

# REVERSE inquiries

*Structured and market-linked product news for inquiring minds.*

## Demystifying SOFR

On April 22, 2019, the Alternative Rates Reference Committee ("ARRC") published "A User's Guide to SOFR" ("Guide"), which explains how market participants can use the secured overnight financing rate ("SOFR") in cash products, such as floating rate notes.<sup>1</sup> The guide covers three main areas:

- The differences between a simple and a compounded average of SOFR over an interest period;
- Whether to observe and average SOFR in advance (prior to) or in arrears (at the end) of the interest period; and
- The relationship of compounded average SOFR to forward-looking SOFR-based term rates.

While the materials covered in the first two bullet points above have been discussed before, the Guide provides additional information with respect to the term rates, and encourages issuers of floating rate notes to use an average of SOFR over an interest period for new issuances, and not wait for publication of SOFR-based term rates.

In the September 2018 ARRC Consultation Regarding More Robust LIBOR Fallback Contract Language for New Issuances of Floating Rate Notes, the first recommended replacement benchmark in the "FRN Replacement Benchmark Waterfall" was forward-looking term SOFR, with compounded average daily SOFR over the relevant compounding period coming in second.<sup>2</sup> Final recommended replacement benchmarks for USD LIBOR in floating rate notes are pending. The Guide states that "those who are able to use SOFR should not wait for the term rates in order to transition.... [i]t is not in the interest of market participants to put off taking action nor can the ARRC guarantee that an administrator can produce a robust, IOSCO-compliant forward-looking term rate before LIBOR stops publication." The Guide suggests that the forward-looking term rate is most appropriate for use as a fallback for existing LIBOR cash products, such as floating rate notes. Otherwise, the ARRC recommends the use of compounded or simple averaged SOFR for new cash products.

## In This Issue

Demystifying SOFR	1
U.S. House Subcommittee Holds Hearing to Examine SEC's Best Interest Rule	3
SIFMA Hosts Annual C&L Seminar with Enforcement and Regulatory Panels	3
Equity Linked Notes are Subject to FINRA's Markup Rule	4
Maryland Uniform Fiduciary Duty Bill Rejected in Senate Committee	4
Refresher: Structured Warrants	5

<sup>1</sup> The Guide is available at: <https://nyfed.org/2Dwzjxw>

<sup>2</sup> The September 24, 2018 ARRC Consultation is available at: <https://nyfed.org/2XGsW2s>

The Guide goes into some detail as to why the anticipated term rates are not the best choice for cash products. Although SOFR derivative markets are developing, according to the Guide, there is not enough depth and liquidity to construct a forward-looking term rate with certainty prior to the planned LIBOR cessation in 2021. The Guide also discusses the costs of hedging a forward-looking term rate, which, due to the number of required transactions, may be higher than the costs associated with hedging compounded average SOFR.

### TECHNICAL MATTERS

The Guide covers in detail many of the plumbing issues relating to using averaged daily SOFR.

- Simple versus compounded interest:
  - Daily interest is calculated each day during the interest period by applying the daily rate to the principal amount, then adding each day's amount at the end of the period; most payment systems are set up for this type of calculation, including for floating rate notes;
  - Compound interest accounts for the unpaid interest during the interest period, by applying the daily interest rate to both the unpaid principal and accumulated interest; this method recognizes the time value of money; and
  - The Guide notes that the difference between the two methods is small at lower interest rates and over shorter time periods.
- In advance versus in arrears:
  - For current LIBOR floating rate notes, the interest rate and the payment are known at the beginning of the interest period, having been determined two London banking days prior to the beginning of the interest period, so note holders have advance notice of the payment amounts;
  - For averaged daily SOFR, whether simple or compounded, the only way to give note holders the same advance notice would be to use an "in advance" method under which the interest rate would be calculated at the start of the interest period using the historic averaged SOFR for the immediately preceding period;
    - Some have expressed concerns about this approach as the interest rate for the current period will be stale;
  - Recent SOFR floating rate notes have used the "in arrears" method in which the interest rate for the period is calculated at the end of the period, generally using a simple average, and the rate is announced and paid on the same day, which is the last day of the interest period;
  - The advantage of the in arrears method is that the interest rate actually reflects what happened during the interest period and likely will fully hedge interest rate risk in a way that LIBOR or a SOFR-based forward-looking term rate may not;<sup>3</sup> and
    - With a backward-looking rate like SOFR, the rate for the last day of the interest period, which is also the interest payment date, would not be announced until the day after the interest payment date, causing a one business day payment delay. Issuers solve this by adding a "lockout" or "suspension" period of one to five days pursuant to which

---

<sup>3</sup> See generally the Guide at p.7.

the daily rate on the first day of the lockout period will apply for each day in the lockout period.<sup>4</sup>

---

## U.S. House Subcommittee Holds Hearing to Examine SEC's Best Interest Rule

In mid-March, the U.S. House Committee on Financial Services' Subcommittee on Investor Protection, Entrepreneurship and Capital Markets held a hearing entitled "[Putting Investors First? Examining the SEC's Best Interest Rule.](#)" The hearing examined the Securities and Exchange Commission's ("SEC") proposed [Regulation Best Interest](#) ("Reg BI"). According to the subcommittee hearing materials, Reg BI would affect 2,800 brokerage firms, 7,000 investment advisory firms, 162 million customer accounts managed by brokers and advisers and \$36.6 trillion in assets.

In opening remarks, Rep. Carolyn Maloney stated, "While Reg BI may be an improvement on the status quo, it is still far too weak." Rep. Maloney outlined a number of pitfalls with proposed Reg BI: it does not subject broker-dealers and investment advisers to a full uniform duty; it fails to define "best interest;" it allows broker-dealers to take their own financial interests into account when they provide advice; and it relies far too much on disclosing conflicts of interest instead of simply eliminating conflicts of interest. Rep. Maloney strongly urged the SEC to strengthen its proposed rule. Many of the witnesses at the hearing shared similar concerns. Barbara Roper, speaking on behalf of the Consumer Federation of America, also noted that Form CRS needs to be completely rewritten, retested and re-proposed. Harvey Pitt, CEO of Kalorama Partners and a former Chairman of the SEC, praised Reg BI as an impressive, creative and well planned effort by the SEC to continue to protect retail investors.

Witnesses were supportive of the proposed "[SEC Disclosure Effectiveness Testing Act,](#)" which would require the SEC to conduct usability testing of current and new disclosures intended for retail investors and would be a requirement prior to the SEC adopting a final rule.

Reg BI is in the final rulemaking stage with a final action expected in September 2019.

---

## SIFMA Hosts Annual C&L Seminar with Enforcement and Regulatory Panels

On March 25, 2019, the Securities Industry and Financial Markets Association's Compliance and Legal Society held its annual seminar. Highlights of the seminar included a regulatory panel that included representatives from the SEC, the Financial Industry Regulatory Authority, Inc. ("FINRA") and the Office of the Comptroller of

---

<sup>4</sup> Table 3 of the Guide shows a few variations on payment methods for using SOFR in arrears, all of which have the interest payment being paid on the day after the last day of the interest period. The last day of the interest period normally is also the interest payment date for that period. Some issuers may choose to set up their SOFR floating rate note programs with the payment options shown in Table 3 of the Guide, but there may not be a reason to delay the interest payment beyond the last day of the interest period when using a lockout period.

the Currency. The enforcement panel included representatives from the United States Attorney's Office for the Southern District of New York, the Commodity Futures Trading Commission, FINRA and the SEC.

During the regulatory panel, Brett Redfearn, Director of the SEC's Division of Trading and Markets provided insights on the current status of Reg BI. Mr. Redfearn asserted that Reg BI is a high priority for the SEC and that the SEC has received over 6,000 comment letters. Robert Colby, Chief Legal Officer, FINRA, emphasized that FINRA is a "very strong supporter of Reg BI." Mr. Colby acknowledged that there is overlap between Reg BI and the existing suitability standard. Since FINRA will be enforcing Reg BI, according to Mr. Colby, FINRA does not want Reg BI and the suitability standard to have inconsistencies. Mr. Colby noted FINRA will wait for Reg BI to be finalized before making any changes to the current "suitability" standard.

---

## Equity Linked Notes are Subject to FINRA's Markup Rule

As we have discussed in a previous issue, FINRA will be reviewing member firms' compliance with the mark-up or mark-down disclosure obligations on fixed income transactions under FINRA Rule 2232 (Customer Confirmations).<sup>5,6</sup>

FINRA recently added a new answer to its FAQs on Fixed Income Confirmation Disclosure:

1.13 Are equity-linked notes subject to mark-up disclosure under Rule 2232?

Yes, if they must be reported to TRACE. Equity-linked notes that are considered "TRACE-Eligible Securities" under FINRA guidance (see [FINRA Trade Reporting Notice – 2/22/08](#)) and reportable under Rule 6730 are reported and disseminated as corporate debt securities. Accordingly, they are subject to the mark-up disclosure requirements in Rule 2232.

The FAQs are available at: <http://bit.ly/2W5gys8>.

---

## Maryland Uniform Fiduciary Duty Bill Rejected in Senate Committee

Recently, the Maryland Senate Finance Committee overwhelmingly voted down the Financial Consumer Protection Act of 2019, which included a provision that would have imposed a uniform fiduciary duty on financial professionals in the state. The financial industry, which has long opposed any state-level regulation on fiduciary standards, welcomed the senate committee's decision. Maryland was one of the several states pursuing uniform fiduciary standards at the state level.

---

<sup>5</sup> See REVERSEinquiries, Volume 02, Issue 02, available at: <http://bit.ly/2Xlfw5l>.

<sup>6</sup> The FINRA 2019 Risk Monitoring and Examination Priorities Letter is available at: <http://bit.ly/2XFanLV>.

## Refresher: Structured Warrants



While structured warrants rarely receive the attention of options or structured notes in the U.S. market, there has been a noticeable uptick in U.S. structured warrant programs. This article will provide a basic overview of structured warrants, including the types of structured warrants, and describe some of the key differences from structured notes and options.

### The Basics

Structured warrants, unlike traditional corporate warrants, are issued by financial institutions and linked to the value of an unrelated reference asset. These structured warrants provide the economic exposure of options with the distribution flexibility of notes. Currently, both U.S. and non-U.S. banks routinely issue structured warrants for sale to institutional and high-net worth investors in the United States.

### NOT OPTIONS

While structured warrants mimic the economics of options, there are certain key differences between structured warrants and exchange-traded or over-the-counter (“OTC”) options. Specifically, structured warrants are:

- “buy only” resulting in a limited loss potential and no margining requirement;
- securities of their issuers rather than derivatives contracts;
- less standardized than listed options (though less customizable than OTC options); and
- more liquid than OTC options (though less liquid than exchange-traded options).

In each of the latter two points, structured warrants occupy a middle ground between listed and OTC options. For example, a typical structured warrant has terms developed through direct conversations between the issuer and the initial purchaser, a CUSIP, a potential secondary market provided by an affiliate of the issuer, and exposure to the credit risk of the issuer due to the structured warrants, as securities, not being cleared through the Options Clearing Corporation.

Market conventions add to the formal differences between structured warrants and options. In particular, structured warrants are generally cash-settled, medium or long-term investments, regardless of the reference asset, while options are typically short-term instruments and may be physically-settled in the case of equity options.

### NOT NOTES

At a first glance at the offering documents relating to structured warrants and structured notes, the products would appear remarkably similar. They are often even issued from the same platform. The main difference is the economic exposure offered to holders. Structured notes represent a zero-coupon bond combined with a package of derivatives, while structured warrants represent only the derivative exposure, which has several ancillary effects. Chiefly, the notional value of a structured note is equal to the zero-coupon bond’s value at maturity, while a structured warrant does not have the interest from the zero-coupon bond to offset the derivative premium and underwriting fees, resulting in an immediate negative return that must be overcome.

The warrant holder also has less potential capital at risk but may be more likely to experience a total loss on investment.

## Reference Assets

Structured warrants may include a wide variety of reference assets and structures. The most common structured warrants are equity and equity-index linked warrants, but structured warrants linked to commodities such as currencies and interest rates are also popular. Each reference asset is associated with certain typical structures. Equity and equity-index linked warrants are often issued as either call or put warrants and may include additional features such as knock-outs or caps. Interest rate linked warrants, conversely, often appear as caps, floors or collars.

## Documentation

### TYPES OF OFFERINGS

Like structured notes, structured warrants are available in many different wrappers. Some structured warrants, particularly equity-index linked warrants, are offered through registered programs. Others are offered on a Regulation S or Rule 144A basis. Notably, just as there are exchange traded notes, there are also exchange traded warrants. However, the discussion herein is limited to unlisted warrants, notes and options, except where otherwise specified.

### INDENTURES AND ISSUING AND PAYING AGENT AGREEMENTS

The issuer will enter into an indenture or an issuing and paying agent agreement (an "IPAA") with a third party agent with respect to the warrants. Unlike the other structured warrants documents, the indenture or IPAA is generally separate from the issuer's structured notes documentation. Despite this separation, the indenture or IPAA will be comparable to its structured notes equivalent in that it will describe the role and responsibilities of the agent, provide the payment mechanics and include the applicable forms of warrants. A warrant indenture that complies with the Trust Indenture Act of 1939 may be recommended for the reasons discussed below under "Key Considerations."

### DISTRIBUTION AND DEALER AGREEMENTS

Typically, the issuer will enter into a distribution agreement with one or more distributors. Many issuers use the same agents and distributors for both structured notes and structured warrants and the agreements are similar. Consequently, the periodic deliverables are often aligned between the structured notes and structured warrants programs to reduce program maintenance costs.

### OFFERING DOCUMENTATION

Issuers will normally sell both structured notes and structured warrants using the same base prospectus or offering circular, and the trade level documentation will follow similar forms and branding. As with structured notes, issuers may choose, but are not required, to use one or more product supplements. While some issuers do choose to create a separate base offering circular for structured warrants, the offering documentation continues to resemble that used for the same issuer's structured notes program.

## Key Considerations

### SUITABILITY

Structured warrants are considered complex products for purposes of FINRA's suitability rules. Structured warrants are also viewed as a separate category from structured notes and broker-dealers typically require separate suitability determinations, new product approval processes, and training and education for structured warrants. In light of their status as complex products and the additional risks associated with structured warrants, structured warrants are generally sold only to high net worth and institutional clients with options approved accounts.

### QUALIFIED INDEPENDENT UNDERWRITERS

Public offerings of structured warrants are subject to FINRA's corporate financing rules, including the requirement for a qualified independent underwriter, unless an exemption applies. Structured note offerings typically rely on the exemption for investment grade rated securities (which includes unrated securities that are (i) of the same series as and (ii) rank pari passu with investment grade rated securities of the same issuer). Accordingly, the most common approach among structured warrants issuers with existing investment grade rated securities is to issue the structured warrants as debt securities under an indenture and therefore be within the above exemption from the qualified independent underwriter requirement. Issuers may rely on this exemption even where the securities are issued under multiple indentures.

### REGULATORY OVERSIGHT

Structured warrants are typically under the jurisdiction of the SEC, but some warrants may be at risk of re-characterization and, as a result, of being regulated by the Commodity Futures Trading Commission. Factors to be considered are: whether the structured warrants were issued under an indenture, the underlying reference asset, whether the structured warrants are fully paid at issuance and do not require any additional payments from the holder over their term and how the structured warrants are marketed.

## ANNOUNCEMENTS



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

In our [latest issue](#) we look at Q4 2018.

**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](mailto: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](mailto:reverseinquiries@mayerbrown.com).

## UPCOMING EVENTS



**REVERSEinquiries Workshop Series: Certificate of Deposit Programs and Brokered CD Programs**

Please join us by webcast on **April 29, 2019**, for our latest REVERSEinquiries Workshop.

Program: 1:00 p.m. – 2:15 p.m. EDT. [Click here to RSVP](#)

We will provide an overview of the documentation and other requirements to establish a certificate of deposit program or brokered certificate of deposit program. We will review the bank regulatory, distribution related, FINRA related, and suitability related considerations. Among other things, we will discuss:

- Setting up a CD program;
- Disclosure and documentation considerations;
- Settlement issues;
- The bank regulatory differences between CD and brokered CD issuances;
- The FDIC advanced notice of proposed rulemaking on brokered CDs; and
- FINRA and securities law considerations.

Save the dates for our entire 2019 REVERSEinquiries Workshop webinars. For more information, please e-mail [REVERSEinquiries@mayerbrown.com](mailto:REVERSEinquiries@mayerbrown.com).

- 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**

## Contacts

**Bradley Berman**

New York

T: +1 212 506 2321

E: [bberman@mayerbrown.com](mailto:bberman@mayerbrown.com)**Martin Estrada**

New York

T: +1 212 506 2597

E: [mestrada@mayerbrown.com](mailto:mestrada@mayerbrown.com)**Marla Matusic**

New York

T: +1 212 506 2437

E: [mmatusic@mayerbrown.com](mailto:mmatusic@mayerbrown.com)**Anna Pinedo**

New York

T: +1 212 506 2275

E: [apinedo@mayerbrown.com](mailto:apinedo@mayerbrown.com)**Mingli Wu**

New York

T: +1 212 506 2270

E: [mwu@mayerbrown.com](mailto:mwu@mayerbrown.com)

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

Please visit [www.mayerbrown.com](http://www.mayerbrown.com) for comprehensive contact information for all Mayer Brown offices.

Mayer Brown is a global services provider comprising associated legal practices that are separate entities, including Mayer Brown LLP (Illinois, USA), Mayer Brown International LLP (England), Mayer Brown (a Hong Kong partnership) and Tauil & Chequer Advogados (a Brazilian law partnership) (collectively the “Mayer Brown Practices”) and non-legal service providers, which provide consultancy services (the “Mayer Brown Consultancies”). The Mayer Brown Practices and Mayer Brown Consultancies are established in various jurisdictions and may be a legal person or a partnership. Details of the individual Mayer Brown Practices and Mayer Brown Consultancies can be found in the Legal Notices section of our website.

“Mayer Brown” and the Mayer Brown logo are the trademarks of Mayer Brown.

© 2019 Mayer Brown. All rights reserved. Attorney Advertising. Prior results do not guarantee a similar outcome.