

# REVERSEinquiries

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

## CARES Act Resources

The US government has enacted three aid packages to provide economic and fiscal relief due to the novel coronavirus ("COVID-19"). The Phase 3 aid package, signed into law on March 27, 2020, and known as the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"), authorizes approximately \$2 trillion in federal stimulus funds to combat the crisis.

We have compiled relevant links for quick reference to the various CARES Act provisions, including provisions relating to small business loans (SBA), business liquidity, tax benefits, employer mandates, government contracts, military housing, transportation & infrastructure, and aid to state and local governments.

Please visit our [CARES Act Resource Page](#) to access the links.

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## FINRA Proposes to Amend its Suitability Rule In Response to Regulation Best Interest

On March 19, 2020, the Financial Industry Regulatory Authority, Inc. ("FINRA") submitted to the Securities and Exchange Commission ("SEC") a notice of filing of a proposed rule change to FINRA Rule 2111, and certain other FINRA rules.<sup>1</sup> The proposed changes to Rule 2111 would add a new paragraph .08 to the Supplementary Material clarifying that Rule 2111 would be limited to situations in which Regulation Best Interest ("Reg BI") does not apply, and also remove the element of "control" from the quantitative basis suitability obligation.

FINRA proposes to amend Rule 2111 in order to provide clarity regarding the standard applicable to broker-dealers and their associated persons and to address inconsistencies with Reg BI. Reg BI addresses the same conduct that is addressed by Rule 2111, but employs a best interest, rather than a suitability, standard, and also

<sup>1</sup> SR-FINRA-2020-007 can be found at: <https://bit.ly/2S1NnGL>.

explicitly requires a consideration of costs. The proposed changes would avoid having a broker-dealer or associated person being required to comply with both Reg BI and Rule 2111.

Reg BI, which goes into effect on June 30, 2020, establishes a standard of conduct for broker-dealers and their associated persons when making a recommendation to a retail customer of any securities transaction or investment strategy involving securities.<sup>2</sup>

Rule 2111 imposes three main suitability obligations: a reasonable basis suitability obligation, a customer-specific suitability obligation, and a quantitative suitability obligation. Quantitative suitability requires a broker-dealer or associated person who has actual or de facto control over a customer's account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive or unsuitable for the customer when taken together in light of the customer's investment profile.<sup>3</sup>

Reg BI's "best interest" standard consists of four component obligations: disclosure, care, conflict of interest and compliance. Specifically, the care obligation incorporates and builds upon the three suitability obligations of Rule 2111. In addition to enhancing the Rule 2111 suitability obligations by imposing a best interest standard, the care obligation requires a greater emphasis on a consideration of reasonably available alternatives. The care obligation also eliminates the "control" aspect of the quantitative suitability obligation.

FINRA proposes to add Supplementary Material .08 to FINRA Rule 2111, which will read that "[t]his Rule shall not apply to recommendations subject to [Reg BI]." While Reg BI will apply to recommendations to retail customers, as defined in Reg BI, Rule 2111 will still be needed for entities and institutions, and natural persons who will not use the recommendations primarily for personal, family or household purposes. For example, Rule 2111 would continue to apply to a recommendation to a natural person who is a small business owner, or a recommendation to a charitable trust.

Consistent with the Reg BI care obligation, the control element found in Supplementary Material .05(c) is being proposed to be removed from the Rule 2111 quantitative suitability obligation, which is consistent with FINRA's proposed amendments to the quantitative suitability obligation, which were released prior to Reg BI having been approved.

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## SEC Office of Compliance Inspections and Examinations Publishes Risk Alerts Relating to Upcoming Reg BI and Form CRS Compliance Inspections

On April 7, 2020, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued two risk alerts, one for initial examinations that will focus on Reg BI, and the other for initial examinations that will focus on Form CRS.<sup>4</sup> The initial examinations for Reg BI will focus on assessing whether broker-dealers have made a good faith effort to implement policies and procedures reasonably designed to comply with Reg BI, including the operational effectiveness of broker-dealers' policies and procedures. The initial examinations of Form CRS

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<sup>2</sup> For a detailed discussion of Reg BI, see our Legal Update at: <https://bit.ly/2KeXSC8>.

<sup>3</sup> See FINRA Rule 2111.05

<sup>4</sup> The Reg BI alert can be found at: <https://bit.ly/34LKqzd> and the Form CRS alert can be found at: <https://bit.ly/2XIDdhN>.

will focus on assessing whether firms have made a good faith effort to implement Form CRS, including reviewing the filing and posting of a firm's relationship summary as well as its process for delivering the relationship summary to existing and new retail investors.

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## SEC Public Statement for Main Street Investors

On April 2, 2020, the SEC issued a public statement<sup>5</sup> by Chairman Jay Clayton assuring the public that, despite the recent SEC initiatives arising from uncertainties caused by the COVID-19 pandemic, the SEC's commitment to investor protection and market integrity remains unchanged.

Chair Clayton emphasized that the securities laws shall continue to apply even during these unprecedented circumstances. Chair Clayton reminded public companies and other persons to continuously provide materially accurate and complete disclosures in accordance with the federal securities laws, including, if warranted, the disclosure of the potential effects of COVID-19 on their operations.

In the same public statement, Chair Clayton noted that the SEC has not extended the June 30, 2020 compliance date for Reg BI and other requirements, including the requirement to file and begin delivering Form CRS. Form CRS and its related rules require each SEC-registered investment adviser and broker-dealer to deliver to every retail investor a brief customer or client relationship summary that provides information about the firm, and file such relationship summary with the SEC.

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## SEC Charges Broker-Dealer in Connection with Making Unsuitable Recommendations of Single-Inverse ETF Investments

The SEC announced on February 27, 2020 that it had settled charges against two entities of a broker-dealer after charging said broker-dealer with improper investment recommendation practices. The SEC stated the broker-dealer not only failed to reasonably supervise investment advisers and registered representatives who had recommended single-inverse exchange traded fund ("ETF") investments to retail investors, but also lacked adequate compliance policies and procedures with respect to the suitability of those recommendations. The broker-dealer agreed to a \$35 million penalty to be distributed to those investors who were harmed from holding these single-inverse ETF investments.<sup>6</sup>

Single-inverse ETFs generate results that track the opposite of the performance of a selected index for a specific trading period. These investments are generally meant to be held for a day, but if held longer, investors could face the prospect of large and unanticipated losses. Accordingly, these investments would be more suitable to knowledgeable investors who fully understand the associated risks. FINRA released Regulatory Notice 09-31 in June 2009, which specifically called out single-inverse ETFs and stressed the obligation of securities firms to have "adequate supervisory procedures" "based on a full understanding of the terms and features of the

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<sup>5</sup> Available at <https://bit.ly/2RO730r>.

<sup>6</sup> Press Release 2020-43. This Press Release is available at <https://bit.ly/3bgRWUY>.

product recommended” if they were to recommend said products to clients.<sup>7</sup> The prospectuses for these single-inverse ETFs highlight that investors could lose money when the level of the index is flat or if the level of the index falls and even state that these investments should be actively monitored as frequently as daily.

This broker-dealer in question settled another action for similar conduct prior to July 2009, and had publicly stated that it had enhanced all policies and procedures to better meet clients’ needs and regulatory duties.<sup>8</sup> While the broker-dealer did have internal guidance regarding the riskiness of single-inverse ETFs, the SEC order found that for a period of over seven years (from April 2012 through September 2019), those internal policies and procedures were not reasonably designed to detect recommendations of single-inverse ETFs that were unsuitable to clients (alleging a violation of Section 206(4) of and Rule 206(4)-7 under the Investment Advisers Act of 1940 (the “Advisers Act”). Furthermore, the SEC order stated that the broker-dealer also failed to provide adequate supervision of its employees with regards to their training concerning single-inverse ETFs and their recommendations of these products (alleging a violation of Section 203(e)(6) of the Advisers Act). The order further alleges that some of the broker-dealer’s advisers did not fully understand the risk of these products when held for longer periods and made recommendations to vulnerable clients with conservative or moderate risk tolerances and limited incomes to hold these unstable single-inverse ETF products for months or years. These clients were not speculative day traders for the most part and many lacked the proper training or tools to understand the risks associated with these products. In some cases these clients were also not aware of the need to actively monitor these investments. The SEC order also alleged that the broker-dealer did not adopt adequate written compliance policies to prevent these recommendations while also failing to adequately implement those policies already in place. The SEC alleged that this constituted unsuitable recommendations to clients and was a violation of Section 17(a)(3) of the Securities Act of 1933. Accordingly, the order also states that the broker dealer failed to “reasonably to supervise its financial advisors with a view to preventing the financial advisors’ violations of the antifraud provision” in violation of Section 203(e)(6) of the Advisers Act and Section 15(b)(4)(E) of the Securities Exchange Act of 1934. The order argues that the clients of the broker-dealer collectively sustained millions of dollars of losses due to the single-inverse ETF positions. “Firms must maintain effective compliance and supervisory programs to ensure that the securities they recommend are suitable for their clients,” Antonia Chion, Associate Director of the SEC enforcement division, said in a statement. According to the SEC, the broker-dealer in question did not meet this standard.

Regulatory actions against misselling leveraged ETFs are an ongoing theme, and this action echoes recent FINRA enforcement proceedings in 2019. See our article at: <https://bit.ly/2VkQZ8N>.

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## The ARRC Announces New Milestones in the Forced March to SOFR

The Alternative Reference Rates Committee (“ARRC”) made several recent announcements relating to the transition from U.S. dollar LIBOR to the secured overnight financing rate (“SOFR”).

One of the missing pieces in the ARRC’s recommended fallback provisions for USD LIBOR floating rate notes was the spread adjustment to be used with the SOFR replacement rate. The spread adjustment is designed to

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<sup>7</sup> Regulatory Notice 09-31. This Regulatory Notice is available at <http://bit.ly/2n2EWP6>.

<sup>8</sup> SEC Order Instituting Administrative and Cease-and-Desist Proceedings available at <https://bit.ly/2xD0QO3>.

adjust for the inherent differences between USD LIBOR and SOFR: USD LIBOR is a forward-looking secured rate that incorporates an element of bank credit risk, while SOFR is a backward-looking secured “risk-free” rate. The use of a spread adjustment should minimize any change in value when a USD LIBOR floating rate note, for example, pursuant to its fallback provisions, switches over to SOFR as the base rate.

On April 8, 2020, the ARRC announced that it is recommending a spread adjustment methodology based on a historical median over a five-year lookback period calculating the difference between USD LIBOR and SOFR.<sup>9</sup> The five-year median spread adjustment methodology matches the methodology recommended by the International Swaps and Derivatives Association (“ISDA”) for derivatives and would make the ARRC’s recommended spread-adjusted version of SOFR comparable to USD LIBOR and consistent with ISDA’s fallbacks for derivatives markets.<sup>10</sup> A more detailed analysis about the recommended spread adjustment will be published in the future by the ARRC.

On April 17, 2020, the ARRC announced its “key objectives” for 2020. Two elements are of interest to issuers of floating rate notes.<sup>11</sup>

By September 30, 2020, the ARRC seeks to establish a “request for proposal” process and criteria for recommendations in order to select an administrator of an ARRC-recommended forward-looking term SOFR rate to be published in the first half of 2021 if liquidity in SOFR derivatives markets has developed sufficiently, and also establish recommended scopes of use for such a term rate.

A forward-looking term SOFR rate is the first fallback in the ARRC’s recommended fallback provisions for USD LIBOR floating rate notes. However, it does not exist. Subject to the caveat above about sufficient SOFR derivatives liquidity, we could see the missing term rate in the first half of 2021.

The second item of interest is the ARRC’s goal to establish final recommended conventions for SOFR-based floating rate notes by July 31, 2020. This should be of interest because, although there have been a number of SOFR floating rate note and certificate of deposit issuances, the market is still developing and has not been consistent with respect to interest rate calculations.

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<sup>9</sup>The ARRC’s spread adjustment methodology announcement can be found at: <https://nyfed.org/3eEEP1S>.

<sup>10</sup>For a more detailed discussion of the ARRC’s consultation on spread adjustments, see our article at: <http://bit.ly/2uXrYpi>.

<sup>11</sup>The ARRC’s 2020 Objectives can be found at: <https://nyfed.org/2VNxEfc>.

## COVID-19 Resources

**All COVID-19 related alerts and events can be found on our [COVID-19 web portal](#).**

### **Selected COVID-19-related Legal Updates** (titles are hyperlinked)

- [Equity funding options for issuers in light of the COVID-19 pandemic](#)
- [Debt Restructuring During the COVID-19 Pandemic – Key Tax Considerations](#)
- [Chair Clayton and Division Director Hinman Issue Public Statement on the Importance of Disclosure in the Current COVID-19 Environment](#)
- [COVID-19 and Managing the Loss of WCSI Status](#)
- [COVID-19: FINRA Addresses U.S. Broker-Dealer Preparedness and Regulatory Relief in Regulatory Notice 20-08](#)
- [COVID-19 Business Continuity Updates for Commodity Futures Trading Commission Registrants and National Futures Association Members](#)
- [CFTC Issues Additional COVID-19 Relief for Remote Derivatives Trading](#)
- [NYDFS Instructs Insurers to Provide COVID-19 “Explanation of Benefits” for All Business Interruption Coverage and Report to NYDFS on Operational and Financial Preparedness](#)
- [COVID-19: US SEC Staff Offers Relief for RIAs and Funds](#)
- [COVID-19: Material Adverse Change Clauses in US Contracts](#)
- [COVID-19: US SEC Provides Temporary, Conditional Relief to Funds and Advisers](#)
- [Initial US Federal and State Tax Relief Developments Relating to COVID-19](#)
- [COVID-19 UK Emergency Legislation](#)
- [COVID-19 Contractual performance – Force Majeure clauses and other options: a global perspective](#)
- [Stimulus Measures of the US Federal Government to Address COVID-19](#)
- [COVID-19: Recent SEC Responses applicable to Investment Advisers and Funds](#)
- [COVID-19: Compliance and Operational Risks for Financial Institutions: EU Financial Authorities Provide Initial Guidance](#)

## Upcoming CLE Events

- **REVERSEinquiries Workshop: US Taxation of Structured Notes (Mayer Brown Webinar)**

April 28, 2020 | 1:00 p.m. – 2:00 p.m. ET | Register here: <https://bit.ly/34Mdre8>.

This presentation will address the current US tax rules and any new developments regarding structured products, including: The proper tax characterization of structured notes; The dividend equivalent provisions and current state of play; The IRS basket option notice; and PFIC and FIRPTA considerations.

- **Brexit: Where Are We Now?** (PLI Webinar)

May 6, 2020 | 11:00 a.m. – 12:00 p.m. ET | Register here: <https://bit.ly/2ykoter>.

The United Kingdom finally exited the European Union on January 31, 2020 ... what does that mean? What will happen next and how should businesses plan for the future? In this presentation, we will discuss: The current state of Brexit and any recent developments; Implications of Brexit for financial markets and global securities laws; The implications of Brexit for relations between the UK and the US, including the potential impact on trans-Atlantic business; The different perspectives on Brexit from the EU and UK, how they differ and why that is important; and COVID-19 and how it impacts Brexit, including any impact on the timetable for the next stages of Brexit.

### 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 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](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).



Mayer Brown is pleased to be shortlisted once again for **Americas Law Firm of the Year** for *GlobalCapital's* Americas Derivatives Awards 2020.

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



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).

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