

REVERSEinquiries

Structured and market-linked product news for inquiring minds.

Regulation Best Interest and Form CRS Compliance Date: June 30, 2020

Since June 2019 when the Securities and Exchange Commission ("SEC") adopted Regulation Best Interest ("Reg BI") and Form CRS, the SEC and its staff have extensively engaged broker-dealers, investment advisers, retail investors, other market participants, the Financial Industry Regulatory Authority, Inc. ("FINRA")

and other regulatory agencies in planning for the implementation of Reg BI and Form CRS. On June 15, 2020, SEC Chair Jay Clayton confirmed that the compliance date for Reg BI and the Form CRS remains June 30, 2020.¹

To assist "Main Street" investors, SEC created a new website page² containing educational resources on Form CRS and additional tools for researching broker-dealers, investment advisers and other financial professionals. The SEC also reminded broker-dealers and investment advisers to be careful in making these investment recommendations to Main Street investors:

- rollovers and withdrawals from 401(k) and other plans, especially those undertaken to take advantage of the tax benefits of the Coronavirus Aid and Economic Security (CARES) Act;
- investments in complex or risky products, in less liquid and more volatile markets, and in significantly leveraged products that rely on derivatives strategies to enhance returns;
- COVID-19 related investments such as investments in securities of publicly traded companies that claim to prevent, detect, mitigate or cure COVID-19 or that claim to be engaging in rapid manufacture of drug candidates that may be useful or necessary to slow down the spread of COVID-19; and
- investments in special purpose acquisition corporations and other structured investment vehicles that may pose conflicts of interest caused by their compensation structures or provide a false sense of security because of the "money-back" feature during these times of heightened market volatility.

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¹ See <https://bit.ly/3ezSUNU>.

² <https://bit.ly/2A7EjKC>.

FINRA Rules Amended to Conform to Reg BI

As we previously reported, FINRA is making changes to Rule 2111, the suitability rule, in order to conform the quantitative suitability prong to the formulation that is used in Reg BI, as well as to make clear the instances in which the FINRA suitability rule remains applicable. In addition, FINRA is amending its rules (Rule 2310, Rule 2320, Rule 2341, and Rule 5110) relating to non-cash compensation in order to conform these rules in light of the prohibition in Reg BI against sales contests, sales quotas, bonuses, and non-cash compensation. The amended FINRA rules will specify that any non-cash compensation arrangement permitted by the rules must be consistent with the requirements of Reg BI.

The amended rules are expected to become effective on Tuesday, June 30, 2020, the Reg BI effective date.³

ARRC: LIBOR Hard Stop by December 31, 2020

On May 27, 2020, the Alternative Reference Rates Committee (the "ARRC") published its "Recommended Best Practices for Completing the Transition from LIBOR" (the "ARRC Recommendation") and an accompanying fact sheet.⁴ The ARRC Recommendation covers cash products, such as floating rate notes ("FRNs"), loans, securitizations and derivatives. This article focuses solely on the ARRC Recommendation's effect on FRNs.

The ARRC Recommendation has several significant milestones:

- there should be no new USD LIBOR issuances after December 31, 2020;
- the ARRC's recommended USD LIBOR fallbacks should be incorporated by June 30, 2020;⁵
- for FRNs that do not incorporate the ARRC's recommended USD LIBOR fallbacks but instead include discretion to adopt a replacement rate, the anticipated replacement rate and any anticipated spread adjustment methodology should be disclosed no later than six months prior to the first interest reset date after USD LIBOR ceases publication; and
- third-party technology and operations vendors should complete all necessary enhancements to support the secured overnight financing rate ("SOFR") by June 30, 2020.

The ARRC Recommendation applies to new issuances of FRNs with maturities after December 31, 2021, remarketing of existing FRNs, perpetual FRNs (floating rate preferred stock) and fixed-to-USD LIBOR FRNs and similar instruments, excluding securitizations.

The ARRC Recommendation applies to FRNs that directly refer to USD LIBOR, rather than instruments that may reference an index or rate that is indirectly linked to USD LIBOR, such as the constant maturity swap rate.⁶

Issuers with outstanding USD LIBOR FRNs with issuer or calculation agent discretion to choose an industry-accepted replacement rate, which was a popular fallback prior to the publication of the ARRC's recommended

³ FINRA Regulatory Notice 20-18 is available at: <https://www.finra.org/sites/default/files/2020-06/Regulatory-Notice-20-18.pdf>

⁴ The ARRC Recommendation is available at: <https://nyfed.org/2BcH51v> and the fact sheet is available at: <https://nyfed.org/2Zdq5jG>.

⁵ For a full discussion of the ARRC's recommended USD LIBOR fallbacks, see our Legal Update at: <https://bit.ly/2NAhhil>.

⁶ See FN3 of the ARRC Recommendation.

USD LIBOR fallback provisions, should review their FRNs to be aware of when they should announce to holders the rate that will be used to replace USD LIBOR, assuming a LIBOR cessation by December 31, 2021. They will also have to disclose any related spread adjustment methodology. These dates would have to be revisited if LIBOR ceases publication prior to that date.

FINRA Report on Artificial Intelligence in the Securities Industry

FINRA published the above-titled report in which it details the ways in which financial services firms are using artificial intelligence (AI) to offer new products, increase revenues, cut costs, and improve customer service. The report identifies the use of AI tools by FINRA member firms to perform certain brokerage account management functions. For example, some firms are developing AI-based applications to create real-time customer profiles, which incorporate information from multiple sources. Other firms are using AI tools in order to create curated research for customers and to share information with customers about specific investments. In this respect, FINRA cautions that while these AI tools offer the possibility of customizing services and investment suggestions for customers, firms should remain focused on potential privacy concerns, the use of corrupt or misleading data, and adapting to each customer's unique circumstances. The report also notes that some FINRA member firms are using AI applications to carry out certain portfolio management and trading functions. Here, FINRA cautions that using AI in portfolio management and trading functions may present issues especially when the applications are designed to act autonomously. For example, models may not account for unusual market volatility, a pandemic, a natural disaster, etc. As a result, reliance on the tools may result in undesired trading and have negative consequences. The report also notes that industry participants have observed that AI trading models across the industry will start to learn from each other, and that may lead to collusive activity, herd behavior or unpredictable results. Broker-dealers also are using AI tools for compliance functions, including surveillance and monitoring, customer identification and financial crime monitoring, regulatory intelligence management, liquidity and cash management, credit risk management and cybersecurity.

The FINRA report sets forth a number of key regulatory considerations, which are not intended to represent an exhaustive list. FINRA notes that AI-based applications depend on models and these AI models pose challenges, requiring that firms consider a comprehensive model risk management program. Such a program would, among other things, update model validation to review inputs for potential bias, review algorithms for potential errors, review parameters for risk thresholds, and review outputs. Firms also should conduct regular testing of current models and employ current and new models in parallel. Current models should be retired only after new models are thoroughly validated. The report also addresses model explainability and identifies areas for firms to consider when establishing policies and procedures that address explainability. Firms also should address data governance within their policies and procedures. Among other data-based risks that firms ought to consider in designing policies are those associated with potential built-in bias, as well as risks associated with data sources and verification of data. FINRA also addresses risks related to data integration, data security and data quality benchmarks and metrics. FINRA cautions that member firms should update their written policies and procedures to address customer data privacy to the extent that information is being

collected in connection with AI applications. The report also identifies areas for consideration for firms to address in their written supervisory procedures to the extent that AI tools are used for customer-facing activities, trading, operations, back-office and compliance functions. Finally, the report addresses cybersecurity concerns.

FINRA solicits comments on the report and on areas in which guidance to FINRA rules may be appropriate. Access the report here: <https://bit.ly/3i3MhFy>.

FINRA Fines a Broker-Dealer for Violations Involving Early Rollovers of UITs

On May 28, 2020, FINRA announced sanctions against a broker-dealer (the "Firm"), fining the Firm \$1.75 million for providing inaccurate information to customers related to rollover costs incurred and for related supervisory violations. FINRA also ordered the firm to pay approximately \$1.9 million in restitution, plus interest, to more than 1,700 customers in connection with early rollovers of Unit Investment Trusts ("UITs").⁷

UIT'S AND EARLY ROLLOVER

A UIT generally holds a fixed portfolio of stocks, bonds, or other securities selected by financial professionals to meet a certain investment objective. Once a UIT is formed, there is no ongoing active management, and thus it is usually considered as a long-term investment. Investors may roll over into a new series of the same trust prior to the maturity of the current series, but they may incur higher sales charges for early rollover transactions. Early rollover transactions are not suitable for every investor. This is particularly true if the rollover does not meet an investor's investment objective or is not appropriate for the investor's portfolio or risk appetite. Therefore, recommending early rollovers may raise some suitability concerns.

FINRA Rule 2111 provides that a member or an associated person of a broker-dealer must "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer." FINRA Rule 3110 requires a broker-dealer firm to have a supervisory system and Written Supervisory Procedures ("WSPs") in place to supervise activities of its associated persons, including recommending early rollovers or exchanges to increase their sales credits.

FINRA FINDINGS

FINRA found that, from January 2012 through December 2016, the Firm executed about \$10.9 billion in UIT transactions, \$935.2 million of which related to early rollovers. FINRA also found that the Firm's WSPs were not properly designed to supervise the suitability of those early rollover transactions. As a result, the Firm failed to identify unsuitable early rollover recommendations. This failure has caused the Firm's customers to incur approximately \$1.9 million in sales charges that they would not have incurred had they held the UITs to maturity. Moreover, FINRA found that the Firm sent about 600 letters to its customers, misrepresenting the

⁷ <https://bit.ly/2Z8l8c2>.

costs incurred by customers relating to early rollovers. These letters understated the costs by approximately 49% on average.

FINRA'S TARGETED EXAMINATION

This action resulted from a 2016 targeted examination with respect to UITs. FINRA, in its 2018 Regulatory and Examination Priorities Letter, also advised that it would review broker-dealers' supervisory controls relating to UITs.

SEC's OCIE to Begin LIBOR Preparedness Exams

On June 18, 2020, the Office of Compliance, Inspections and Examinations ("OCIE") of the SEC announced in a risk alert (the "Risk Alert") that it will conduct examinations of SEC-registered investment advisers, broker-dealers and investment companies ("registrants"), among others, to assess their preparedness for LIBOR's expected discontinuation. In a clear warning to registrants regarding LIBOR preparedness, OCIE stated the following in the Risk Alert:

Preparation for the transition away from LIBOR is essential for minimizing any potential adverse effects associated with LIBOR discontinuation. The risks associated with this discontinuation and transition will be exacerbated if the work necessary to effect an orderly transition to an alternative reference rate is not completed in a timely manner.

The Risk Alert publication follows through on the OCIE's earlier announcement that LIBOR preparedness would be an examination priority for 2020.

Read our full Legal Update [here](#).

Catch up on recent events you missed...

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

June 18, 2020 | Recording available: <https://bit.ly/2A6fluF>

During this session, members of Mayer Brown's Structured Products team spoke on offering structured products into the European Union following Brexit and under the new EU Prospectus regulation. The panel discussed: 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 provided an overview of market trends and insights into the still growing German retail market.

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

June 12, 2020 | Recording available: <https://bit.ly/2zxEAGI> (for PLI members)

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 provided an overview of the various support schemes implemented in the UK and the US.

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

June 9, 2020 | Recording available: <https://bit.ly/2zy8qmH>

This webinar addressed 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 RESOURCES

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

IBOR TRANSITION PAGE

On our IBOR Transition Page, we provide a comprehensive repository of information on the background of LIBOR and other IBORs, the proposed IBOR benchmark replacements, the latest market developments and our thought leadership. **Visit our IBOR Transition Page [here](#).**

ANNOUNCEMENTS



VOTING OPEN NOW: Structured Retail Products has released its Awards Survey for 2020 SRP Americas Awards. **Survey ends June 30, 2020.**

Vote here: <https://bit.ly/2Mpc9gF>

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TAXQUARTERLY

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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 cover some of the COVID-19 related federal tax law changes that have occurred with blinding speed since mid-March..

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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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