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REVERSE inquiries

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IRS Again Extends Phase-In of Section 871(m) Regulations

In This Issue

IRS Again Extends Phase-In of Section 871(m) Regulations 1

FDIC Proposes Changes to Brokered Deposits Restrictions 3

Proposed Sales Practice Rule Affects Leveraged/Inverse ETFs; ETNs and Structured Notes Also in the Crosshairs 5

NAIC Developments Related to Principal-Protected Notes 8

Proposed Amendments to Advertising Rule for Registered Investment Advisers 8

FINRA Tips on ESG Investing 9

Proposed Changes to the Definition of Accredited Investor and the Definition of Qualified Institutional Buyer 9

On December 16, 2019, the Internal Revenue Service (the "IRS") released Notice 2020-2 (the "Notice"),[1] which further extends the phase-in of regulations under Section 871(m) of the Code[2] (the "Regulations")[3] and related provisions. Section 871(m) and its Regulations generally treat "dividend equivalents" paid (or deemed paid) under certain contracts as U.S. source dividends that are subject to withholding tax if paid to a non-U.S. person.

Prior to the release of the Notice, the IRS had issued the following guidance on the Regulations:

- Notice 2010-46 containing the qualified securities lender (the "QSL") regime, published in June 2010;
- Notice 2016-76 delaying the effective date of the Regulations, among other things, published in December 2016, and its corresponding final and temporary regulations published in January 2017;[4]
- Revenue Procedure 2017-15 containing the final Qualified Intermediary Agreement (the "2017 QI Agreement"), published in January 2017;
- IRS Notice 2017-42 providing a similar phase-in of the Regulations and related provisions, published in August 2017; and
- IRS Notice 2018-72 also providing a similar phase-in of the Regulations and related provisions, published in October 2018.[5]

The Notice is a near mirror image of Notice 2018-72, again providing for extensions to four areas related to Section 871(m): (1) the phase-in for non-delta-one transactions, (2) the simplified standard for determining

[1] Notice 2020-2 is available at http://bit.ly/2YRdrXa.

[2] All section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations promulgated thereunder.

[3] For a more detailed discussion of the 2015 final regulations, see http://bit.ly/2ZPqIA6.

[4] For a more detailed discussion of Notice 2016-76, see http://bit.ly/2SKXwbJ.

[5] For a more detailed discussion of Notice 2018-72, see http://bit.ly/39wBSxW.

whether transactions are "combined transactions" within the meaning of the Regulations, (3) relief for qualified derivative dealer ("QDD") reporting,[6] and (4) the transition out of the qualified securities lender (the "QSL") regime. Each of these extensions is discussed in more detail below.

In addition to the Notice, the IRS also released a small set of regulations finalizing some temporary regulations under Section 871(m).[7] Those final regulations do not make significant changes.

Extension of Phase-in for Delta-One and Non-Delta-One Transactions

Under previous IRS guidance, the Regulations would not apply to potential Section 871(m) transactions[8] that were not delta-one and that were entered into before January 1, 2021. The Notice extends this relief for non-delta-one transactions to cover transactions entered into before January 1, 2023.[9] This additional two-year extension is welcome to the structured products market, since a majority of structured products are non-delta-one transactions.

The Regulations still apply to any potential Section 871(m) transaction that has a delta of one entered into on or after January 1, 2017.

Previous IRS guidance provided that 2017-2020 would be phase-in years for delta-one transactions, meaning that the IRS would take into account a taxpayer's or withholding agent's good faith effort[10] to comply with the Regulations when enforcing the same. Prior guidance also provided that through 2020 non-delta-one transactions would be reviewed on this good faith standard. The Notice extends this more lenient enforcement standard through 2022 for delta-one transactions and provides that examinations of non-delta-one transactions will use the good faith standard through 2022. Additionally, previous IRS guidance provided that the IRS would take into account the extent to which a qualified derivatives dealer (a "QDD") made a good faith effort to comply with the Regulations and the relevant provisions of the 2017 QI Agreement through 2020. The Notice extends this similar good faith enforcement standard through 2022.

Extension of the Simplified Standard for Determining Whether Transactions Are Combined Transactions

IRS guidance provides for a simplified standard for withholding agents to apply in determining whether two or more transactions should be combined in order to determine whether the transactions are subject to Section 871(m), namely that a broker may presume that transactions should not be combined for Section 871(m) purposes unless they are over-the-counter transactions that are priced, marketed, or sold in connection with each other. Under the general rule in the Regulations, a short party could have presumed that transactions that

[6] For a more detailed discussion of the QDD rules, see http://bit.ly/2tnBu4f.

[7] Those final regulations are available at http://bit.ly/2FcslhC.

[8] See Treas. Reg. Section 1.871-15(a)(12). A "potential Section 871(m) transaction" is any securities-lending or sale-repurchase transaction, NPC, or ELI that references one or more underlying securities.

[9] The Notice and thus the grandfather for non-delta-one instruments does not apply to a "specified NPC," as described in Treas. Reg. section 1.871-15(d)(1).

[10] Relevant considerations for the determination of good faith include whether a taxpayer or withholding agent made a good faith effort to: (i) build or update its documentation and withholding systems to comply with the Section 871(m) regulations, (ii) determine whether transactions are combined, (iii) report information required under the Section 871(m) regulations, and (iv) implement the substantial equivalence test. *See* Notice 2016-76.

together generate the required dividend equivalent payments are not entered into in connection with each other if either (i) the long party holds the transaction in separate accounts and the short party does not have actual knowledge that the accounts were created separately to avoid Section 871(m) or (ii) the transactions were entered into two or more business days apart. IRS guidance provided a simplified standard for 2017-2020. The Notice extends application of the simplified standard through 2022.

Extension of Phase-ins for QDDs

The Notice extends the same three QDD phase-ins that were pushed until 2021 by prior IRS guidance. Previous IRS guidance provided that a QDD:

- will not be subject to tax on dividends and dividend equivalents received in the QDD's equity derivatives dealer capacity until 2021;
- will be required to compute its Section 871(m) tax liability using a net delta approach beginning January 1, 2021; and
- pursuant to the 2017 QI Agreement must perform certain periodic reviews with respect to its QDD activities, but only beginning in 2021.

The Notice pushes each of these dates back to begin in 2023.

Extension of QSL Transition Rules

Notice 2010-46 contained an early IRS solution to potential overwithholding on a chain of dividends and dividend equivalents (i.e., where an intermediary is withheld upon and subsequently withholds on the same payment stream). The QSL regime provides for (1) an exception to withholding for payments to a QSL, and (2) a framework to credit forward prior withholding on a chain of dividends and dividend equivalents. The QDD rules were meant to replace the QSL regime; however, IRS guidance provided that withholding agents may use the QSL rules for payments made in 2018 through 2020. The Notice provides that withholding agents can use the QSL rules for payments made in 2021 and 2022 as well.

Looking Forward

What will ultimately become of Section 871(m) and its regulations? The tax community has wondered whether non-delta-one transactions might one day become exempt from the Regulations completely. However, with extensions until 2023, Section 871(m) and its regulations may go back on the back burner for the immediate future. The Notice states that taxpayers are permitted to rely on it until the Regulations and the 2017 QI Agreement are amended to reflect the extensions contained in the Notice.

FDIC Proposes Changes to Brokered Deposits Restrictions

On December 12, 2019, the Federal Deposit Insurance Corporation ("FDIC") proposed revisions to the restrictions on brokered deposits (the "Proposal").[11] The Proposal is intended to modernize the FDIC's

[11] Press Release, *FDIC Issues Proposed Rule on Brokered Deposit Restrictions* (Dec. 12, 2019), http://bit.ly/2SO9PEc.

framework for brokered deposits, and would revise both the substantive regulations for brokered deposits and the procedures for requesting exceptions and filing reports.

The Proposal would narrow the scope of the brokered deposits regulation by (i) more explicitly defining who is a deposit broker and (ii) expanding the exclusions for putative brokers that are subsidiaries of the insured depository institution or operate with a primary purpose other than placing funds at depository institutions (the "Primary Purpose Exception").

As is relevant to structured products, the Proposal would define "deposit broker" to include: "Any person engaged in the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties." The FDIC states that this prong of the definition is intended to "capture" the brokered certificate of deposit ("CD") market and would apply to registered broker-dealers who subdivide bank-issued "master CDs" and then sell the modified CDs to brokerage customers. Such arrangements, however, are within the scope of the existing definition of "deposit broker," and, therefore, should not be viewed as an expansion of the restrictions.

With respect to the Primary Purpose Exception, the Proposal would:

1. Expand the Primary Purpose Exception to explicitly be available to an agent or nominee that (i) has assets under management for customers and places less than 25 percent of its total assets under management at depository institution[12] and (ii) places customer funds in transactional accounts at a depository institution to enable transactions or make payments. The assets under management option appears to be designed for broker-dealers that sweep uninvested cash balances into deposit accounts, so long as those cash balances do not exceed 25 percent of the broker's assets under management.
2. Provide that assets under management will be measured based on the total market value of all financial assets that are managed on behalf of customers that participate in a particular business line of an agent or nominee.[13] The inclusion of a business line element in this provision is intended to prevent brokers from amalgamating unrelated business lines to satisfy the 25 percent aggregate threshold discussed above.
3. Clarify that the Primary Purpose Exception will not be available if the purpose of the broker's relationship with the customer is to encourage savings, maximize yield, or provide deposit insurance, or has a similar purpose to those examples.
4. Provide a formal process for institutions and putative deposit brokers to apply to qualify for the Primary Purpose Exception (including arrangements beyond the assets under management and enabling transactions), thus allowing persons who would otherwise be deposit brokers to not be treated as such.

It is expected that a portion of existing brokered deposits would no longer be characterized as brokered under the Proposal. While such deposits may be subject to certain reporting requirements, they would not be subject

[12] This action would effectively codify the industry-wide relief provided in Advisory Opinion 05-02, although it would be more generous than the staff relief. *See* FDIC, Adv. Op. 05-02 (Feb. 3, 2005).

[13] A "business line" would be defined as the group of customers for whom the agent or nominee places or facilitates the placement of deposits as part of a broader business relationship.

to the general restrictions on brokered deposits or the less favorable treatment for brokered deposits under the Liquidity Coverage Ratio and deposit insurance assessments.[14]

Comments on the Proposal must be submitted to the FDIC within 60 days of publication in the Federal Register. Please stay tuned for Mayer Brown's more fulsome alert and webinar on the Proposal in early 2020.

Proposed Sales Practice Rule Affects Leveraged/Inverse ETFs; ETNs and Structured Notes Also in the Crosshairs

On November 25, 2019, the Securities and Exchange Commission ("SEC") re-proposed Rule 18f-4, a new rule under the Investment Company Act of 1940 (the "1940 Act"), which is designed to address the investor protection purposes and concerns underlying Section 18 of the 1940 Act, and update the SEC's approach to the regulation of funds' use of derivatives. The proposed rule would apply to, among others, exchange-traded funds ("ETFs").[15]

The Release also proposed two new sales practice rules, which would require a broker, dealer or investment adviser that is registered (or required to be registered) with the SEC (a "RIA") under the Investment Advisers Act of 1940 (the "Advisers Act") to exercise due diligence in approving a retail customer's or client's account to buy or sell shares of certain "leveraged/inverse investment vehicles" before accepting any order from, or placing an order for, the customer or client to engage in these transactions.[16] The proposed sales practice rules are designed to address specific risks posed by "leveraged/inverse investment vehicles," which include registered investment companies and exchange-listed or commodity- or currency-based trusts or funds that seek, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specific multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time, generally on a daily basis.[17]

Proposed Rule 15*l*-2 under the Securities Exchange Act of 1934 ("the Exchange Act") would require a broker-dealer (or any of its associated persons) to exercise due diligence to ascertain certain essential facts about a customer who is a retail investor before accepting the customer's order to buy or sell shares of a leveraged/inverse ETF, or approving the customer's account to engage in those transactions. Proposed Rule 211(h)-1 under the Advisers Act would have a similar effect on an RIA. Under both of these proposed rules, a firm could approve the retail investor's account to buy or sell shares of a leveraged/inverse ETF only if the firm had a reasonable basis to believe that the investor is capable of evaluating the risks associated with these products.[18]

[14] The preamble to the Proposal notes that the FDIC is considering further modifications to its deposit insurance assessment regulations.

[15] Release No. 34-87607 (Nov. 25, 2019) (the "Release") is available at: http://bit.ly/39BkXKu.

[16] The proposed sales practice rules are contained in Rule 15*l*2 under the Securities Exchange Act of 1934 and Rule 211(h)-1 under the Advisers Act.

[17] See the Release at 13 and FN13. For the purposes of this article, we will refer only to ETFs.

[18] See the Release at 181-182.

The SEC noted in the Release that compliance with the proposed rules would not supplant, by itself, other broker-dealer or investment adviser obligations, such as a broker-dealer's obligations under Regulation Best Interest or a RIA's fiduciary duty under the Advisers Act. The Release did not mention broker-dealers' obligations under Financial Industry Regulatory Authority, Inc. ("FINRA") Rule 2111 (Suitability), perhaps because the market anticipates that Regulation Best Interest will essentially supplant FINRA Rule 2111's suitability requirements.

The proposed sales practice rules are modeled on current FINRA rules governing options account approval requirements for broker-dealers.[19] Under these FINRA rules, a broker-dealer may not accept a customer's options order unless the broker-dealer has approved the customer's account for options trading. The SEC used these FINRA rules as a model because leveraged/inverse ETFs, when held over longer periods of time, may have certain similarities to options. Like the FINRA rules, the proposed sales practice rules would not require firms to evaluate retail investors' eligibility to transact in these products on a transaction-by-transaction basis.

In the Release, the SEC requested comments on a number of aspects of the proposed sales practice rules, including the definition of "leveraged/inverse investment vehicle." Request for comment number 173 asks whether the scope of the definition should be expanded to include exchange traded notes ("ETNs") with the same or similar return profile as, for example, a leverage/inverse ETF. The same request for comment also asks whether additional "complex products," such as those discussed in FINRA Regulatory Notice 12-03 (including, among others, certain structured or asset-backed notes, unlisted REITs, securitized products, and products that offer exposure to stock market volatility) should be subject to the same due diligence and account approval requirements as in the proposed sales practice rules.[20]

The proposed due diligence requirement provides that a broker-dealer must exercise due diligence to ascertain the essential facts relative to the retail investor, his or her financial situation, and investment objectives. At a minimum, a firm must seek to obtain information about a retail investor's:

- investment objectives and time horizon;
- employment status;
- estimated annual income;
- estimated net worth;
- estimated liquid net worth;
- percentage of the retail investor's liquid net worth that he or she intends to invest in the leveraged/inverse investment vehicles; and
- investment experience and knowledge regarding leveraged/inverse investment vehicles, options, stocks and bonds, commodities and other financial instruments.[21]

After evaluating this information, a firm would be required to specifically approve or disapprove the retail investor's account for purchase or sale of a leveraged/inverse ETF. An approval must be in writing. The firm

[19] See FINRA Rule 2360(b)(16), (17) (requirements for options accounts firm approval, diligence and recordkeeping). Release at 183.

[20] See the Release at 186-187.

[21] See the Release at 188.

must have a reasonable basis for believing that the retail investor has the financial knowledge and experience to be reasonably expected to be capable of evaluating the risks of buying and selling leveraged/inverse ETFs. According to the SEC, this would not be a bright-line determination; rather, it would be based on all relevant facts and circumstances.

A "retail investor" is limited to a "natural person" or "a legal representative of a natural person," with the definitions aligning with the definitions used in Regulation Best Interest. High net worth individuals are considered retail investors.

The proposed rules would require firms to adopt and implement written policies and procedures addressing compliance with the applicable rule.

One of the requests for comment (number 187) asks whether the proposed rule should require firms to provide a short, plain-English disclosure generally describing the risks associated with inverse/leveraged ETFs (such as risks relating to compounding and other risks that the inverse/leveraged ETFs disclose in their prospectuses).

Why the concern about leveraged/inverse ETFs?

As discussed in the Release, leveraged/inverse ETFs rebalance their portfolios on a daily (or other predetermined) basis to achieve a constant leverage ratio. As a result, the reset, and the effects of compounding, can result in performance over longer holding periods (even for longer than one day) that differs significantly from the leveraged or inverse performance of the underlying reference asset (such as an index) over the same holding periods. Consequently, buy-and-hold investors who have an intermediate- or long-term time horizon, and who may not evaluate their portfolios frequently, may experience large and unexpected losses or otherwise experience returns that are different from what was expected.[22]

As a result, inappropriate sales of leveraged/inverse ETFs and ETNs have been the focus of regulatory scrutiny for a long time. Both FINRA and the SEC have issued investor alerts regarding leveraged/inverse ETFs and ETNs with daily resets.[23] There have also been a number of enforcement actions relating to inappropriate sales to retail investors of leveraged/inverse ETFs and ETNs, including sales into retirement accounts.[24]

Issuers are well aware of the regulatory concerns about leveraged/inverse ETFs and ETNs, particularly those with daily resets. Offering documents for leveraged/inverse ETNs with daily resets normally include fulsome risk factor disclosure about the potential negative effects of compounding and leveraged inverse exposure, and also warnings that they should not be purchased by investors as a buy-and-hold investment. These offering documents also warn investors that they should not purchase the leveraged/inverse ETNs unless they are sophisticated investors who plan to monitor their investments on a daily basis.

With the proposed sales practice rules, the SEC is adding another layer of protection for retail investors in leveraged/inverse ETFs. However, structured notes issuers should take note of potential regulatory over-reach,

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[22] Release at 178-179.

[23] See FINRA Regulatory Notice 09-31 (FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds); SEC Investor Alert (Aug. 1. 2009) (Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors); FINRA Investor Alert (July 10, 2012) (Exchange-Traded Notes-Avoid Unpleasant Surprise); and SEC Investor Bulletin (Dec, 1, 2015) (Exchange Traded Notes (ETNs)).

[24] See Reverse Inquiries, Vol. 2, Issue 9, available at: http://bit.ly/2VbyzWf, discussing a FINRA Letter of Acceptance, Waiver and Consent. See also the Release at FN 315.

particularly request for comment 173, which asks whether ETNs and certain “complex products” covered in FINRA Regulatory Notice 12-03 should also be subject to the proposed sales practice rules.

NAIC Developments Related to Principal-Protected Notes

At the NAIC Valuation of Securities (E) Task Force meeting on December 8, 2019 the SVO director and task force chair provided the following update regarding the initiative relating to “principal protected securities“:

The SVO has been working with industry representatives, particularly the American Council of Life Insurers (ACLI), to refine the definition of “principal protected securities.” They are taking seriously the concern that the definition needs to be carefully drafted so as not to be inadvertently over-inclusive.

Two examples of securities that the SVO wants to make sure are *excluded* from the definition are defeasance bonds and *bona fide* securitizations. The revised definition of “principal protected securities” that will be forthcoming in 2020 will be more “robust“ and will include examples. It may not be until mid-February before the revised definition is available.

Three types of characteristics were mentioned as likely to bring a security *within* scope of the (revised) definition:

1. When the security includes underlying performance assets that are intended to provide additional returns above the “promised” return.
2. When the underlying fixed-income asset has a below-market return for its tenor, such that an insurer would not have invested in it on a standalone basis.
3. When the security results in a more favorable risk-based capital treatment than if the insurer had owned the underlying assets directly.

A representative of the American Council of Life Insurers (ACLI) spoke briefly to express appreciation on behalf of the ACLI for the SVO’s willingness to work with industry in refining the definition. There was nothing said at the meeting that would suggest that the SVO or Task Force will be revisiting the decision (evident on the October 31, 2019 conference call) not to change course on the retroactivity issue raised by some of the original commenters. Rather, the comment they have taken on board is the call for a more carefully drafted definition of “principal protected securities.” Having said that, it is clear that the process has slowed down, and that a lot of thought and deliberation, including input from the ACLI, is going into developing the revised definition — and that is a welcome development.

Proposed Amendments to Advertising Rule for Registered Investment Advisers

In November 2019, the SEC proposed amendments to the advertising rules promulgated under the Advisers Act for RIAs. Among other things, the proposed rules would allow the use of hypothetical performance, related performance, and extracted performance subject to satisfaction of certain conditions. An RIA would be required to adopt policies and procedures reasonably designed to ensure that hypothetical performance is disseminated only to persons for whom it is relevant to their financial situation and investment objectives. The hypothetical information would have to be accompanied by disclosure related to the criteria used, the assumptions made and the limitations of, and associated risks of reliance on, the information. Perhaps if adopted these amended rules relating to hypothetical performance may provide a useful analogy for structured products marketing materials that frequently include hypothetical backtested data.

FINRA Tips on ESG Investing

The appetite for socially responsible investing has intensified over the past decade, with particular emphasis on environmental, social and governance ("ESG") factors. This trend has led wealth managers, broker-dealers and investment advisers to examine ESG factors of public companies through public filings and disclosures as an increasing number of retail investors are becoming more interested in ESG investments, including structured products linked to ESG-themed indices.

On December 11, 2019, FINRA published an article explaining how each ESG investment "is unique, and should be evaluated on its own terms." This type of investment uses a variety of ESG criteria in selecting specific investment components with the primary aim of generating competitive financial returns while enabling a positive impact on society. Positive impacts on the environment may include clean energy technology and water conservation; on society, the promotion of human rights, gender equality, fair labor standards and safe working conditions; and on governance, anti-bribery and corruption policies and board diversity.

FINRA reminded ESG investors to keep these tips in mind:

1. Know one's investment goals and risk tolerance.
2. Understand the ESG fund's investment criteria.
3. Be alert to potential "green washing."
4. Do a values check.
5. Stay diversified.
6. Be prepared for lack of "criteria consistency."
7. Be on the lookout for "green" scams.
8. Look beyond marketing materials.
9. Know and compare fees.

For more details, a copy of the FINRA article is available here.

Proposed Changes to the Definition of Accredited Investor and the Definition of Qualified Institutional Buyer

On December 18, 2019, the SEC approved a proposing release for public comment that would amend the definition of "accredited investor," as well as amend the definition of "qualified institutional buyer." Many structured note issuers include a Regulation D offering alternative in their continuous issuance programs, which would be affected by these amendments, if adopted. The Regulation D offerings typically rely on the Rule 506(b) safe harbor and allow for offers and sales to be made solely to "accredited investors." The changes set forth in the SEC's proposing release would have the effect of broadening the potential universe of individuals and entities that might qualify as accredited investors. In particular, the proposed amendments to the accredited investor definition would add new categories of natural persons based on professional knowledge, experience or certifications (such as Series 7, 65 and 82 licenses) and would leave intact the current net income and asset tests. Knowledgeable employees of private funds also would be considered accredited investors eligible to invest in their funds. The proposed amendments would also add new categories of entities, including a "catch-all" category for any entity owning in excess of $5 million in investments so long as it is not formed for purposes of investing in the offered securities. Family offices with at least $5 million of assets under management and their family clients would be considered accredited investors. Qualified institutional buyers (QIBs) would be considered accredited investors, and certain limited liability companies would also qualify as accredited investors. The proposed amendments would similarly expand the definition of a QIB to include additional entities.

2019 GlobalCapital Derivatives Awards

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

In 2019, Mayer Brown was also 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.

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