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REVERSE inquiries

Structured and market-linked product news for inquiring minds.

Division of Investment Management Calls for Clearer Risk Factor Disclosure about Indices with Emerging Markets Exposure

In This Issue

In a speech given on December 3, 2019, Ms. Dalia Blass, Director, Division of Investment Management ("DIM") of the Securities and Exchange Commission ("SEC"), raised concerns about adequate risk factor disclosure by funds that track indices with significant exposure to emerging and frontier markets.[1] Director Blass raised issues prevalent in foreign markets, such as less publicly available information about index constituents, less regulatory oversight in those markets (which may lead to unreliable information being used by index providers), and weaker rights and remedies available to a fund against index constituents located in such markets.

Director Blass suggested that funds address the following risks in their disclosure documents:

- What are the risks in using unreliable or outdated information when assessing if a constituent should be included in an index?
- What if the issue is not just the quality of the information but that the index provider has access to partial or very limited information?
- What are the limitations, if any, in assessing the index provider's due diligence process?
- What are the limitations, if any, to the rights and remedies available to the fund?

Director Blass noted that each of these risks potentially affect index data reliability, index construction and index computation, and that the DIM Staff would apply a heightened review to these disclosures.

Many of these concerns have been addressed in offering documents for structured notes. For example, structured notes linked to the iShares® MSCI Emerging Markets Index ETF contain risk factors that address most of the risks raised by Director Blass. Also, both structured notes and funds, when linking to any index, including an index of constituents issued by emerging or frontier markets, would ensure, as part of their

[1] Director Blass's speech is available at: http://bit.ly/367k1LD.

diligence, that the index complies with IOSCO and EU standards relating to index governance and data reliability. Nonetheless, Director Blass' comments serve as a useful reminder in preparing and reviewing index-related risk factor disclosures.

Clayton Questions Index Disclosures and LIBOR Replacement in One Speech

In remarks made to the SEC Fixed Income Market Structure Advisory Committee on November 4, 2019, SEC Chair Jay Clayton raised concerns for both the structured and rate notes communities.[2]

Chair Clayton questioned whether investors and their advisers understood how indices are constructed from a technical perspective (e.g., weightings and adjustments), the opportunities and risks of an investment referencing the index and the types of key value adjustments that the index administrator may make, such as what types of companies are included in the index. Chair Clayton also asked whether more disclosure should be encouraged or required. Chair Clayton echoed these remarks three days later in a speech to the SEC Investor Advisory Committee.[3]

On rates, Chair Clayton lauded current efforts to replace LIBOR and referred to the secured overnight financing rate ("SOFR") as a "potential replacement." He also voiced his concern that "more work needs to be done for the transition to avoid substantial frictions, including frictions that will harm investors directly, through higher costs, and as a result of uncertainty more generally." Chair Clayton gave a simplified explanation of his concerns, noting that current LIBOR securities reflect three components: a risk free rate, a bank funding/base lending spread over the risk free rate and an additional fixed spread to/from the lender/borrower or customer. The last would be the typical spread added to a LIBOR floating rate note. Current 3-month USD LIBOR incorporates the risk free rate and the spread over the risk free rate.

In contrast, SOFR is just a risk free rate, but does not reflect the fluctuating bank funding spread over the risk free rate. A SOFR product, such as a SOFR floating rate note, would incorporate the SOFR rate and a fixed spread, but would not fully incorporate the floating bank funding spread.

In Chair Clayton's view, this would "make a like-for-like mapping of a LIBOR product to a SOFR product challenging." Chair Clayton's skepticism of SOFR as a replacement for LIBOR continues a theme expressed by the SEC in July 2019, when the SEC Staff stated that it did not endorse the use of any particular reference rate as a LIBOR replacement.[4]

[2] Chair Clayton's speech is available at: http://bit.ly/2sGsgzD.

3 Chair Clayton's speech to the Investor Advisory Committee is available at: http://bit.ly/2Pc7waI.

[4] We discussed the July 2019 SEC Staff Statement on LIBOR Transition in Volume 02, Issue 07 of REVERSEinquiries, available at: http://bit.ly/34REqE5. The Staff Statement is available at: http://bit.ly/2rWRI3u.

FRBNY Requests Comment on Proposed Publication of SOFR Averages and a SOFR Index

On November 4, 2019, the Federal Reserve Bank of New York ("FRBNY") published a request for comment on the proposed publication of three compounded averages of the SOFR and also a daily SOFR index.[5] The three compounded averages of SOFR would have tenors of 30, 90 and 180 days.

Both the compounded averages and the index would use daily compounding. Simple interest would apply to non-business days, such as weekends and holidays. Because SOFR is backward looking, the averages and the index would use the SOFR value from Friday for Friday, Saturday and Sunday, multiplying that value by the three days, and compounding the rates/index once by that adjusted term.

One difference from the daily SOFR rate would be that the published values of the averages and the index would be for that day. A published daily SOFR rate reflects the rate that was used in trades the day prior; e.g., Tuesday's daily SOFR rate reflects transactions that occurred on Monday.

The SOFR index would measure the cumulative impact of compounding SOFR over time, with the initial value set to 1 on April 2, 2018, when daily SOFR was first published. Investors could use the index to calculate compounded SOFR averages over custom time periods.

The averages and the index would be published by the FRBNY at 8:00 a.m. each business day with, if necessary due to an error or revision to the daily SOFR rate, a revised value being published at 2:30 p.m. on that day.

The request contains a number of questions for the public's consideration and response. The request is another step in encouraging acceptance of SOFR in the market.

The ARRC Publishes Model Term Sheets for Three SOFR Floating Rate Notes Conventions

On November 21, 2019, the Alternative Reference Rates Committee (the "ARRC") published an appendix (the "Appendix") to the SOFR matrix of SOFR floating rate notes conventions (the "Matrix"), which was published in August 2019. The Appendix contains three "key provisions" for calculating compounded SOFR, a comparison of the three key provisions and a universal SOFR floating rate note ("FRN") fallback provision.[6] The three key provisions are lookback, observation period shift and payment delay.

The reason that any of the three provisions might be used by an issuer of a SOFR FRN goes to the nature of SOFR. SOFR is a backward-looking daily overnight rate, as opposed to LIBOR, which is a forward-looking term rate. Among other differences, issuers of LIBOR FRNs and FRN holders know the interest rate for any LIBOR interest period, say three months, at the beginning of the interest period. Consequently, there is certainty and advance notice as to how much interest will be paid to the holder three months hence.

[5] The FRBNY Operating Policy can be found at: https://nyfed.org/33KTzG5.

[6] The Appendix is available at: https://nyfed.org/2rTQndR. The Matrix is available at: https://nyfed.org/2DJOX8i.

Because SOFR is an overnight rate that is compounded daily during the interest period, the rate for the interest period will not be known until the interest payment date. Interest on FRNs accrues from and including the issue date or the previous interest payment date, to but excluding the following interest payment date or the maturity or redemption date, as applicable. For example, if an interest payment date for a SOFR FRN falls on a Friday, the rate announced on that Friday would be Thursday's rate, allowing the interest rate to be calculated on Friday but with no advance notice to holders and insufficient time to ensure that the paying agent can receive funds from the issuer and then pay the interest payment to holders on that day.

The Appendix details how to alleviate this problem by using any of the three approaches. For a lookback period, the daily SOFR rate for each day in the interest period will be the daily SOFR rate for a certain number of U.S. government securities business days before the date of determination. For example, if the interest payment date was Friday, with interest accruing through Thursday, and a five U.S. government securities business day lookback was in effect, the last daily SOFR rate used for the determination of the compounded SOFR rate for the interest period would have occurred on the Thursday the week prior. Consequently, on the Friday interest payment date, the issuer, paying agent and the holders would have had a week's advance notice of the payment to be made on the Friday interest payment date.[7]

For the observation period shift, the interest period is shifted back a certain number of U.S. government securities business days prior to the relevant interest payment date. For example, if the interest payment date were to be on a Friday, the relevant interest period would be from and including the Wednesday prior to the previous interest payment date to but excluding the Wednesday prior to the relevant interest payment date. With a two U.S. government securities business day shift, this allows two business days' notice of the interest payment.[8]

The final approach, payment delay, simply delays payment for two business days after the interest payment date, except at maturity or early redemption. The interest periods run from and including an interest payment date to but excluding the following interest payment date. Consequently, if an interest period ends on a Friday, holders will be paid their interest on the following Tuesday. For the final interest period prior to maturity or early redemption, a "rate cut-off date" or "lockout" is used, so that the daily SOFR rate in effect a certain number of U.S. government securities business days prior to the maturity or redemption date applies to but excluding the maturity or redemption date, as applicable. For example, with a three-U.S. government securities business day rate cut-off date in effect, if the maturity date is a Friday, the SOFR rate on Tuesday will apply from Tuesday through Thursday, and the holder will be paid on Friday. The Appendix contains a number of other technical explanations relating to compounding and the effect of non-business days. The Appendix also contains a SOFR FRN fallback provision, which puts into a logical order the SOFR replacement provisions originally published by the ARRC in April 2019 in the context of a LIBOR fallback, but tailored for a SOFR cessation.[9]

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[7] In the Matrix, this approach was referred to as "FRNs with Five-Day Lookback and No Lockouts." Note that a "lockout" approach was not used as a main provision in the Appendix, as the market seemed to express concerns that locking in a SOFR rate a certain number of U.S. government securities business days prior to the interest payment date and holding that rate for that number of days created the possibility that an unusually volatile SOFR rate might get locked in for multiple days. However, a lockout is used in the payment delay provision for a brief period prior to maturity or redemption.

[8] In the Matrix, this was referred to as "FRNs with a Two-Day Backward-Shifted Observation Period and No Lockouts."

[9] We discussed the ARRC's LIBOR fallback provisions in our Legal Update found at: http://bit.ly/2rYcccs.

Update on NAIC SVO Consultation on an Updated Definition of Principal Protected Securities

As we have discussed in prior issues of our newsletter, the National Association of Insurance Commissioners' ("NAIC") Valuation of Securities Task Force is developing a definition of "principal protected securities" that are proposed to be removed from the filing-exempt category – meaning that they will need to be filed with the NAIC's Securities Valuation Office ("SVO") in order to receive an SVO designation.

At its last meeting on October 31, 2019, the Task Force discussed comments that had been received from the American Council of Life Insurers ("ACLI"), the North American Securities Valuation Association ("NASVA"), Kroll Bond Rating Agency ("KBRA"), Security Benefit Life Insurance, Delaware Life Insurance Company and Guggenheim Life and Annuity Company. The minutes of the October 31, 2019 meeting summarize the concerns raised in the comment letters:

1. Concern whether the SVO has the capacity and resources to take on the security-by-security evaluation of principal protected securities – the SVO responded it believes it currently has the resources it needs to perform these evaluations, but if it needs more resources, the NAIC will provide them.
2. Concern regarding the specific methodology the SVO would use to analyze the securities – the SVO responded that it has the latitude to interpret how the instructions and methodologies contained in the *Purposes & Procedures Manual* apply to specific securities. This discretion is important given that the securities may take different forms, although the SVO is very likely to apply a variant of the look through weighted average rating factor (WARF) methodology because such a methodology permits the SVO to look at each source of risk.
3. Concern regarding the definition of "principal protected securities" being overbroad and perhaps having unintended effects – the SVO responded that it is happy to work with the ACLI and other interested parties to refine the definition of "principal protected securities" to address such concerns.
4. Concern about whether the proposal, if adopted, would apply retroactively to already owned securities or would only apply to newly acquired securities – the SVO responded that it is recommending that the new requirements become effective for annual statements for the year ending December 31, 2020, which will give insurers a transition period to adjust their portfolios. The SVO opposes any grandfathering because it believes it has identified a risk to insurers that needs to be addressed with respect to insurers' entire portfolios of these types of securities.

At the conclusion of the October 31, 2019 Task Force meeting, the hope was expressed that a revised definition of "principal protected securities" would be prepared in time for the December 8, 2019 Task Force meeting. However, the agenda and materials for the December 8, 2019 meeting have now been posted, and they indicate that the SVO will only provide an oral update at the meeting on the status of the discussions between the SVO and interested parties, and that a new definition is not yet ready for the Task Force to review. It appears, therefore, that the unveiling of a revised definition will occur at an interim meeting of the Task Force in early 2020.

Seminar: Issuing Structured Products into the EU

Wednesday, December 11, 2019
Registration: 8:00am – 8:15am ET
Program: 8:15am – 9:00am ET

To register, please visit our event site.

During this session, members of Mayer Brown's US and EU Structured Products team will speak on offering structured products into the European Union following Brexit and under the new EU Prospectus regulation. The panel will discuss:

- Implications for non-EU issuers;
- What regulations apply;
- Who are the key regulators;
- What do prospectuses look like under the EU Prospectus regulation; and
- How to handle EU/UK parallel offerings in the future.

We will also give an overview of market trends and insights into the still growing German retail market.

Location: Mayer Brown LLP
1221 Avenue of the Americas
New York, NY 10020-1001

2019 GlobalCapital Derivatives Awards

Mayer Brown has been named Global Law Firm of the Year (Overall) at *GlobalCapital's* 2019 Global Derivatives Awards.

Earlier this year, Mayer Brown was named Americas Law Firm of the Year (Overall) at *GlobalCapital*'s Americas Derivatives Awards.

Many thanks to *GlobalCapital* magazine for this recognition and to our clients for their trust in us and continued support.

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 Q3 2019.

LinkedIn Group. Stay up to date on structured and market-linked products news by joining our 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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