (2) the legal standards of conduct that apply to each; (3) the fees the customer pays; and (4) certain conflicts of interest that may exist. Director Blass also noted a provision of Regulation Best Interest that would restrict the use of the term "adviser" and "advisor" by standalone broker-dealers. In addition, the Division proposed, as part of Regulation Best Interest, an interpretation of the investor advisers' fiduciary duty standards that would reaffirm or clarify the SEC's view on the fiduciary duty owed by investment advisers. The full text of the prepared testimony may be found here: https://goo.gl/Ust7TF.

Congress Urges SEC to Revise Regulation Best Interest

In a letter to SEC Chair Jay Clayton in September, 35 House and Senate members urged the SEC to revise its proposed Regulation BI before it is finalized, asserting that the proposed rule "falls woefully short" in protecting retail investors. The letter claims that that the SEC has proposed Regulation BI pursuant to the rulemaking mandate under Section 913(f) of Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, but, in the view of the signatories, Section 913(g) contemplated a fiduciary standard. Moreover, the legislators argue that the SEC failed to adequately consider the results of its own study, which recommended that the SEC conduct rulemaking under Section 913(g). The letter goes on to note that while proposed Regulation BI sets out a standard that can be distinguished from the standard set forth in Section 913(g), the SEC fails to explain and define the proposed "best interest" standard clearly. The legislators are concerned that proposed Regulation BI relies heavily on disclosures to investors without any evidence suggesting that these disclosures would be effective. Finally, the legislators urge the SEC to adopt a more principles-based approach to prevent brokers from holding themselves out as investment advisers or acting in an advisory capacity. To read the letter, visit: https://goo.gl/PpjYQy.

FINRA Releases Report on the Rise of RegTech

In September, the Financial Industry Regulatory Authority, Inc. ("FINRA") released a report outlining recent regulatory technology ("RegTech") developments within the securities industry. FINRA noted that securities market participants are exploring and using a variety of RegTech tools to enhance their regulatory compliance efforts. The report can be found in full here.

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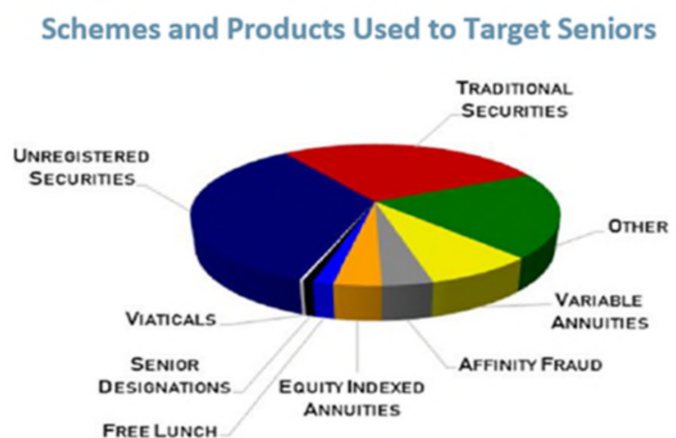
FINRA outlined several benefits that RegTech offers broker-dealers to further promote regulatory compliance, including enhanced risk management, increased effectiveness and efficiency, and opportunities for enhanced industry collaboration. FINRA highlighted five areas where securities industry participants have incorporated RegTech innovations: surveillance and monitoring, customer identification and anti-money laundering compliance, regulatory intelligence, reporting and risk management and investor risk assessment. Although RegTech offers several potential benefits to firms, FINRA encourages broker-dealers to be cognizant of potential challenges that might arise from the adoption of RegTech tools and services. These include issues with regards to procedures and control systems for supervision of RegTech tools, outsourcing discrete compliance and reporting functions, customer data privacy, and additional security risks. FINRA encourages broker-dealers to conduct their own assessments of the implications of RegTech tools and services, based on their business models and compliance needs.

RegTech may be particularly helpful as FINRA members begin to engage in electronic structured products trading platforms. These platforms, which enable broker-dealers to access structured products from multiple issuers in one location, may have the effect of increasing sales volumes or shortening evaluation times for distributors. Similarly, broker-dealers may rely on educational materials and on tools or analytics provided by such platforms. However, in prior FINRA notices to members, as well as in this report, FINRA cautions that FINRA member firms must have a reasonable basis for relying on outsourced providers and must diligence the outsourced providers.

FINRA has requested comments to the RegTech report by member firms and other interested parties by November 30, 2018.

NASAA Releases Annual Enforcement Report 2018

The North American Securities Administrators Association (NASAA) released its 2018 Enforcement Report based on 2017 data collected from 51 NASAA US members. NASAA reported that state securities regulators conducted 4,790 investigations in 2017 and took 2,105 enforcement actions overall. These actions led to the ordered restitution of nearly $486 million to investors, fines of nearly $79 million and criminal relief of 1,985 years, including incarceration and probation. The newly released survey reveals that seniors continue to be a primary target of fraudsters. NASAA members continue to prioritize senior financial exploitation through enforcement and through encouraging adoption of the NASAA Model Act to Protect Vulnerable Adults from Financial Exploitation, which we addressed in a prior issue of this publication.



According to NASAA members, actions against unregistered individuals and firms increased 24 percent over the prior year and surpassed actions against registered individuals and firms by 675 against 647, respectively.

The complete enforcement report is available on the NASAA website at www.nasaa.org.

ISDA Benchmark Supplement

Introduction to the ISDA Benchmarks Supplement. In September, ISDA published the ISDA Benchmarks Supplement (the "Benchmarks Supplement"**)** primarily in order to aid parties addressing certain requirements in Article 28(2) of the EU Benchmark Regulation ("EU BMR") but also to help implement the guidance contained in the Statement on Matters to Consider in the Use of Financial Benchmarks (the "IOSCO Statement")[7] published on January 5, 2018, by the Board of the International Organization of Securities Commissions ("IOSCO").

The Benchmarks Supplement, although aimed primarily at addressing Article 28(2) of the EU BMR, has been drafted generally and may therefore also be used by market participants not subject to the EU BMR, who wish to incorporate its provisions. Furthermore, as opposed to supplements generally applicable to ISDA definitions and provisions, the Benchmarks Supplement is an optional supplement that does not apply automatically; so parties will need to explicitly incorporate the Benchmarks Supplement in order for its provisions to apply. Future updates of the Benchmark Supplement will be published by the ISDA from time to time in order to include additional definitions and provisions.

Requirements under EU BMR. Article 28(2) of the EU BMR requires EU supervised entities that use a benchmark to produce and maintain robust written plans, setting out the actions they would take in the event that a benchmark materially changes or ceases to be provided. Where feasible and appropriate, those plans must nominate one or several alternative benchmarks that could be referenced to substitute the benchmarks no longer provided, indicating why such benchmarks would be suitable alternatives. These plans must be reflected in the contract with clients.

The EU BMR also provides that a supervised entity cannot use a benchmark or a combination of benchmarks in the EU unless the benchmark or the administrator, as required, is included in the European Securities and Markets Authority's register of administrators and benchmarks.

Finally, Article 35 of the EU BMR provides that if a competent authority withdraws the authorization or registration of an administrator of a benchmark, then Article 28(2) shall apply.

Requirements under IOSCO Statement. IOSCO's Statement on Matters to Consider in the Use of Financial Benchmarks focuses on contractual robustness in relation to financial instruments that reference benchmarks. In this context, it provides that users of benchmarks should consider (i) the appropriateness of a benchmark before using it and (ii) contingency plans in the event a benchmark is no longer available or materially changes, in order to mitigate risks. This is similar to the requirements of Article 28(2) of the EU

7 The IOSCO Statement is available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD589.pdf.

BMR and provides that, where feasible and appropriate, contingency plans for the cessation of a benchmark should include sufficiently robust fallback provisions in financial contracts and instruments which should ideally involve at least one alternative fallback rate and/or figure as a substitute for the original benchmark.

Approach of the Benchmarks Supplement. The Benchmarks Supplement is relevant for transactions which incorporate one or more of the following ISDA definitions:

- the 2006 ISDA Definitions;
- the 2002 ISDA Equity Derivatives Definitions (Equity Definitions);
- the 1998 FX and Currency Option Definitions (FX Definitions); and
- the 2005 ISDA Commodity Definitions (Commodity Definitions).

The Benchmarks Supplement contains several trigger events in connection with benchmarks and fallbacks, which apply upon the occurrence of one of such triggers. The approach taken in relation to each relevant set of ISDA definitions depends on the provisions already included in the definitions.

Effect of Benchmarks Supplement on transactions that incorporate the 2006 ISDA Definitions. With regard to fallbacks, the Benchmarks Supplement makes contracts more robust by providing for scenarios of permanent cessation, something that the 2006 ISDA Definitions lacked. Also, the Benchmarks Supplement presents a new permanent cessation trigger (referred to as an "Index Cessation Event") for transactions subject to the 2006 ISDA Definitions. Likewise, it introduces a novel trigger event (referred to as an "Administrator-Benchmark Event") applicable in cases in which a benchmark or an administrator is not approved and therefore applicable laws and regulations (including where any such approval is suspended or withdrawn) ban its use.

Generally, the Benchmarks Supplement demands that parties to a transaction consider several fallbacks (referred to as "Alternative Continuation Fallbacks") upon the occurrence of an Index Cessation Event or an Administrator-Benchmark Event. There is a hierarchy in place in case more than one of these fallbacks can be utilized to allow the transaction to carry on. The Alternative Continuation Fallbacks are:

- Agreement between the parties.
- Use of a replacement benchmark nominated by the parties at the time of trading, plus an Adjustment Payment/Adjustment Spread.
- Use of a substantially equivalent replacement benchmark nominated by the administrator or use of a benchmark nominated by a Relevant Nominating Body (the "Alternative Post-nominated Index"), plus an Adjustment Payment/Adjustment Spread. A "Relevant Nominating Body" is a relevant supervisor, central bank or any working group or committee officially endorsed or convened by a relevant supervisor, central bank, group of supervisors/central banks, the Financial Stability Board or part thereof.
- Use of a replacement benchmark nominated by the Calculation Agent, plus an Adjustment Payment/Adjustment Spread.

Effect of Benchmarks Supplement on transactions that incorporate the Equity Definitions. As for the 2016 ISDA Definitions, the Benchmarks Supplement introduces an Administrator-Benchmark Event as a new trigger event and related fallbacks. In compliance with Article 20(2) of the EU BMR, it also introduces a mechanism by which parties can nominate one or several alternative benchmarks that can be used to substitute the original benchmark following the permanent cancellation of the index or an Administrator-Benchmark Event.

Effect of Benchmarks Supplement on transactions that incorporate the FX Definitions. The Benchmarks Supplement applies the existing trigger event and related fallbacks for scenarios where it is not possible to obtain the "Settlement Rate" to deliverable transactions that use a benchmark. Also, the Benchmarks Supplement contains an acknowledgement that if a benchmark changes, unless otherwise agreed, references to a benchmark will be to that benchmark as changed.

Effect of Benchmarks Supplement on transactions that incorporate the Commodity Definitions. The Benchmarks Supplement incorporates an Administrator-Benchmark Event trigger into transactions which incorporate the Commodity Definitions. Upon the occurrence of an Administrator-Benchmark Event, the fallbacks for it that are specified in the confirmation will apply or, if none, those specified for the permanent discontinuance or unavailability of a commodity reference price will apply. Failing this, the deemed fallbacks in the Commodity Definitions apply. The Benchmarks Supplement is available at https://goo.gl/yTgDrn.

For structured notes that reference the performance of a benchmark, and where the issuer is entering into a countervailing hedging transaction in order to hedge its exposure arising in connection with the issuance of the structured notes, market participants should take into account that the terms of the hedging arrangement may be affected by the implementation of the Benchmarks Supplement.

Product Intervention – a new tool in EU securities regulation

WHAT DOES "PRODUCT INTERVENTION" MEAN

"Product intervention" means that regulators have the power to ban or restrict certain types of financial instruments or activities, for example, by imposing restrictions on the type of investors to which certain financial instruments may be offered or by restricting the leverage that may be incorporated in a financial instrument. This power is provided for in the revised EU Markets in Financial Instruments Directive ("MiFID II") and the accompanying EU Markets in Financial Instruments Regulation ("MiFIR"), each of which became applicable in all EU member states in January 2018. As set out in more detail below, the European Securities and Markets Authority ("ESMA") has already exercised its new product intervention power with respect to binary options and contracts for differences ("CFDs").

WHAT IS NEW ABOUT PRODUCT INTERVENTION?

Prior to MiFID II, EU investor protection efforts were mainly directed at improving the information provided to potential investors. The underlying assumption was that if investors are provided with sufficient information about financial products and issuers, they are in a position to make a rational decision on whether to invest in the product. Therefore, EU investor protection efforts have for many years relied on

improving disclosures, for example, by expanding the amount of information required to be included in a prospectus, as well as by improving the way in which that information is presented, such as by requiring distributors to provide investors with key investor documents that summarize essential information about structured products concisely.

Product intervention may be regarded as a turn away from the "traditional" approach to investor protection, as it is based on the assumption that despite all of the improvements in offering disclosures and delivery of information, certain financial products may be so risky that investors may still not be able to make an informed decision. Another rationale for product intervention is that certain financial products may create risks for the financial system as a whole and should therefore be banned, irrespective of whether investors understand the risks of an investment in such products.

THE PRODUCT INTERVENTION POWERS UNDER MIFIR

According to article 42 of MiFIR, the competent authority of each EU member may exercise product intervention powers in the relevant member state. In addition, according to articles 40 and 41, ESMA and (if restrictions are to be based on structured deposits) the European Banking Authority ("EBA") have temporary product intervention powers. These powers are temporary because if ESMA or EBA make use of their intervention powers, they have to review the prohibitions or restrictions they have imposed at least every three months. However, they may extend a ban or restriction an indefinite number of times. A competent authority of an EU member state may prohibit or restrict financial products or services on a permanent basis, but it has to revoke the prohibition or restriction if the reasons for the product intervention no longer apply. Since most types of financial products are distributed in more than one EU member state, we would expect that ESMA is more likely to exercise product intervention powers than the national competent authorities.

Generally, ESMA may only exercise its product intervention powers if these are required in order to address a significant investor protection concern or to address a threat to the orderly functioning and integrity of financial markets or commodity markets or the stability of the financial system in the EU. Also, existing regulatory requirements must not sufficiently address the threat. When ESMA intends to impose bans or restrictions on financial products or services, it has to consider a broad range of criteria that are set out in article 19 of Commission Delegated Regulation (EU) 2017/565. These criteria include, for example, the complexity of the financial product or service, the size or the notional of the financial instruments, the degree of innovation and the leverage incorporated in the product.

RESTRICTIONS IMPOSED BY ESMA ON BINARY OPTIONS AND CONTRACTS FOR DIFFERENCES

ESMA used its product intervention power for the first time in May 2018, when it decided to impose a prohibition on the marketing, distribution and sale of binary options to retail investors, beginning July 2, 2018. On the same day, ESMA also decided to impose restrictions on the marketing, distribution and sale of CFDs to retail investors, starting on August 1, 2018. These restrictions include, *inter alia*, initial margin protection (by limiting the permitted leverage of the CFD) and margin close-out protection (by requiring CFD providers to close-out a client's open CFD at 50 percent of the initial margin required to open the position) and negative balance protection (by imposing a limit of zero on a retail client's aggregate liability for all CFDs held by a retail client with a specific CFD provider). On September 21, 2018, ESMA decided to renew the aforementioned prohibitions and restrictions for binary options and CFDs.

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PRIOR EXPERIENCE WITH PRODUCT INTERVENTION IN GERMANY

Even prior to the application date of MiFID II and MiFIR, EU member states could invest their national competent authorities with product intervention powers. For example, Germany introduced these product intervention powers in July 2015. In May 2017, the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, "BaFin") had already banned the marketing, distribution and sale of CFDs that provide for additional payment obligations to retail investors. Earlier, it had announced in March 2016 that it was considering prohibiting the marketing, distribution and sale of credit-linked notes ("CLNs") to retail investors. The BaFin finally refrained from imposing the ban after industry associations presented a self-commitment, which is aimed at protecting retail investors in CLNs. Pursuant to this self-commitment, issuers of CLNs shall, for example, issue only CLNs with a simple structure. This means that retail CLNs should only have a single reference entity. CLNs with multiple reference entities are only allowed if this results in risk diversification. In addition, retail CLNs must have a fixed or step-up coupon and a minimum denomination of EUR 10,000. The reference entities must have an investment grade rating and their shares or bonds shall be listed on an organized market, which means that the reference entity is subject to extensive statutory disclosure requirements. This example shows that product intervention powers may have a significant impact on the market, even if they are finally not exercised, as issuers have incentives to discuss with regulators and, if necessary, change the structure of their products.

Announcements

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TAXQUARTERLY

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

Capital Markets Tax Quarterly. Mayer Brown is pleased to announce our new Capital Markets Tax Quarterly, which will provide capital markets-related US federal tax news and insights. In this first volume of CMTQ, we look at Q3 2018. Read our inaugural issue here: https://goo.gl/hwwiLu.

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.

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Contacts

Bradley Berman
New York
T: (212) 506-2321
E: bberman@mayerbrown.com

Martin Estrada
New York
T: (212) 506-2597
E: mestrada@mayerbrown.com

Agustin Ferrari
New York
T: (212) 506-2639
E: aferrari@mayerbrown.com

Gonzalo Go
New York
T: (212) 506-2390
E: ggo@mayerbrown.com

Anna Pinedo
New York
T: (212) 506-2275
E: apinedo@mayerbrown.com

Holger Schelling
Frankfurt
T: +49 69 7941 1124
E: hschelling@mayerbrown.com

Patrick Scholl
Frankfurt
T: +49 69 7941 1060
E: pscholl@mayerbrown.com

Mingli Wu
New York
T: (212) 506-2270
E: mwu@mayerbrown.com

Hanwen Zhang
New York
T: (212) 506-2146
E: hzhang@mayerbrown.com

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