

REVERSEinquiries

Structured and market-linked product news for inquiring minds.

FINRA Reminds Dealers about Sales Obligations Relating to Oil-linked ETPs

On May 15, 2020, the Financial Industry Regulatory Authority, Inc. ("FINRA"), in Regulatory Notice 20-14 (the "Notice"), discussed its concerns relating to sales of exchange-traded products ("ETPs") that provide exposure to the oil market.¹ The price of oil, as we all know, has been extremely volatile lately, plunging to unprecedented lows. Consequently, oil-linked ETPs have experienced significant volatility, and some have lost a substantial percentage of their value.

CHARACTERISTICS OF THE MARKET

Oil-linked ETPs are not linked to the spot price of oil. Rather, they track oil futures, through an index of monthly futures contracts, in the case of exchange-traded notes ("ETNs"), or they actually hold a portfolio of futures contracts (or other commodity interests), in the case of commodity pools. One of the concerns raised by FINRA in the Notice is the lack of understanding by investors and sales representatives of the differences between these underlying assets and the spot price of oil. The Notice states that, based on experience with similar complex products, "some retail investors and investment professionals recommending oil-linked ETPs, including commodity pools and ETNs, may have mistakenly thought that these ETPs are a proxy for the spot price of oil, when in fact their investment objectives are to track oil futures contracts."

Volatile markets and investor demand can cause both ETNs and commodity pool ETP shares to behave erratically, or "unhinge," from the value of the underlying commodity. For commodity pool ETPs, the example in the Notice was that due to investor demand, the ETP commodity pool reached the maximum number of shares available under its registration statement. Unable to issue new shares, demand exceeded supply, causing significant variations between the market price of the ETP's shares and the ETP's net asset value.

A similar situation occurred when an ETN issuer called its oil futures-linked ETN and stopped creations of new units. The issuer's press release noted that the issuance suspension could cause fluctuations in the trading

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¹Regulatory Notice 20-14 is available at: <https://bit.ly/2zAq94I>.

value of the ETNs, and that, due to supply and demand, the ETNs had been trading at a premium to the closing indicative value.

Another aspect of oil-linked ETPs that retail investors or investment professionals recommending such ETPs may not understand is the effect of the regular replacement of the underlying expiring existing contracts with new contracts of the same maturity, in order to maintain that maturity in the index or portfolio. If a 3-month contract is being replaced at the end of its term with a new 3-month contract that is more expensive, the market is said to be in "contango," with the cost of purchasing the more expensive contract potentially causing a loss to the index or portfolio. If the new replacement contract is less expensive than the contract being replaced, the market is said to be in "backwardation," which may lead to gains. Over time, these losses or gains can cause the value of the underlying index or portfolio to significantly diverge from the spot price of the commodity.

FINRA'S SALES PRACTICES RECOMMENDATIONS

FINRA reiterated its concerns about recommendations of complex products to retail customers, citing Regulatory Notice 12-03, and reminded firms to consider whether to use the heightened scrutiny and supervision suggested therein for complex products.²

Regarding suitability under FINRA Rule 2111 and satisfying the "customer-specific" prong of that rule, and the requirement that a recommendation be suitable for a particular customer based on the customer's investment profile, including risk tolerance, FINRA stated that "an oil-linked ETP might be suitable for an experienced customer with a speculative investment objective, but it likely would not be suitable for a less experienced customer or a customer with a more conservative or buy-and-hold investment objective."

Associated persons of dealers must understand what they are recommending – in this case, an understanding of the products' main features and associated risks, how oil-linked ETPs work, the effect of contango and backwardation, and how oil-linked ETPs may perform as opposed to the spot price of oil, particularly over long time periods. The associated person should also understand the difference between oil-linked ETNs and commodity pools, and the effect of a call on the ETNs or a suspension of issuance of an ETN or a commodity pool.

After June 30, 2020, firms should consider how any recommendation of an oil-linked ETP will comply with Regulation Best Interest.

Another concern raised by FINRA was compliance with Rule 2210 (Communications with the Public) in relation to communications regarding oil-linked ETPs. Such communications must, according to FINRA:

- Balance any discussion of benefits with a clear explanation of the risks, which would include:
 - The inherent fluctuations of oil prices;
 - The speculative nature of futures investments; and
 - A clear explanation that the ETP's price will not track directly the spot price of oil;

²FINRA Regulatory Notice 12-03 can be found at: <https://bit.ly/3gvNZP8>.

- Not omit any material fact or qualification that would cause such communication to be misleading;
- Explain the effect on the investment of contango and backwardation; and
- If the ETP is designed to achieve its investment objective on a short-term, such as daily, basis, explain that the ETP is not designed to track the underlying index or asset over a longer period of time.

FINRA specifically reminded member firms that having sufficient disclosure in a separate document, such as a prospectus, will not cure otherwise non-compliant sales materials, even if those sales materials are preceded or accompanied by a prospectus. In other words, the sales materials must stand alone under a Rule 2210 analysis.

Under the supervision requirements of FINRA Rule 3110, firms must act reasonably to ensure that their registered representatives and supervisors understand the risks presented by oil-linked ETPs. Registered persons of firms must be trained to understand the terms, features and risks of oil-linked ETPs, as well as the factors that would make such products either suitable or unsuitable for investors, particularly retail investors.

The ARRC Releases a New Sample Termsheet for the SOFR Index and Follows Up on Its Spread Adjustment Consultation

On May 6, the Alternative Reference Rates Committee (the "ARRC") published a statement and a sample termsheet on how to use the new SOFR Index with floating rate notes.³

The SOFR Index is an alternative to the calculation methods in three previously published ARRC sample termsheets for SOFR floating rate notes.⁴ Under the previous methods, essentially, SOFR (the secured overnight financing rate) was measured each day in the interest period, compounded, and the interest rate for the period was calculated.

The SOFR Index measures SOFR, compounded since April 2, 2018, the first date of publication of SOFR. For a SOFR floating rate note with a base rate of the SOFR Index, the interest rate would be calculated by comparing the SOFR Index levels at the start and end dates of the interest period. The interest period can be of any length. The compounding is reflected in the index level. Just like a structured note linked to the performance of the SPX measured at two points, the result could be a negative or zero interest rate. Consequently, issuers should build in an interest rate floor of zero.

The sample termsheet uses a "shifted observation period," wherein the period when interest is measured is a certain number of U.S. Government Securities Business Days prior to the first day of the interest period, and the same number of days prior to the interest payment date.

On the same day, the ARRC released a supplemental consultation on its spread adjustment methodology.⁵ The supplemental consultation summarizes feedback received by the ARRC on its original consultation of January 2020, and seeks further input on certain technical details of the spread adjustment. The spread adjustment is designed to be used in the ARRC-recommended fallback provisions for U.S. dollar LIBOR floating rate notes.

³The ARRC's statement on the use of the SOFR Index is available at: <https://nyfed.org/2M0VnnV>.

⁴We previously discussed the ARRC's three earlier termsheets at: <https://bit.ly/2XwcnQ>.

⁵The supplemental consultation is available at: <https://nyfed.org/2ZJw7KH>.

These fallback provisions provide that the U.S. dollar LIBOR rate will fall back to SOFR upon a LIBOR cessation. The spread adjustment is designed to minimize value transfer between the U.S. dollar LIBOR rate and SOFR, which are inherently different rates.

FINRA Identifies Common Firm Practices in Preparing for Regulation Best Interest

FINRA reported⁶ some initiatives commonly undertaken by broker-dealers and investment advisers in preparing to comply by June 30, 2020 with Regulation Best Interest (“Reg BI”) and the required brief relationship summary on Form CRS. These initiatives include:

1. project teams, workstreams or working groups to lead and manage Reg BI and Form CRS compliance requirements;
2. timelines, project plans, multistage review processes and contingency plans in making the necessary technology, delivery methodology and other updates;
3. training and capacity building for staff and supervisors;
4. list of gaps and changes that need to be addressed in developing new or amended policies and procedures or supervisory systems;
5. written supervisory procedures with clear criteria to be used in determining whether a particular recommendation is in a customer’s best interest;
6. recalibrated systems, reporting and technology tools in identifying and developing supervisory system modifications;
7. automated tools to track, limit, report and document existing conflicts of interest in systems, controls and products;
8. reliance on existing or newly created conflicts committees to identify existing or potential conflicts of interest;
9. updated compensation practices that address differential compensation triggered by certain product sales;
10. account surveillance for excessive trading, unusual commissions and conflicts of interest;
11. updated account documentation and customer disclosure forms;
12. thoughtful use of the terms “adviser” or “advisor,” depending on the registration status of the firm or its associated persons;
13. limited time period for sales contests; and

⁶ Available at <https://bit.ly/36ASpji>.

14. simplified and easily understandable Forms CRS and the procedures and timelines to deliver to retail investors.

Additional FAQs on FINRA Coronavirus Pandemic Relief

FINRA provided⁷ additional guides on documentation, individual registration, qualification examinations and supervision, all in connection with the temporary relief provided to FINRA member firms due to the Coronavirus pandemic.

A FINRA member firm is required to document its reliance on any temporary relief from obligations in rules or requirements during the COVID-19 pandemic, such as new procedures that vary from its written supervisory procedures. If FINRA deems appropriate, FINRA will guide its member firms if, where and how to publicly disclose such reliance.

FINRA Rule 3110(e) (Responsibility of Member to Investigate Applicants for Registration) requires members to establish and implement written procedures reasonably designed to verify the accuracy and completeness of the information contained in an applicant's initial or transfer Form U4 no later than 30 calendar days after the Form U4 is filed with FINRA. It also requires each FINRA member to include in its procedures a search using reasonably available public records or a third-party service provider to verify the accuracy and completeness of the information contained in the applicant's initial or transfer Form U4. If verification of some of the information contained in an initial or transfer Form U4 filed with FINRA between February 15, 2020 and May 31, 2020 is not currently feasible or practical within the 30-day period following the submission of the Form U4 due to the COVID-19 outbreak, such FINRA member firm should (1) record which information could not be verified, the reason for the inability to verify and the steps it has undertaken to verify that information, (2) make reasonable efforts to verify the information contained in the Form U4 by no later than June 30, 2020 and (3) if necessary, file an amended Form U4 to correct any discrepancies.

FINRA Rule 1220(b)(3)(B) (Qualifications) allows eligible individuals to function as an Operations Professionals for 120 calendar days before having to pass the appropriate qualification examination. Due to the temporary closure of the Prometric test centers, FINRA has extended expiring qualification examination windows until June 30, 2020. Individuals who were designated to function as Operations Professionals under Rule 1220(b)(3)(B) prior to February 2, 2020 have until June 30, 2020 to pass the appropriate examination.

Due to the work-from-home arrangement and the lack of a central operations center for principal review during the coronavirus pandemic, a firm should direct or forward firm mail from a branch office to a principal's residence, and if not possible, to the residence of an associated person who is not a principal (e.g., a registered representative's residence). The firm, however, must continue to supervise the activities of its associated persons (e.g., handling of customer correspondences received, etc.) so that a principal may complete the appropriate reviews. A firm should document the revised procedures based on the foregoing and consider potential additional risks in the retention and reporting of customer complaints, the handling of customer non-public information and the possible net capital implications of checks received. Depending upon the activities conducted at a person's residence, the residence may qualify as a "branch office" under FINRA Rule 3110(f)(2)

⁷Available at <https://bit.ly/2ZJB7zk>.

(Supervision). However, as provided in Regulatory Notice 20-08, a firm is not required to file a Form BR to register a temporary branch office resulting from an emergency relocation due to the coronavirus pandemic.

NAIC Eliminates Filing Exemption for Principal Protected Securities

The NAIC Valuation of Securities (E) Task Force held a telephonic meeting on May 14, 2020, and adopted amendments to the NAIC *Purposes and Procedures Manual* that will significantly change the way insurers treat investments in “principal protected securities” (“PPS”) for risk-based capital (“RBC”) purposes.

The PPS definition is designed to capture notes with underlying components where the noteholder obtains a more favorable RBC treatment based on the NRSRO rating assigned to the note than if it held the underlying components directly. The notes must also satisfy other criteria to be considered PPS investments. When the new provisions become effective, securities meeting the PPS definition will need to be filed with the NAIC Securities Valuation Office (“SVO”) for analysis in order to receive an NAIC designation, instead of being “filing exempt” (*i.e.*, automatically assigned the NAIC designation equivalent to the NRSRO rating on the security). As the examples show, the SVO-assigned designations will generally be significantly lower than the NRSRO equivalents.

The Task Force softened the impact a bit by establishing a long transition period: the new regime will become effective in 2021 for the December 31, 2021 statutory financial statements. Any PPS investment acquired *on January 1, 2021 or later* will need to be filed with the SVO within 120 days after acquisition (this is the standard filing schedule for securities that are not filing exempt). Any PPS investment owned *prior to January 1, 2021* will need to be filed with the SVO by July 1, 2021.

The NAIC Statutory Accounting Principles (E) Working Group has a parallel initiative underway to amend *Statement of Statutory Accounting Principles No. 43R – Loan-Backed and Structured Securities* to exclude certain types of CFOs that are deemed not to have debt-like cash flows. That initiative is on a much longer timeline. At its March 18, 2020 telephonic meeting, the SAP working group exposed a preliminary (and partial) draft of an issue paper. The original deadline for comments was June 26, 2020, but it has since been extended to July 31, 2020. The intent is for the working group to discuss the comments, and perhaps a revised draft of the issue paper, at the NAIC National Meeting scheduled for August 8-11, 2020 in Minneapolis (or the virtual equivalent thereof if travel is still not practicable). Any changes to *SSAP No. 43R* would only be considered after the issue paper is adopted. Given that the draft issue paper is still preliminary and incomplete, it is unlikely that any changes to *SSAP No. 43R* could be put in place before 2020 year-end.

Another initiative of the Valuation of Securities (E) Task Force that was discussed was an issue paper of the NAIC Investment Analysis Office (of which the SVO is a subdivision). The issue paper identifies six “red flags” for “bespoke securities” that would become a new analytical category midway between “filing exempt” and “subject to filing.” For “bespoke” securities, the SVO would review the underlying legal agreements and make a decision on whether the rating agency’s rating is acceptable for determining the NAIC designation or whether the security needs to be filed for an SVO-determined designation. The Task Force voted to expose the issue paper for a 90-day comment period.

Mayer Brown's insurance team discussed the NAIC's development on a webinar, a recording of which can be found [here](#). Read more about this topic in our May 28, 2020 [Legal Update](#).

Upcoming CLE Events

- **Intelligize Webinar: Developments Affecting Social Media Usage by Issuers and Regulated Entities**

June 9, 2020 | 1:00 p.m. – 2:00 p.m. ET | Register here: <https://bit.ly/2zy8qmH>

This webinar addresses how federal regulation of securities has evolved in the face of the growing use of social media by investors, securities issuers, broker-dealers, investment advisers and investment companies.

- **COVID 19 UK and US Economic Support Schemes** (PLI Webinar)

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

The rapid onset of COVID-19 in the UK and the US has led to a plethora of economic policy commitments to support business. This webinar provides an overview of the various support schemes implemented in the UK and the US.

- **Issuing Structured Products in the EU After Brexit**

June 18 | 11:00 a.m. – 12:00 p.m. ET | Register here: <https://bit.ly/2A6fluF>

During this session, members of Mayer Brown's 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, and will provide an overview of market trends and insights into the still growing German retail market.

Catch up on Recent Events You Missed

- **REVERSEinquiries Workshop: US Taxation of Structured Notes**

April 28, 2020 | Access recording here: <https://bit.ly/2M2VwqI>

This presentation addresses 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 | Access recording 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.

- **REVERSEinquiries Workshop: Sustainability & Structured Products**

May 20, 2020 | Access recording here: <https://bit.ly/2X5CWEO>

In recent years, investors have been increasingly interested in aligning their interests in advancing environmental, social and governance (ESG) objectives with achieving attractive yields. Structured products that reference ESG indices, as well as “green” indices and “green” structured products, provide an opportunity to do so. During this webinar, we trace the development of sustainable structured products and provide insight into key topics such as: Market developments in the US and the EU with respect to ESG indices and investments; EU Benchmark Regulation; Sustainable Indices; Green structured products; and US regulatory concerns regarding ESG indices.

COVID-19 Resources

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

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.

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.



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.

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