MAYER | BROWN

VOLUME 04, ISSUE 04 | July 19, 2021

REVERSEinquiries

Structured and market-linked product news for inquiring minds.

Early UIT Rollovers Bring on a FINRA Fine

Over the past several years, structured products have come in a new outfit – a unit investment trust ("UIT") wrapper. These UITs, as opposed to typical UITs with a basket of common stocks as the trust assets, have structured note payoffs, with features such as buffers, leverage and caps. Structured UITs have the same fee structure as typical UITs – an initial sales charge, a deferred sales charge and a creation and development fee.

Recently, a broker-dealer was fined $8.4 million by the Financial Industry Regulatory Authority, Inc. ("FINRA") for failure to supervise early rollovers of non-structured UITs.[1] This occurs when an investor in an existing UIT sells out of his position prior to maturity, and buys into another UIT, often with the same or similar assets in the trust. The effect of this rollover on the investor is that the investor will pay increased sales charges over time. The broker-dealer had a system in place to flag rollovers for UITs that had been held seven months or less, but it did not flag rollovers after seven months. Most UITs have a maturity of 15-24 months, and are treated as long-term investments, to be held to maturity.

Broker-dealers should ensure that any UIT rollover features are not being abused, whether with respect to non-structured UITs, as in this case, or structured UITs.

In This Issue

Chair Gensler Does Not Like BSBY

Over the past four years, the Securities and Exchange Commission ("SEC") has generally maintained a "strict neutrality" policy with respect to replacement rates for U.S. dollar LIBOR, or the London InterBank Offered Rate. The SEC's concerns have been mainly with respect to clear disclosure by issuers, broker-dealers and others of any material effects relating to the upcoming LIBOR cessation.[2] This nonjudgmental approach came to an end

[1] The FINRA News Release and Letter of Acceptance, Waiver and Consent can be found at: FINRA Order for $8.4 Million in Restitution to Customers for Supervisory Failures Involving UITs

[2] We discussed the SEC's concerns about LIBOR disclosure and its approach to SOFR at: REVERSEinquiries Newsletter, Volume 2, Issue 7. Former Chair Clayton did question the mechanics of SOFR as a replacement for LIBOR, which we discussed at: REVERSEinquiries Newsletter, Volume 2, Issue 11.

recently when Chair Gensler criticized the Bloomberg Short-Term Bank Yield Index, or "BSBY," as a credit-sensitive USD LIBOR replacement.

In remarks before the Financial Stability Oversight Council on June 11, 2021, Chair Gensler stated that BSBY has many of the same problems as LIBOR: the actual number of transactions underpinning BSBY are insufficient, and the some of the markets measured to calculate BSBY are unstable.[3]

BSBY is a forward-looking term rate based on transaction data for commercial paper, certificates of deposit and TRACE-reported senior unsecured corporate bonds. Chair Gensler noted that the commercial paper market dried up for about five weeks in 2020 during the early part of the pandemic. He also compared LIBOR to BSBY in that both are "inverted pyramids," in that a small amount of measurable data underpins a large number of transactions, compared to the Secured Overnight Funding Rate ("SOFR"), which is based on a nearly trillion dollar market. According to Chair Gensler, this "mismatch" is an incentive for manipulation.

BSBY is an International Organization of Securities Commissions (IOSCO)-compliant rate. There are a number of features of BSBY that are different from LIBOR. For example, no bank makes a submission to Bloomberg for inclusion in the BSBY calculations. Rather, Bloomberg uses available market data. The data is anonymized, and none of the 34 Global Systemically Important Banks (G-SIBs) from which the data is drawn are aware of how their trades are being used to calculate BSBY. There are currently 16 panel banks that make submissions for USD LIBOR, as opposed to 34 G-SIBs from which BSBY data is drawn. Lastly, BSBY uses a three-day rolling window to calculate the index level. If there are insufficient transactions, the index falls back to a four-day window and, if necessary, a five-day window. If a five-day window doesn't produce a sufficient number of transactions, then the previous day's index level is used.

The BSBY methodology does not provide a fallback index in the event that BSBY terminates.[4] However, issuers are free to choose a replacement rate and include that rate in their documentation. At least one bulge bracket issuer that issued a BSBY floating rate note has SOFR as a replacement rate.

The reason that there are credit sensitive rates like BSBY is that the market demands it, and SOFR doesn't have a credit element. Even with the advent of forward-looking term SOFR, there will still be demand for credit-sensitive rates like BSBY, Ameribor or the ICE Bank Yield Index.

Cloudy Future for the USD CMS Rate

The Constant Maturity Swap Rate, also known as the CMS rate, ISDAFIX or the ICE Swap Rate, represents the mid-market fixed rate for fixed/floating interest rate swaps for a set of tenors at a specified time of day. For the USD CMS Rate, the floating rate leg references three-month USD LIBOR.[5] That, in a nutshell, will be a problem after June 30, 2023, when three-month USD LIBOR will cease publication.

The USD CMS Rate is often referenced in structured notes, usually as the difference between two tenors, such as 30Y CMS – 5Y CMS. What will happen to the USD CMS Rate after June 30, 2023?[6] There are two approaches that have been put forth.

[3] The Public Statement is available at: SEC.gov | Prepared Remarks Before the Financial Stability Oversight Council.

[4] The BSBY methodology is available at: BSBY Methodology (May 2021).

[5] The CMS Rate is also published based on GBP LIBOR and EURIBOR.

[6] New York General Obligations Law Article 18-C does not apply to contracts or securities based on the USD CMS Rate.

In March 2021, the Alternative Reference Rates Committee ("ARRC") published a white paper discussing a suggested fallback formula for the USD CMS Rate.[7] The fallback formula is designed to be built into USD CMS Rate instruments (such as floating rate notes, although the white paper focuses on derivatives) so that, upon the cessation of the USD CMS Rate, the instrument will continue to function properly, but the floating rate will be calculated based upon an expected SOFR CMS Rate as adjusted by the fallback formula.

For a floating rate note, the terms would have to be drafted so that the fallback formula would take effect after a cessation of the USD CMS Rate, or the USD CMS Rate becoming non-representative. The terms could be modeled after the USD LIBOR to SOFR recommended fallback language published by the ARRC. Of course, this suggested fallback formula is not helpful for any existing USD CMS Rate floating rate notes. In any event, the fallback formula cannot be used until the SOFR CMS Rate, computed at the same time, with the same day count convention and the same payment frequency as the USD CMS Rate, exists.

Another option is for ICE to cease publication of the USD CMS Rate after June 30, 2023. In May 2021, ICE published a consultation on the potential cessation of the GBP LIBOR CMS Rate.[8] The floating rate leg of the GBP LIBOR CMS Rate is GBP LIBOR, which will cease publication on December 31, 2021. According to the IBA, it "does not expect to be able to continue to publish GBP LIBOR ICE Swap Rate settings for which the 3 Month or 6 Month GBP LIBOR settings serve as the underlying rate for the floating leg of the relevant interest rate swaps after December 31, 2021, because IBA does not expect sufficient (or perhaps any) input data to be available based on eligible new interest rate swap transactions referencing GBP LIBOR settings from this time." There is some discussion on the IBA website about using potential synthetic, unrepresentative GBP LIBOR settings to continue the publication of the GBP LIBOR CMS Rate.

IBA noted that it expects to consult on the potential cessation of the USD LIBOR CMS Rate "in due course." Similar to the GBP LIBOR CMS Rate, the IBA pointed to the possibility of a potential synthetic USD LIBOR for use in the USD CMS Rate. The IBA also stated that the consultation is "not … an announcement that IBA will cease or continue the publication of … any other ICE Swap Rate settings, after December 31, 2021 or any other date."[9]

All of this should serve as a warning to issuers of USD CMS Rate floating rate notes to have clear fallback language built into their notes if and when the USD CMS Rate ceases publication. This fallback language could anticipate a replacement of the USD LIBOR floating rate leg while the USD CMS Rate continues to be published, or a cessation of the USD CMS Rate and its replacement with another industry accepted or governmental body recommended rate.

FINRA Expands Scope of Filing Requirements for Private Placements

In Regulatory Notice 21-26 (July 15, 2021), FINRA amended the filing requirements of Rules 5122 and 5123 to require members to file with FINRA any "retail communications," as defined in FINRA Rule 2210, that promote or recommend private placement offerings.[10] FINRA Rule 5122 covers private placements of securities issued by a FINRA member, while Rule 5123 covers other private placements. Both rules have filing requirements, as

[7] The ARRC White Paper is available at: NewYorkFed.org, ARRC White Paper on Suggested Fallback Formula for the USD LIBOR ICE Swap Rate.

[8] The ICE GPB CMS rate consultation (the "Consultation") is available at: ICE Swap Rate (theice.com).

[9] See the Consultation at 4.

[10] FINRA Notice 21-26 is available at: FINRA.org; Regulatory Notice 21-26.

well as exemptions from those filing requirements for offerings to institutional accounts (as defined in FINRA Rule 4512(c)), qualified purchasers (as defined in the Investment Company Act of 1940), and qualified institutional buyers (as defined in Rule 144A under the Securities Act of 1933), among others.

The filing requirements of Rules 5122 and 5123 currently require the filing of any "private placement memorandum, term sheet, or other offering document" provided to any prospective investor, for Rule 5122, or used in connection with the sale, for Rule 5123. The amendments to these rules, which will come into effect on October 1, 2021, add to each rule's filing requirement, "any retail communication (as defined under Rule 2210) that promotes or recommends the [member private offering] [private placement] …." A "retail communication" means "any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period."[11]

According to FINRA, most members currently file these retail communications, although not required by the current versions of Rule 5122 or 5123. Examples provided by FINRA of retail communications that will now fall within the filing requirements include web pages, slide presentations, fact sheets, sales brochures, executive summaries, and investor packets.

Financial Stability Board Releases Latest Progress Report on LIBOR Transition, Urging Action to Complete Transition by Year-End and Calling Out the Loan Markets

On July 6, 2021, the Financial Stability Board (the "FSB") released its latest Progress Report to the G20 on LIBOR Transition Issues. The report finds that, given the extent of risks associated with a failure to prepare adequately for the transition, the onus of action is on market participants. The FSB believes that the tools necessary to complete the transition are currently available, and have been for some time. Over the past several years, market participants have established mechanisms to use compounded risk-free rates ("RFRs") not only in derivative markets, where use of RFRs was already common, but also in the cash markets. Firms now have certainty about the cessation timeline, and the fixing of spread adjustments by the International Swaps and Derivatives Association ("ISDA") creates a clear economic link between LIBOR and selected RFRs, providing clarity for market participants to engage in discussions about active transition of LIBOR referencing contracts that expire after end-2021.

The FSB urges market participants to cease new use of LIBOR in all currencies as soon as practicable, respecting national working group ("NWG") timelines and supervisory guidance where applicable, and in any case no later than the end of 2021. With only a few months left until end-2021, all financial and non-financial firms across the globe must ensure that they follow the necessary steps to avoid disruption to the performance of their contracts, acting with urgency. A smooth and orderly transition requires, at a minimum, steps to stop issuance of new products linked to LIBOR and efforts to transition away from LIBOR in legacy contracts wherever feasible in accordance with the FSB's recently updated Global Transition Roadmap for LIBOR.

In the report, the FSB states that a particular area of concern continues to be the loan markets, with much new lending still linked to LIBOR, increasing the stock of contracts affected by its discontinuation. The FSB

[11] FINRA Rule 2210(a)(5).

emphasized that "the continuation of major USD LIBOR panels through June 30, 2023 *is not meant to support new USD LIBOR activity*." (Emphasis added.)

The report concludes with specific action steps for regulators and market participants, as well as an analysis of data from a November 2020 survey regarding supervisory issues.

With fewer than six months remaining until December 31, 2021, the FSB stated that LIBOR transition is a "significant priority," and that active engagement by both private and public sector market participants is "critical," and international cooperation, coordination, and consistency is "crucial."

This article was originally published by J. Paul Forrester and Mary Jo Miller on the "Eye on IBOR Transition" blog.

IOSCO Ratchets Up Pressure on ESG Disclosure for Companies and Asset Managers

In two reports released within days of each other, IOSCO draws further attention to ESG-related disclosures by issuers and asset managers.

June 28 Report

On June 28, 2021, in the first report (with a related media release and factsheet), IOSCO reiterates the urgent need to improve the consistency, comparability and reliability of sustainability reporting for investors.

The media release states:

> An important aspect of IOSCO's work has been engagement with the International Financial Reporting Standards (IFRS) Foundation's efforts to develop a common set of global sustainability standards to help meet investor needs and to set a sound baseline for jurisdictions to consider when setting or implementing their sustainability-related disclosure requirements. The IFRS is seeking to establish an International Sustainability Standards Board (ISSB) to sit alongside the International Accounting Standards Board (IASB), and the [June 28 IOSCO] Report elaborates on IOSCO's vision and expectations for an ISSB.[12]

And states (footnote omitted):

> IOSCO recognises that individual jurisdictions have different domestic arrangements for adopting, applying or otherwise availing of international standards. It will be important for individual jurisdictions to consider how the common global baseline of standards might be adopted, applied or otherwise utilized within the context of these arrangements and wider legal and regulatory frameworks, in a way that promotes consistent, comparable and reliable sustainability disclosures across jurisdictions.

June 30 Report

In the second report, issued on June 30, 2021, IOSCO sets out and asks for feedback on five proposed recommendations about sustainability-related regulatory and supervisory expectations in asset management.

[12] Also discussed in our related June 25, 2021, Legal Update "*Setting Standards for the Standard-Setters: Recent Developments in the IFRS Foundation's Sustainability Reporting Project*."

IOSCO makes the following five recommendations for "securities regulators and/or policymakers, as applicable":

- **Recommendation 1**: *Asset Manager Practices, Policies, Procedures and Disclosure*
  [C]onsider setting regulatory and supervisory expectations for asset managers in respect of the: (a) development and implementation of practices, policies and procedures relating to sustainability-related risks and opportunities; and (b) related disclosure.
- **Recommendation 2**: *Product Disclosure*
  [C]onsider clarifying and/or expanding on existing regulatory requirements or guidance or, if necessary, creating new regulatory requirements or guidance, to improve product-level disclosure in order to help investors better understand: (a) sustainability-related products; and (b) material sustainability-related risks for all products.
- **Recommendation 3**: *Supervision and Enforcement*
  [H]ave supervisory tools to ensure that asset managers and sustainability-related products are in compliance with regulatory requirements and enforcement tools to address any breaches of such requirements.
- **Recommendation 4**: *Terminology*
  [C]onsider encouraging industry participants to develop common sustainable finance-related terms and definitions to ensure consistency throughout the global asset management industry.
- **Recommendation 5**: *Financial and Investor Education*
  [C]onsider promoting financial and investor education initiatives relating to sustainability, or, where applicable, enhance existing sustainability-related financial and investor education initiatives.

European Commission Adopts New Sustainable Finance Strategy and Proposes European Green Bond Standard

On July 6, 2021, the European Commission announced that it has adopted a new Sustainable Finance Strategy and proposed a European Green Bond Standard (and published related annexes and FAQs). The Sustainable Finance Strategy includes the following six actions:

- Extend the existing sustainable finance toolbox to facilitate access to transition finance
- Improve the inclusiveness of small and medium-sized enterprises (SMEs), and consumers, by giving them the right tools and incentives to access transition finance
- Enhance the resilience of the economic and financial system to sustainability risks
- Increase the contribution of the financial sector to sustainability
- Ensure the integrity of the EU financial system and monitor its orderly transition to sustainability
- Develop international sustainable finance initiatives and standards and support EU partner countries

The proposed European Green Bond Standard is intended to create a voluntary "gold standard" available to all issuers (private and sovereign) to help the financing of sustainable investments.

There are four key requirements under the proposed framework:

- The funds raised by the bond should be allocated fully to projects aligned with the EU Taxonomy;
- There must be full transparency on how bond proceeds are allocated through detailed reporting requirements;

- All European green bonds must be checked by an external reviewer to ensure compliance with the EU Taxonomy and that funded projects are aligned with it. Specific, limited flexibility is foreseen here for sovereign issuers;
- External reviewers providing services to issuers of European green bonds must be registered with and supervised by the European Securities Markets Authority. This will ensure the quality and reliability of their services and reviews to protect investors and ensure market integrity. Specific, limited flexibility is foreseen here for sovereign issuers.

The framework also contemplates "transition" financing by making sure that the related funds raised by the bond are allocated to environmentally sustainable investments. There are three main ways in which European green bonds can be used by companies to support their sustainability transition:

1. **Funding long-term projects**: Issuers may use European green bonds to fund multi-year EU Taxonomy-alignment projects, such as converting a production facility (such as a steel plant) to reduce its emissions and meet the EU Taxonomy thresholds. The condition is that the transformation results in an EU Taxonomy-aligned project.
2. **Transitioning toward EU Taxonomy-alignment**: A company could issue a European green bond to acquire or construct an EU Taxonomy-aligned asset, such as a new energy-efficient building. In this way, the company is gradually increasing its share of EU Taxonomy-aligned assets.
3. **Funding transition activities**: A company could issue a European green bond to perform an activity that meets the criteria for "transition activities" (e.g., cement and steel manufacturing) as set out in the EU Taxonomy.

Eeny, Meeny, Miny, Muse; Which LIBOR Alternative Shall I Choose?

By now most, if not all, financial market participants know that the recommended alternative for LIBOR for U.S. Dollars is SOFR. Many also are aware that, in addition to SOFR, five additional benchmark rates and/or spread adjustments have been proposed to replace LIBOR. These alternative benchmarks generally capture the cost of unsecured bank borrowing, which is the cost that LIBOR also reflects and which is a rate that is more relevant to the way many banks fund themselves than SOFR, which is a secured overnight rate based on transactions in U.S. Treasury securities.

The following chart summarizes what we know so far about these alternative benchmarks:

Alternative	Basis	Administrator	Forward Term Structure?	# Public Filings	Fallback provisions
SOFR	Bilateral and tri-party Treasury securities repurchase transactions	Federal Reserve Bank of New York	Not in recommended form. CME is publishing indicative rates for 1-, 3-, and 6- months	1	None
Bloomberg Short-Term Bank Yield Index	Commercial paper, certificates of deposit, deposits, senior unsecured bank corporate bonds	Bloomberg Index Services Limited	Yes. 1-, 3-, 6-, and 12-months	2	1. a. Term SOFR, b. Daily Simple SOFR, c. Agreed rate 2. Agreed rate
Ameribor	Daily executed transactions in the overnight unsecured loan market on the AFX	American Financial Exchange	Yes. 1-week 1-, 3-, and 6-months 1- and 2-year	None	—-
ICE Bank Yield Index	Wholesale, unsecured bank investment yields for primary market funding transactions and secondary market bond transactions	ICE Benchmark Administration	Yes, as test rates. 1-, 3-, 6-, and 12-months	None	—-
Credit Inclusive Term Rate (CRITR) and Credit Inclusive Term Spread (CRITS)	Commercial paper, certificates of deposit and short-term corporate bonds issued by banking institutions	IHS Markit Benchmark Administration	Not in approved form. IHS Markit is publishing indicative rates for 1-, 3-, 6-, and 12-months	None	—-
Across-the-Curve Credit Spread Index (AXI) and Financial Conditions Credit Spread Index (FXI)	AXI – Credit spreads of short- and medium-term unsecured bank funding transactions FXI – an extension of AXI that incorporates data based on transactions of both financial and non-financial corporate debt instruments	SOFR Academy	Still under development. 1-, 3-, 6-, and 12-months expected	None	—-

As noted above, in this limited universe of market transactions, the SOFR agreement did not provide a fallback provision, while one of the BSBY agreements falls back to SOFR or, if SOFR is unavailable, an agreed rate, and the other BSBY agreement falls back to an agreed rate only. In comparison, the ISDA 2020 IBOR Fallbacks Protocol offers a robust multi-tiered waterfall of fallback rates for LIBOR, starting with SOFR and, if SOFR is unavailable, falling to (a) the Fed Recommended Rate (the Fed-recommended replacement for SOFR), (b) the Fed's Overnight Bank Funding Rate, and finally, (c) the Fed's Federal Open Market Committee Target Rate.[13]

[13] See definition of "Applicable Fallback Rate" in ISDA 2020 IBOR Fallbacks Protocol.

While some regulatory officials recently have expressed that SOFR is a preferred benchmark replacement (specifically as compared with BSBY),[14] the joint regulators have not revised their November 2020 guidance in which they acknowledged that banks should assess the suitability of alternative reference rates in light of their funding models and customer needs, and will not be criticized for using a suitable reference rate other than SOFR to replace LIBOR.[15]

With the ARRC "best practice" recommendation date for cessation of new LIBOR-linked loans upon us (i.e., June 30, 2021), we are seeing increased activity in implementing alternative reference rates and expect to see substantial transition progress (and, hopefully, rate preference clarity) during the third quarter of the year.

This article was originally published by J. Paul Forrester, Mary Jo Miller, and David Duffee on the "Eye on IBOR Transition" blog.

Events

IN CASE YOU MISSED IT…

- **Medium-Term Note Programs**
  June 8, 2021 | *Access this webinar's materials and recording here*
- **The New 2021 ISDA Definitions: Part 2: The Impact on Products and Geographies**
  June 3, 2021 | *Listen to this Global Financial Markets Initiative teleconference here*

GlobalCapital Derivatives Awards

Mayer Brown is pleased to have been recognized as **US Law Firm of the Year – Transactions** at the GlobalCapital's **AMERICAS DERIVATIVES AWARDS 2021**.

We were also shortlisted for **Global Law Firm of the Year, European Law Firm of the Year – Regulatory** and **European Law Firm of the Year – Transactions** for GlobalCapital's **GLOBAL DERIVATIVES 2021 AWARDS**.

This follows our win as **European Law Firm of the Year – Transactions** and **US Law Firm of the Year – Transactions** for GlobalCapital's **AMERICAS AND GLOBAL DERIVATIVES AWARDS 2020**, respectively.

[14] See the second article in this newsletter.

[15] See Statement on Reference Rates for Loans, November 6, 2020, and Statement on LIBOR Transition, November 30, 2020.

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 cover Info Letter 2020-0033, key tax changes in Biden's American Jobs Plan and American Families Plan, the Corporate Transparency Act, and more.

Derivatives Blog: *The Long and Short of It*. Mayer Brown has launched "The Long and Short of It," a new blog providing comment and analysis on the latest legal and regulatory developments in derivative products.

You'll find everything from topical ISDA developments and the divergence between EU and UK derivatives regulation post-Brexit, derivatives regulatory capital issues, to US and Asia derivative regulatory developments and the implementation of global margin rules. Mayer Brown lawyers in Asia, Europe and the US will make regular contributions. With content ranging from detailed and technical to practical and digestible, the blog appeals to both product specialists and generalists.

To visit and subscribe, scan the QR code with your phone's camera.

At the Crossroads: CFTC and DOJ Enforcement. "At the Crossroads: CFTC and DOJ Enforcement" is a video series hosted by Mayer Brown partners Matt Kluchenek and Glen Kopp. In each episode, the two discuss a topic at the intersection of enforcement by the Commodity Futures Trading Commission (CFTC) and the Department of Justice (DOJ). ***The goal:*** to help legal and compliance departments protect their organizations in an increasingly rigorous regulatory environment.

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To join the LinkedIn group or to send us suggestions/comments, scan this QR code with your phone's camera, which will notify us via email at REVERSEinquiries@mayerbrown.com.

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