MAYER • BROWN

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REVERSEinquiries

Structured and market-linked product news for inquiring minds.

Responses to ISDA's Proposals for IBOR Replacements: A Step Toward Certainty for LIBOR Notes

In July 2018, the International Swaps and Derivatives Association, Inc. ("ISDA") published a consultation (the "ISDA Consultation") on options for calculating adjusted risk-free rates ("RFRs") and spread adjustments to be used as fallbacks in derivatives contracts referencing various interbank offered rates ("IBORs"). Although the ISDA Consultation focused on non-USD IBORS, it solicited preliminary feedback for derivatives fallbacks relating to USD LIBOR, EUR LIBOR and EURIBOR, which will be specifically covered in a separate consultation. In late December 2018, ISDA published a report (the "Report") summarizing responses by market participants to the questions raised in the ISDA Consultation.[1]

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HOW AND WHY DOES THIS RELATE TO REPLACING LIBOR IN FLOATING RATE NOTES?

LIBOR may cease to be published in 2021. Issuers of floating rate notes and other market participants are now including new fallback replacement rate provisions in their floating rate note documents, with guidance from USD LIBOR and Sterling LIBOR, the Alternative Rates Reference Committee (the "ARRC") and the Bank of England's Working Group on Sterling Risk Free Rates (the "BOA Working Group"), respectively. The next step in this process will be developing an agreed-upon industry standard replacement rate for USD and Sterling LIBOR for relevant LIBOR floating rate notes. As we previously have reported, the replacement rate for USD LIBOR will be based on the secured overnight financing rate ("SOFR"), which is a secured, overnight,

[1] The Report is available at: https://goo.gl/uKB21p. See also: REVERSEinquiries, Volume 1, Issue 7, available at: https://goo.gl/paUhmx.

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backward-looking rate published by the Federal Reserve Bank of New York. The replacement rate for Sterling LIBOR will be based on the Sterling Over Night Interest Average ("SONIA"), which is a measure of the rate at which interest is paid on sterling short-term (overnight) wholesale funds. Unlike SOFR, SONIA is an unsecured rate in the same manner as LIBOR. However, because SONIA is a measure of overnight borrowing costs, it does not, unlike LIBOR, incorporate bank credit risk so it operates as a near proxy for a risk-free rate.

Similar to the way in which ISDA proposed a number of options for calculating replacement adjusted RFRs, ARRC also, in its most recent publication, set forth a number of choices for an adjusted RFR based on SOFR. Because the market participants responding to the ARRC solicitation will most likely be the same ones that responded to the Report with the same concerns, we can expect that the adjusted RFR chosen in response to the ISDA Consultation will be the same in the responses to the ARRC Consultation. Indeed, some market participants in their responses pointed to the need for consistency across instruments, including cash instruments such as floating rate notes, that are hedged by derivatives.

The BOA Working Group has also acknowledged the need for consistency across derivatives and cash instruments, including floating rate notes hedged by derivatives, and the need for triggers and fallbacks to be aligned where possible. The BOA Working Group also acknowledges that cash product markets (including loans, mortgages and, to a lesser extent, the bond and securitization markets) have a preference for the development of term SONIA reference rates ("TSRR") that can provide cash flow, certainty, the simplicity of forward-looking rates, and consistency with current market practice for the cash product markets.

AND THE WINNERS ARE …

(Drum roll/cymbal crash) Not surprisingly, the compounded setting in arrears SOFR rate was the overwhelming choice of respondents to the ARRC Consultation. Why is this not surprising? This is, essentially, the same rate that recent SOFR floating rate note offerings have used. Under this method, the daily SOFR rate is compounded over the interest period (one month, three months, etc.) and averaged to determine, at the end of the period, the rate for that period.

Similarly, in the United Kingdom there has been, in the absence of TSRRs, twelve issues of SONIA-linked floating rate notes (totaling over £6bn in principal amount), a market that was kicked off in earnest in June 2018 by the European Investment Bank and swiftly followed by the issuances from the private sector by Lloyds Bank plc, the Royal Bank of Canada, Santander UK plc and others. The interest payable on these floating rate notes for any period is based upon the compounding of the interest rate observed on each London business day during an observation period. At present, an agent bank takes the daily published SONIA rate and applies a formula to compound the rate over the relevant period, adding the relevant margin to the compounded rate. It is anticipated, however, that this manual calculation of the rate may be simplified in the future by publication of a compounded rate on a screen that can be referred to directly in the interest rate calculation provisions of the floating rate notes.

So what are the differences between these rates and LIBOR rates? First, the new rates are not term rates. USD LIBOR and Sterling LIBOR are term rates that are published at several different maturities (for example, 3-month, 6-month and one year), are known prior to the beginning of the relevant interest period, and are fixed and applicable for the whole interest period. These rates are forward-looking. The SOFR and SONIA rates are, on the other hand, "assembled" from overnight fixings during the relevant interest period and are

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not known until the end of the interest rate period, which creates some interesting settlement mechanics (more on that below). Therefore, the new rates are backward-looking; but also take into account daily variations in the overnight rates during the interest period.

Another effect of using a rate derived from a backward-looking rate is how to manage the last day of the interest period. For any floating rate note, the last day of the interest period is an interest payment date, and interest accrues up to and including that interest payment date (or maturity date). The interest accrued on that last day is known and paid. For a SOFR- or SONIA-derived rate, the daily rate published on the last day of the interest period, which is also an interest payment date (or maturity date), is the rate that was used on the prior day. For example, if Friday is the interest payment date, the SOFR or SONIA rate published on Friday morning is Thursday's rate, and Friday's rate would not be available until Monday, after the interest payment date. Consequently, on Friday, the agent bank will not have enough data to determine the rate for the just completed interest period and also will not know the correct amount of interest to be paid. This suggests that payment date conventions may need to be changed in the future.

To address this problem, recent floating rate notes linked to SOFR and SONIA have developed a short mismatch (or lag) between the period for which the rate is observed and used to calculate the payment (known as the observation period) and the interest period itself. Recent floating rate notes linked to SOFR have used a four-day lockout period pursuant to which the SOFR rate in effect on the fourth business day prior to the interest payment date remains unchanged for the rest of the interest period. Similarly, SONIA-linked issuances to date have been based upon an observation period commencing five London business days before the start of the relevant interest period and ending five London business days before the end of the relevant interest period. Adding this certainty as to the actual interest payment also eases any burdens with settlement systems, which need a certain amount of advance notice for payments.

In selecting the new rate, market participants in the United States have noted the following positive characteristics:

- it has the aforementioned ability to reflect daily interest-rate movements during the relevant interest period;
- it is less volatile than the spot overnight rate;
- it mirrors the structure of the overnight index swaps that reference the RFRs; and
- it is understandable to market participants.

The fact that the rate could not be determined until the end of the period was not considered to be a significant issue.

As mentioned above, momentum is also building in the United Kingdom for SONIA FRNs using overnight SONIA as a reference (with the characteristics described above also viewed as positive in the London markets). However, the BOA Working Group has acknowledged that there are some users (issuers and investors alike) for whom a forward-looking term rate may better meet their needs and is consulting rapidly with commercial providers and market participants on how TSRRs that are robust and transparent can be created.

THE SPREAD ADJUSTMENT

When structuring a transaction that will reference an IBOR but will continue past 2021, one must not only include an agreed upon replacement rate but also a spread/margin adjustment. That is because although everyone may agree on the replacement rate, the risk-free replacement rate will not be, and will not behave in the same manner as, the IBOR. As noted by ISDA, IBORs are available in multiple tenors while the RFRs are overnight rates. The IBORs also incorporate a bank credit risk premium and a variety of other factors (such as liquidity and fluctuations in supply and demand) while RFRs do not. The spread adjustments to the RFR are intended to ensure that legacy derivatives contracts referencing an IBOR continue to function as closely as possible to what was intended when the contracts were entered in the event that a fallback takes effect (*i.e.*, the IBOR transitions to RFR).

The ISDA Consultation's criteria for a spread adjustment methodology was "(i) eliminating or minimizing value transfer at the time the fallback is applied, (ii) eliminating or minimizing any potential for manipulation and (iii) eliminating or mitigating against the impact of market disruption at the time the fallback is applied."

According to ISDA, the historical mean/median approach could be based on the mean or median spot-spread between the IBOR and the adjusted RFR calculated over a significant, static look-back period (*e.g.*, 5 or 10 years) prior to the announcement of the relevant triggering event. This spread adjustment could then be used from the end of a one-year transition period from when the fallback took effect. During the one-year transition period, the spread would be calculated using linear interpolations between the spot IBOR/adjusted RFR spread at the time the fallback took effect and the spread that would apply at the end of the one-year transition period.

The historical mean/median approach was chosen by the majority of respondents primarily because of its robustness, simplicity, and resistance to manipulation. This spread adjustment was also chosen by the most respondents to be used with the compounded-setting-in-arrears rate. The majority of respondents also preferred the median spot-spread to the mean approach as it removes the impact of outliers in the calculation.

In response to feedback from market participants, ISDA will develop specific fallbacks to include in its standard definitions and also work to determine the appropriate parameters for the historical mean/ median spread adjustment (whether to use a mean or median calculation and the length of the historical look-back period).

LOOKING FORWARD TO THE ARRC AND THE BOA WORKING GROUP'S RESPONSES

Because very similar questions were asked by ARRC of market participants with respect to the replacement RFR and spread adjustment for USD LIBOR floating rate notes, we can expect that the responses from these market participants will likely mirror those provided to ISDA. This will help clarify how to draft workable fallbacks for USD LIBOR floating rate notes with maturities that extend past 2021 (or any earlier LIBOR cessation). We can also expect a similar response from the BOA Working Group and will look to update you as the group's mandate to develop workable fallback provisions for Sterling LIBOR progresses in the next few months.

How Does an Index Split?

We are all familiar with forward and reverse stock splits of common stock and shares of exchange-traded funds ("ETFs"), and the related anti-dilution provisions contained in structured notes linked to those underliers. Those provisions disclose how to adjust for these events if the events should occur following the setting of an initial price for an underlying common share or ETF share. You will not find similar provisions in structured notes linked to an index.

But at least two indices have had, in effect, splits since their inception. An issuer of a structured note linked to an index that split would have to adjust the final index level for that event.

The Hang Seng China Enterprises Index had a base value of 1,000 at launch on August 8, 1994. On January 3, 2000 it was re-based to 2,000 (in effect, a split). Similarly, the Nasdaq-100 Index® launched on January 31, 1985 with a base index value of 250. On January 1, 1994, the NDX was reset to 125 (in effect, a reverse split).

Holders of shares of common stock or an ETF that have had a two-for-one split or a one-for-two reverse split suffer no economic impact. They either end up with two shares with the same value as the pre-split share or with twice the value in a reverse split. When an index changes its base value, there is no equivalent as there are no ownership rights.

Draftspersons should consider this possibility when crafting provisions relating to index-linked structured notes. One would not want to have to deal with a change in the base index level without some disclosure in the terms of the note permitting an adjustment in the final index level to reflect the change.

OCIE Risk Alert on Electronic Messaging

The Securities and Exchange Commission's (the "Commission") Office of Compliance Inspections and Examinations ("OCIE") released a Risk Alert on December 14, 2018 encouraging investment advisers to review their Investment Advisers Act of 1940 (the "Advisers Act") Rule 204-2 and Advisers Act Rule 206(4)-7 compliance programs with respect to electronic messaging. The Risk Alert was prompted by the OCIE's observation of the increased use of non-email electronic communication, including text/SMS messaging, instant messaging, social media and the use of third-party applications, and the increased use of personal devices. The OCIE recommendations include the following:

Policies and Procedures:

- permitting only those forms of electronic communication that can be used in compliance with the Advisers Act;
- prohibiting the use of apps that allow anonymous communication or automatic destruction of messages or prohibit third-party viewing or backup;
- requiring the retention and transfer of messages received on prohibited apps or services to a compliant electronic system; and

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- addressing the use of personal devices, social media, personal email accounts, personal websites, instant messaging, texting and information security.

Employee Training and Attestations:

- conducting training on electronic communication policies and procedures and compliance therewith; and
- soliciting feedback regarding forms of messaging requested by clients for use in the ongoing review and adaption of the firm's policies.

Supervisory Review:

- monitoring and archiving, directly and through the use of third-party service providers, the use of electronic communications; and
- conducting regular Internet and social media searches for unauthorized communication and the creation of a confidential reporting program.

Control over Devices:

- requiring prior approval for the use of personal devices for business purposes, limiting remote access to virtual private networks, and the installation of security apps and software that enable the adviser to push security patches, monitor for prohibited apps, and remotely wipe out all devices.

In addition to the specific recommendations noted above, the OCIE encourages advisers to stay abreast of evolving technology and regularly review their compliance policies and procedures in light of ongoing developments in electronic communication. The OCIE recommendations are applicable as well to broker-dealers. The Risk Alert can be found here.

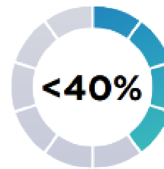
SEC Investor Advocate Report on Activities for Fiscal Year 2018: Survey Results Regarding Investment Advice

The Office of the Investor Advocate released its "Report on Activities for the Fiscal Year 2018" (the "Report").[2] During the 2018 fiscal year, the Investor Advocate focused significant attention on proposed Regulation Best Interest and on the standard of conduct applicable to broker-dealers and investment advisers. In the Investor Testing section of the Report, the Office summarized some of the key findings from its survey, "Research on the Market for Investment Advice."[3] These findings, which are summarized below, should help inform the Commission's consideration of proposed Regulation Best Interest:

[2] Office of Investor Advocate, Report on Activities, Fiscal Year 2018, available at https://goo.gl/GkHjNF.

[3] Brian Scholl, Ph.D. & Angela Hung, Ph.D., SEC, Office of the Investor Advocate, The Retail Market for Investment Advice (Oct. 12, 2018), available at https://goo.gl/yuqsrP.

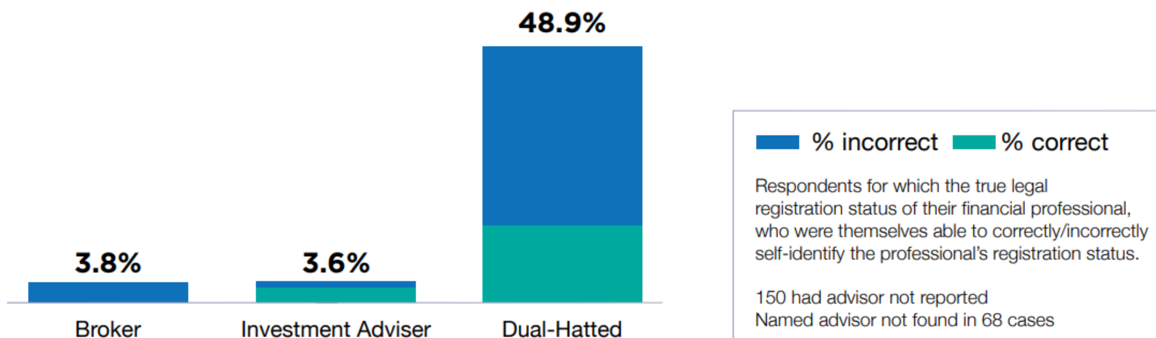
Most investors do not currently receive financial advice regarding their assets. Consumers were asked whether they are currently consulting a financial professional regarding their investment strategies, the type of account to open, or specific financial investments. The aim of these questions was to determine the percentage of investors that receive financial advice from professionals. Only 38.7% of consumers responded "yes" to one or more of these questions. This research shows that the majority of investment decisions are not informed by professional advice. The cost associated with finding and screening an investment professional was among the leading reasons that investors cited for not seeking professional advice. The finding that the majority of investment decisions are not professionally informed may be a cause of concern for regulators.



of investors reported using a financial professional for advice about:

- Investment strategies
- Specific financial investments
- Types of accounts to open

Most consumers of investment advice turn to "dual-hatted" professionals. The majority of financial advice consumers receive is delivered by a dual registered broker-dealer and investment adviser. Only 3.8% of advice seekers work with a professional that is exclusively registered as a broker-dealer. The majority of consumers were unable to identify the correct legal status of their financial professional.



The general public does not understand the obligations arising from the requirement to act in the customer's "best-interest." A survey of investor understandings of the term "best interest" found that 73% of investors believe that the reference to "best interest" requires financial professionals to help them choose the lowest cost product; all else being equal, 6.1% thought that it required professionals to avoid taking higher compensation for selling one product when similar but less costly products are available, and 86% thought that it required professionals to monitor their account on an ongoing basis. However, the proposed best interest standard applies to broker-dealers who are generally not required to actively monitor accounts as part of their service offerings. Furthermore, it is unclear whether the best interest standard would require professionals to choose the lowest cost product.

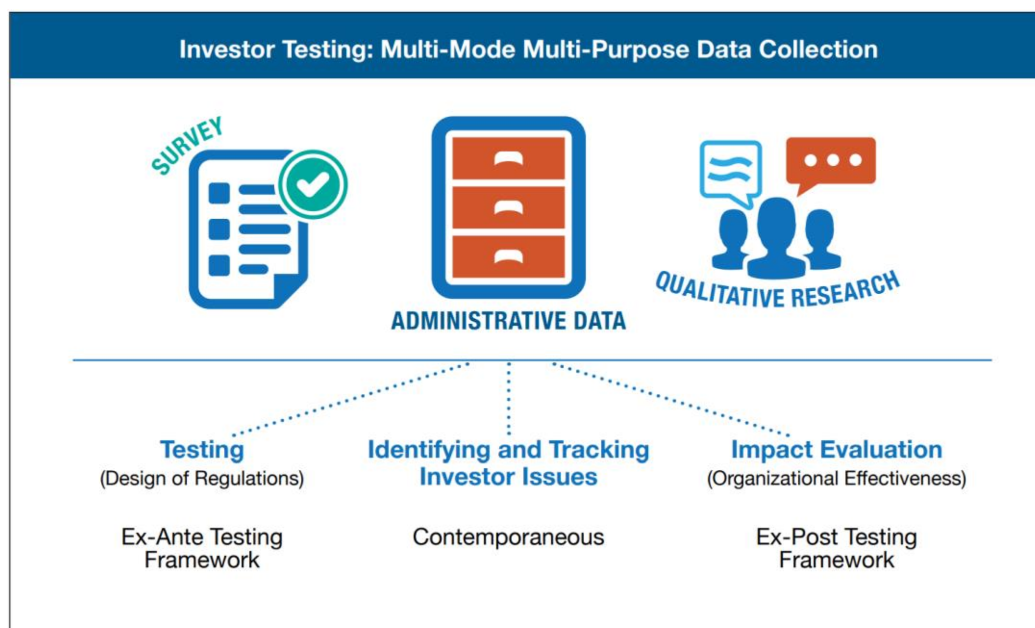
Avoid taking higher compensation for selling one product when a similar but less costly one is available | 61%

Help them choose the lowest cost products, all else being equal | 73%

Monitor their accounts on an ongoing basis | 86%

POSITIER Investor Testing

The Investor Advocate Report also included a report on the newly developed research initiative POSITIER (Policy Oriented Stakeholder and Investor Testing for Innovative and Effective Regulation). This investor testing tool is designed to, among other things, assess the effect on investors of proposed changes to Commission rules and identify policies that will improve outcomes for stakeholders. POSITIER collects data and uses analytics both for *ex-ante* testing of potential regulatory changes and *ex-post* evaluation and outcomes of regulatory change. The below illustration provides an overview of the process. By comparison to the Commission's economic analysis efforts as well as the Commission's request for investor feedback through the comment letter process, POSITIER can collect much more data that can be more informative in the rule-making process. The Report is available at https://goo.gl/QwTTtj.



FDIC Announces Review of Brokered Deposits and Requests Comments

On December 18, 2018, the Federal Deposit Insurance Corporation (the "FDIC") published an advance notice of proposed rule-making and request for comments (the "Notice") in connection with a comprehensive review of the regulatory approach to brokered deposits, due to the technological and market developments since the applicable rules were first adopted. The Notice also provides an overview of the current laws and regulations applicable to brokered deposits, a brief history of brokered deposits and the development of the corresponding rules and market data the FDIC has collected. The Notice describes the potential areas for attention that the FDIC has identified, including the:

- Definition of “brokered deposit” and “deposit broker”;
- Exclusions from the “deposit broker” definition;
- Treatment of deposit listing services;
- Classification of accounting software and personal banking apps used to place deposits;
- Applicability of the primary purpose exception to prepaid cards; and
- Interest rate restrictions, including the method of calculating rates and the applicability to new products.

While the Notice identifies the above areas for potential clarification or modification, the FDIC does not propose any changes at this time. Instead, the FDIC requests input from the industry on this topic, in particular with respect to the following points:

- The scope of the current definitions;
- Unaddressed developments or areas where clarity is required;
- Any required revisions to the current rules or FDIC materials, including Call Report instructions;
- Additional market data; and
- Modifications to the interest rate restrictions, including the calculation methods, treatment of deposits with promotional or special features and treatment of internet-based or e-commerce-based institutions.

The full text of the Notice is available here, and comments may be submitted here. Readers of this publication may be particularly interested in commenting on the scope of the definitions given that for various purposes retail deposits are viewed more favorably than brokered deposits and market-linked certificate of deposit programs generally are administered in a manner consistent with the taking of retail deposits.

United Kingdom Financial Services Legislation in the Aftermath of a No-Deal Brexit—What Potential Changes to UK Securities Laws and Regulations Should Issuers of Securities be Aware of?

INTRODUCTION

A significant portion of the law and regulation applicable in the United Kingdom (the "UK") pre-Brexit is derived from the European Union (“EU”). In order to avoid confusion and gaps in UK law when Brexit takes effect and EU law will otherwise cease to apply in the UK (currently scheduled for “exit day,” 11:00 pm on March 29, 2019), the European Union (Withdrawal) Act 2018 (the "EUWA") aims at preserving UK legislation

that implements EU obligations and converting directly applicable EU legislation into domestic law (so called "on shoring").

If the withdrawal agreement negotiated between the UK government and the EU is approved by the UK Parliament and comes into effect, an implementation (or transition) period will apply from exit day until the end of December 2020. During that time, EU law will remain applicable in the United Kingdom, notwithstanding that the United Kingdom will no longer be an EU member state. The implementation period should enable the on shoring process to happen smoothly, taking into account any subsequent agreement reached as to the future relationship between the United Kingdom and the European Union.

If that approval is not forthcoming and the Article 50 notice is not extended or withdrawn, a “no deal Brexit” will occur on March 29, 2019 without the benefit of an implementation period. The Statutory Instruments (“SIs”, a form of secondary legislation) described in this note are being brought into effect to address that possibility. They are being promulgated by Her Majesty's Treasury ("HMT") pursuant to powers in the EUWA for ministers to pass secondary legislation to ensure that retained EU law functions effectively when the United Kingdom leaves the European Union on March 30, 2019.

Accordingly, the SIs described below represent, at this stage, a contingency against a scenario in which the implementation period, which has been agreed as part of the United Kingdom's withdrawal agreement with the European Union, does not take effect on March 29, 2019.

In general terms, HMT's approach (and that of the UK's Financial Conduct Authority (the "FCA") and Prudential Regulatory Authority (the "PRA"), which have confirmed that they will follow the same path) is not to rely on any new or specific arrangements being in place between the United Kingdom's and the European Union after Brexit, but to treat EU member states as third (non-EU) countries pursuant to the UK's existing financial services legislation. So, for example, the draft Markets in Financial Instruments (Amendment) (EU Exit) Regulations 2018 make a number of changes to the UK's existing Financial Services and Markets Act 2000 ("FSMA") and Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, such as (i) changing the territorial scope of the legislation from the European Union to the United Kingdom, (ii) modifying definitions that relate to third-country activities or entities so that they cover entities from the European Union, (iii) revoking so called "passporting rights" (in summary, the rights of entities in the European Union to notify the permissions granted to them by their home member state regulators to undertake regulated activities and, thereby, undertake such regulated activities in the United Kingdom without the further permission of the FCA or, as the case may be, the PRA) and (iv) transferring functions of the European Securities and Markets Authority ("ESMA") to the relevant United Kingdom regulator – be it the FCA or the PRA – and the functions of the European Commission to HMT.

OFFERS OF SECURITIES AND LISTING OF SECURITIES IN THE UNITED KINGDOM

Currently, pursuant to Article 3 of Directive 2003/71 (EC) (as amended, the "Prospectus Directive"), member states of the European Union shall not allow an offer of securities to be made to the public within their territories or admission of securities to their respective regulated markets without, in each case, the publication of a prospectus that is either approved by the competent authority of the relevant member state or approved by the competent authority of another EU member state and passported into the relevant member state under the "mutual recognition" regime for EU prospectuses set out in the Prospectus Directive.

The Prospectus Directive has been transposed into UK law by FSMA so, for example, pursuant to section 85(1) of FSMA it is unlawful for transferable securities to be offered to the public in the United Kingdom unless an approved prospectus has been made available to the public before the offer is made.

Regulation 2017/1129 (the "Prospectus Regulation") was adopted by the European Council on May 16, 2017, with certain of its private placement exemptions applying from July 21, 2017 and July 21, 2018, respectively, and the remainder of the Prospectus Regulation due to apply across the European Union from July 21, 2019 – so, after the United Kingdom leaves the European Union. Because on shoring under the EUWA only applies to European Union law in force as at exit day, the parts of the Prospectus Regulation that are not then in force (which comprises most of the substantive aspects of the Regulation) will not apply in the United Kingdom pursuant to the EUWA.

HMT intends, however, to use the EUWA powers to domesticate the remaining provisions of the Prospectus Regulation as part of its approach to on shoring financial services legislation. Accordingly, HMT published on November 21, 2018 guidance on its proposed "Draft Official Listing of Securities, Prospectus and Transparency (Amendment) (EU Exit) Regulations 2019,"[4] which will replicate in the United Kingdom the European prospectus, transparency, and the listing regime that will apply across the European Union post-Brexit. In addition, the SI will:

- require issuers wishing to offer securities to the public in the United Kingdom or have securities admitted to trading on the London Stock Exchange's regulated market to seek approval of their prospectuses by the FCA;
- provide that prospectuses "passported" into the United Kingdom prior to March 30, 2019 will be grandfathered for use in the UK until their validity expires but, that, from March 30, 2019, pass porting of prospectuses approved by the regulators of the 27 EU member states will no longer be permissible (an additional approval of such prospectuses by the FCA will be required); and
- ensure that EU issuers are treated in the same manner as any other third-country issuer in terms of the private placement exemptions available to them from the requirement to publish a prospectus.

OFFERS OF PACKAGED RETAIL AND INSURANCE-BASED INVESTMENT PRODUCTS TO UK RETAIL INVESTORS

Regulation (EU) 1286/2014 (as amended, the "PRIIPs Regulation") requires a key information document ("KID") to be issued and distributed to retail investors in the European Union when packaged investment or insurance-based investment products ("PRIIPs") are offered and sold to them.

HMT has published a draft version of the "Packaged Retail and Insurance-based Investment Products (Amendment) (EU Exit) Regulations 2019,"[5] accompanied by an explanatory note. The SI corrects deficiencies in (a) the directly applicable PRIIPS Regulation (and its secondary legislation) and (b) the U.K. Packaged Retail and Insurance-based Investment Products Regulations 2017 No. 1127 (which implement the PRIIPs Regulation in the United Kingdom) that are, in each case, to be retained on Brexit. The draft SI:

[4] See: https://goo.gl/S4nE62.

[5] See: https://goo.gl/oFwGtU.

- narrows the scope of the PRIIPs Regulation so that it applies only to those UK or third-country firms that manufacture, advise on or sell PRIIPs to investors in the United Kingdom (post-Brexit, UK firms that manufacture, advise on or sell PRIIPs to investors in the European Union or another third-country will not in doing so be subject to the UK PRIIPs regime, but will be subject to the PRIIPs Regulation or relevant third-county regulations);
- ensures that, after Brexit, the United Kingdom treats EU member states in the same way as other third countries in relation to the existing exemption under the PRIIPs Regulation from the requirement to prepare and distribute a KID for certain products that are outside the scope of the Prospectus Directive and Prospectus Regulation; and
- provides that functions currently carried out by ESMA and the European Insurance and Occupational Pensions Authority under the PRIIPs Regulation will be carried out by the FCA and that functions carried out by the European Commission will be transferred to HMT.

INSIDER TRADING AND MARKET ABUSE RULES

HMT has published a draft version of the "Market Abuse (Amendment) (EU Exit) Regulations 2018"[6] that seek to ensure that the retained EU law relating to market abuse, which stems from Regulation (EU) 596/2014 (as amended, the "Market Abuse Regulation" or "MAR"), continues to operate effectively post-Brexit. The SI:

- ensures that the scope of the market abuse regime applicable in the United Kingdom captures conduct related to instruments admitted to trading or traded on both UK and EU trading venues;
- retains the general disclosure requirements for issuers of securities that fall within the scope of MAR that relate to the disclosure of inside information and the preparation of insider lists;
- transfers the powers and functions of ESMA with regard to enforceability of the market abuse regime to the FCA; and
- removes the unilateral obligation on UK supervisors to share information or cooperate with EU authorities.

USE OF BENCHMARKS IN SECURITIES OFFERED OR LISTED IN THE UNITED KINGDOM

HMT has also published the draft "Benchmarks (Amendment) (EU Exit) Regulations 2018"[7]. The SI will make amendments to retained EU law related to the EU Benchmarks Regulation (BMR) to ensure that it continues to operate effectively in the United Kingdom once the United Kingdom has left the European Union. The explanatory note details that the SI will:

- ensure that UK-located benchmark administrators seeking authorization or registration will continue to apply to the FCA;
- clarify that the scope of the onshored Regulation (and thus of authorisation or registration by the FCA) is the United Kingdom, and not the whole of the European Union;

[6] See: https://goo.gl/5b1U3o.

[7] See: https://goo.gl/aPtw1i.

- ensure that EU-located administrators are subject to the UK regime, which requires third-country administrators or benchmarks to become approved through recognition or endorsement applications to the FCA to allow use of their benchmarks in the United Kingdom by supervised entities (unless and until an equivalence determination is made); and
- create a UK register for benchmarks, which the FCA will maintain from Brexit.

As a result of the SI, UK supervised entities will only be permitted to use benchmarks that are on the UK register. However, the SI contains an additional transitional provision, which temporarily migrates over to the UK register for a 24-month period any benchmarks or administrators, which appear on the ESMA register as at exit day as a result of a successful application outside of the United Kingdom. These third-country administrators or benchmarks must become approved by the FCA through equivalence, recognition or endorsement to enable their continued use within the United Kingdom beyond this 24-month period.

FINAL THOUGHTS

In recent days, the UK Government has lost a vote on the withdrawal agreement in the UK Parliament. The future of the withdrawal agreement (including the implementation period) and, accordingly, the consequences (and even the timing) of Brexit, remain uncertain. If the withdrawal agreement (whether in its current form or another form that has been agreed between the UK Government and the European Union, provided it retains the implementation period) were to be approved by the UK Government, the European Union and the United Kingdom Parliament, then the need to implement the SIs would be deferred and, to the extent that an international treaty covering financial services could be concluded between the United Kingdom and the European Union during the implementation period, removed in whole or in part.

While hoping for the best outcome, HMT, in planning for the worst, appears to be taking a consistent approach to converting existing EU securities laws, regulations and rules in force as at Brexit into UK law, as well as domesticating other important elements of EU securities law, such as the Prospectus Regulation, so as to ensure, so far as possible, that the United Kingdom retains a level playing field in financial services regulation with the European Union post-Brexit.

New QFC Stay Rules Affect Dealer Agreements and Distribution Agreements

Starting in 2019, U.S. globally systemically important banking organizations ("GSIBs") and their subsidiaries worldwide, as well as the U.S. subsidiaries, branches and agencies of foreign GSIBs ("Covered Entities"), must include new language in their underwriting and similar agreements to recognize U.S. special resolution regimes. The "QFC Stay Rules" require Covered Entities to include contractual stay language in certain of their qualified financial contracts ("QFCs") to mitigate the risk of destabilizing closeouts of Covered Entities' QFCs, which is a perceived impediment to the orderly resolution of a GSIB.

Recently, the Securities Industry and Financial Markets Association ("SIFMA") published a revised version of their standard master selected dealer agreement, which includes the new QFC language. They also published an explanatory memorandum addressing the application of the QFC Stay Rules to underwriting and similar agreements. The revised master selected dealer agreement is available at https://goo.gl/6aMZZ3 and the memorandum is available at https://goo.gl/ujH5ZJ.

Covered Entities have begun to include the new QFC language in terms agreements to their distribution agreements. There are exclusions to the new requirement, which are covered in the SIFMA memorandum and may be available to a Covered Entity.

Refresher: Structured Products: A Framework for Post-Approval Review

Many issuers and their affiliated broker-dealers have an elaborate new product approval process, but may focus less time on the post-approval review. FINRA has regularly commented on its expectations regarding the need for member firms to have in place a similarly robust post-sale review process. The post-sale review may be conducted by a broker-dealer's "new product committee." FINRA Notice 05-26 states that broker-dealers should:

- track and monitor customer complaints and grievances relating to new products;
- reassess the firm's training needs regarding a product on a continuing basis;
- establish procedures to monitor, on an ongoing basis, firm-wide compliance with any terms or conditions that have been placed on the sale of the product;
- periodically reassess the suitability of the product; and
- review any product before lifting any restrictions or conditions on the sale of the product.

Similarly, FINRA Notice 12-03 states that a "well-designed system of internal controls should include a process to periodically reassess complex products a firm offers to determine whether their performance and risk profile remain consistent with the manner in which the firm is selling them." FINRA Notice 12-03 notes that, as to complex products, member firms should implement a post-approval review process:

- periodically reassess the complex products a firm offers to determine whether their performance and risk profile remain consistent with the manner in which the firm is selling them;
- consider developing procedures to monitor how the products performed after the firm approved them; and
- conduct periodic reviews to ensure that only associated persons who are authorized to recommend complex products to retail customers are doing so.

In its Report on Conflicts of Interest, FINRA stated, "effective practice for product manufacturing firms is to implement post-launch reviews to identify potential issues with a product that may not have *been* apparent during the initial review process, which could lead to conflicts of interest or reputational risk. Such issues could include unexpected product performance, subsequent activity by the manufacturer that may specifically influence the performance of the product, use by investors for whom the product was not intended, or use that is inappropriate or unanticipated."

With these principles in mind, we provide a framework and checklist for conducting a post-approval review. Each broker-dealer will need to consider its processes in light of its own business model, including the nature of its investor base, the types of products that it sells, and the channels through which it offers its products. Moreover, if a broker-dealer sells any of its products outside of the United States, the laws and practices of the relevant jurisdictions may need to be considered as well in formulating an appropriate post-sale review process.

SELECTION PROCESS FOR REVIEW

The broker-dealer may consider selecting notes for review:

- by underyling reference asset in order to ensure a variety of reference asset exposures are considered;
- by date (i.e., some issued in the first quarter of the most recent year, some issued in the third quarter, or through some other random or non-randomized sampling);
- by pay-off feature (principal-protected, buffered, etc.) with an emphasis on the most complex structures;
- by distribution channel;
- based on sales volumes, retail focus of distribution or other relevant criteria; or
- any other reasonable sampling basis.

PROCEDURES FOR POST-APPROVAL REVIEW

The new product committee should be provided with data, including:

- amounts offered;
- distribution channel;
- types of investors;
- products of performance;
- actual performance versus product performance anticipated when the product was introduced;
- any inquiries received from regulators on the product type, marketing material used, offering documents used and initial new product committee approval submissions.

The committee also may wish to consider the extent to which:

- the product is described appropriately in marketing and disclosure documents, particularly as to the disclosure of the relevant risk factors, as well as in internal training materials;
- the product description in the original new product committee submission remains accurate;
- the product has performed as contemplated at the time of approval;
- additional training of the representatives or distributors is advisable;
- the performance is consistent with any relevant hypothetical back-tested data and/or any sensitivity or similar tests;
- the objective of the product remains valid or continues to address a market need;
- investors have attempted to liquidate the product prior to maturity to a greater extent than other products;
- any operational issues have arisen in relation to the issuance, hedging or trading of the product;
- any compliance issues have arisen, including any unexpected conflicts of interest;
- peer firms are offering similar products;
- any other products are offered that are advantageous as compared to the relevant product, for example, with fewer fees, greater liquidity, etc.; and
- the distribution channel should be changed, minimum purchase amount required or other precautions taken.

ADDITIONAL CONSIDERATIONS

In addition to assessing the adequacy of a firm's internal controls with regard to a firm's post-approval review process, when dealing with complex products FINRA encourages firms to:

- thoroughly train registered representatives to understand the features and risks associated with the product;
- consider the customer's financial sophistication when making product suitability determinations;
- discuss with retail customers the features of the product, how it is expected to perform under different market conditions, the risks and possible benefits, and the costs of the product;
- consider whether less complex or costly products could achieve the same objectives for the customer; and
- be cognizant that the broker-dealer suitability obligation extends from the product design and product approval process to post-approval review.

Last, FINRA notes that even the most elaborate procedures will not be effective unless they are rigorously implemented, something that ultimately depends on the firm's culture and the level of commitment on the part of the firm's leadership.

Upcoming Events

***REVERSEinquiries* Workshop Series: Benchmark and Proprietary Indices**

Join us for our inaugural REVERSEinquiries Workshop on **Monday, February 4, 2019** at Mayer Brown's New York Office. *Registration: 8am; Program: 8:30am – 9:45am ET.* **Click here to RSVP.**

What makes an index an index? We will discuss, among other things:

- rules-based indices,
- the various definitions of indices,
- index governance and index rules,
- discretion, the Advisers Act, and tax considerations,
- index descriptions and rulebooks,
- conflicts of interest and the IOSCO and ESMA guidance, and
- European benchmark regulation.

Save the dates for our entire 2019 REVERSEinquiries Workshop series. For more information, please e-mail REVERSEinquiries@mayerbrown.com.

- March 4, 2019
  Structured UITs and Repack Structures
- April 29, 2019
  Certificate of Deposit Programs and Brokered CD Programs
- June 13, 2019
  New Product Governance and Post-Sale Reviews
- October 17, 2019
  ETNs and Daily Redeemable Notes
- November 14, 2019
  Platforms and Securities Law and Commercial Considerations

Our REVERSEinquiries Workshops are limited to 40 participants; Press is not permitted.

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Announcements

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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