MAYER | BROWN

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REVERSE inquiries

Structured and market-linked product news for inquiring minds.

No Offers, No Sales, but Section 17 Liability

In This Issue

United States Oil Fund, L.P. ("USO") is an exchange-traded fund that issues limited partnership shares traded on the NYSE Arca (the "Shares"). USO is also a commodity pool operator regulated by the Commodity Futures Trading Commission. According to USO's registration statement filed with the Securities and Exchange Commission ("SEC"), USO's investment objective is for the net asset value ("NAV") of the Shares to reflect the daily changes, in percentage terms, of the NYMEX West Texas Intermediate Crude Oil Futures Contract that is the near-month contract to expire (the "Benchmark Oil Futures Contract"), subject to certain exceptions.

In March and April 2020, with oil futures contracts settling below zero, investors were pouring into USO. On April 20, 2020, USO announced, in a Form 8-K, that it anticipated exhausting its inventory of Shares and the next day filed another Form 8-K confirming that it was suspending issuances of Shares. On April 21, 2020, USO filed a registration statement on Form S-3 with the SEC to register more Shares.

At about the same time as when USO made its announcements and also filed the Form S-3, its sole futures commission merchant (the "FCM") told USO, on April 22, 2020, and confirmed the next day, that FCM would henceforth limit USO's ability to invest through the FCM the proceeds of future Share creations. Consequently, USO would be forced to use the proceeds from future Share creations to purchase U.S. Treasuries or to hold cash, rather than investing in oil futures contracts. Investing in oil futures contracts was USO's stated investment objective. Investing in U.S. Treasuries or cash would cause a risk of tracking error between USO's investment objective (tracking the changes in the spot price of crude oil) and its NAV when the new Shares were available for offer and sale.

Without disclosing the FCM limit and in response thereto, USO filed Forms 8-K between April 24 and April 30, 2020, describing a change in USO's investments from its stated investment objective to diversified investments ranging from front-month futures contracts to further-down-the-curve futures contracts, and ending with investments-in-oil futures contracts other than the Benchmark Oil Futures Contract.

Following the imposition of the FCM limit, USO filed several pre-effective amendments to its Form S-3. None of these amendments fully disclosed the character and nature of the FCM limit. During the review by the SEC Staff of these amendments, USO did not inform the Staff of the FCM's limitation. The FCM asked USO whether the SEC Staff had been informed of the FCM limit, to which USO gave a non-responsive answer. Ultimately, the FCM contacted the Staff and told them of the nature of the limitation. The Staff, in a comment letter dated May 13, 2020, asked USO to disclose the constraints put on USO by the FCM. In a pre-effective amendment dated May 21, 2020, USO disclosed the FCM's limitation. USO filed Forms 8-K on May 29 and June 9, 2020 announcing agreements with additional futures commission merchants allowing USO to invest the proceeds from sales of new Shares in oil futures contracts. On June 12, 2020, the registration statement was declared effective and a prospectus was filed offering new Shares.

In a Cease and Desist Order dated November 8, 2021 (the "Order"), the SEC stated that "[b]y failing to adequately inform the investing public, during the period from April 24 through May 21, 2020, of the specific constraints put on [USO] and, in turn, the impact that those constraints would have on [USO's] ability to meet its investment objective, each of the above public filings [was] materially misleading."[1] The "above public filings" were the Forms 8-K and the pre-effective amendments to the registration statement filed between April 24, 2020 and May 21, 2020, except the final pre-effective amendment dated May 21, 2020, in which corrective disclosure was included about the FCM limit and a related risk factor.

The Order states that "[a]s a result of the conduct described above, USO … violated Section 17(a)(3) of the Securities Act, which prohibits the offer or sale of securities, engaging in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser."[2]

Analysis

At first blush, this would seem like an opportunity for the SEC to call down fire upon USO. We have an issuer that did not fully disclose information material to investors in multiple public filings, even when the FCM prompted USO to tell the Staff as part of their review of the registration statement. The Order notes that USO was experiencing record daily inflows of retail investors while oil futures contracts were settling in negative territory.[3] Yet the Order does not allege any financial harm to these investors.

What is missing from this story are offers and sales. During the time that USO was making misleading filings, it had no Shares to sell. Many of the alleged misstatements were in pre-effective amendments to the registration statement, under which no Shares were offered or sold until the disclosure was corrected and the registration statement declared effective. Without offer and sales, there is no liability under Sections 11 or 12 of the Securities Act, nor under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. That leaves the catchall negligence liability of Section 17 of the Securities Act, even though there is no purchaser who suffered fraud or deceit.

Perhaps the reason that the SEC could not find any investors alleging financial harm was the timing of the events. The reason that there were record inflows of investors into USO was that oil prices were bottoming out at historical lows. On the day that USO announced it had no new inventory to sell, the Shares closed at $33.68. The next day, when USO filed the registration statement with the SEC, the Shares closed at $30.00. They dropped to as low as $16.88 on April 28, 2020, closed at $26.43 on June 12, 2020, the day that the

[1] The Order is available at: [United States Commodity Funds LLC and United States Oil Fund, LP (sec.gov)](https://www.sec.gov).

[2] Order at p. 8. "Negligence is sufficient to establish a violation of Section 17(a)(3) of the Securities Act." Order at n.4 (citation omitted).

[3] See the Order at 2.

registration statement was declared effective, and, in the period from December 10, 2020 to December 10, 2021, ranged from $31.37 to $58.69. Investors in USO made, not lost, money during the time period covered by the Order.

The SEC Staff Statement on LIBOR Transition

On December 7, 2021, the SEC Staff released a statement to remind investment professionals of their obligations when recommending LIBOR-linked securities and to remind companies and issuers of asset-backed securities of their disclosure obligations related to the LIBOR transition.[4]

The Statement covers several areas of concern to the SEC, summarized below:

- Recommendations by broker-dealers of LIBOR securities or investment strategies involving LIBOR securities to retail customers;
- Disclosure obligations of issuers with material exposure to LIBOR securities;
- The effect on retail customers of a recommendation of LIBOR securities with no fallback provisions; and
- The effect on retail customers of a recommendation of LIBOR securities with fallback provisions, and the resulting change in the interest rate from USD LIBOR to the secured overnight financing rate ("SOFR").[5]

BROKER-DEALERS. The Staff stated that broker-dealers should be "especially mindful of their obligations when recommending LIBOR-linked securities or investment strategies involving LIBOR-linked securities to retail customers." Under Regulation Best Interest, a broker-dealer recommending LIBOR securities or investment strategies involving such securities must have a reasonable basis to believe that the recommendation is in the best interest of the retail customer.[6] The care obligation of Regulation Best Interest requires that a broker-dealer must exercise reasonable diligence, care and skill to understand the potential risks, rewards and costs associated with the recommendation, and in light of the retail customer's investment profile, that the recommendation is in the best interests of the particular retail customer.[7] Accordingly, a broker-dealer must understand whether there are robust fallback provisions providing for a clear replacement rate after USD LIBOR is no longer available, and the effect of the replacement rate on the LIBOR security.

The Staff also stated that it would be difficult for a broker-dealer to recommend a LIBOR security with no fallback provision, absent the recommendation being premised on a specific, identified, short-term trading objective.

[4] The SEC Staff Statement can be found at: SEC.gov | SEC Staff Statement on LIBOR Transition—Key Considerations for Market Participants.

[5] The focus of this article is on USD LIBOR floating rate notes and preferred stock, related recommendations by broker-dealers and related disclosures by issuers. The Statement also covers municipal securities underwriting by broker-dealers and the obligations of registered investment advisers and funds.

[6] See Rule 15l-1(a)(2)(i) under the Securities Exchange Act of 1934.

[7] See Rule 14l-1(a)(2)(ii)(B) under the Securities Exchange Act of 1934.

Legacy USD LIBOR securities with no fallback provisions would, without any external action, become fixed-rate notes after June 30, 2023, when most USD LIBOR tenors will no longer be published. The Staff's concern is the effect of this change in the interest rate, which would be material, on a retail investor. Most outstanding USD LIBOR securities with fallback provisions will switch over to SOFR, and the Staff is concerned that, even with adequate fallback provisions and because SOFR is not a perfect match for USD LIBOR, the effect on the LIBOR securities' interest payments may be material to a retail investor.

Although the Statement makes reference to Article 18-C of the New York General Obligations Law, which will cause any legacy USD LIBOR New York law governed securities without adequate fallbacks to switch over to SOFR after June 30, 2023, the Statement treats recommendations of these legacy USD LIBOR securities differently than recommendations of USD LIBOR securities with robust fallback provisions.[8] Also, at this point, any legacy USD LIBOR securities without adequate fallback provisions would be available only in the secondary market.

The Staff's concern with legacy LIBOR securities without fallback provisions would be applicable to non-USD LIBOR securities, such as a GBP LIBOR floating rate note ("FRN") governed by New York or other U.S. state law. These types of FRNs will not be affected by the New York or federal legislation. However, these types of FRNs are a small slice of the market. USD LIBOR-preferred stock, which is generally governed by Delaware law, will be addressed by the upcoming federal LIBOR legislation.

Broker-dealers who agree to monitor a retail customer's account were also reminded of their obligations under Regulation Best Interest, in that the broker-dealer must reassess the potential risks, rewards and costs of any LIBOR securities in a retail customer's account at each time of the agreed-upon review, based on the current state of the LIBOR transition and the potential effect on a customer's LIBOR security holdings. The broker-dealer's recommendation at the time of each monitoring may be to buy, sell or hold, and if the broker-dealer remains silent, that is an implicit hold recommendation.

ISSUERS. Issuers must keep investors informed of their progress toward LIBOR risk identification and mitigation, and the anticipated effect on the issuer, if material. This disclosure could be included in the risk factors, management's discussion and analysis, board risk oversight and the financial statements sections of the prospectus. Issuers with material risk related to outstanding LIBOR debt with inadequate fallback provisions should consider how much debt will be outstanding after the LIBOR cessation date and the steps the company is taking to address the situation. As discussed above, this would seem to apply only to non-USD LIBOR securities or preferred stock, the latter of which will be solved by the upcoming federal LIBOR legislation. Issuers with material outstanding non-USD LIBOR securities may have to disclose upcoming plans for tender or exchange offers, or consent solicitations.

The Staff Statement also notes that the recommendations of the Alternative Reference Rates Committee on fallback language for new issuances of USD LIBOR FRNs are not binding on U.S. issuers, in that issuers are not obligated to include any particular fallback language in such securities.

As of October 4, New 2021 ISDA Definitions Are Now In Effect

For more, read "***Updating MTN Program Disclosures for the 2021 ISDA Definitions***" in our REVERSEinquiries Newsletter, Volume 04, Issue 03.

[8] The Statement makes no reference to the federal USD LIBOR legislation.

IOSCO Report Highlights ESG Data Deficiencies, Calls for Oversight and Makes Remedial Recommendations

On November 23, 2021, the International Organization of Securities Commissions (IOSCO)1 issued its "Environmental, Social and Governance (ESG) Ratings and Data Providers" final report (Report) in which IOSCO notes that "the use of environmental, social and governance (ESG) ratings and data products has grown considerably in response to investors' mounting interest in investing in companies that take account of sustainability in the way they are run. As a result, the role and influence of ESG ratings and data products providers in financial markets more generally, and in the sustainable finance ecosystem more specifically, have grown significantly. This has led some securities markets regulators to take a closer interest in the activities and business models of these providers."

Reporting on its related preliminary fact-finding exercise, IOSCO said:

- there is little clarity and alignment on definitions, including on what ratings or data products intend to measure;
- there is a lack of transparency about the methodologies underpinning these ratings or data products;
- while there is wide divergence within the ESG ratings and data products industry, there is an uneven coverage of products offered, with certain industries or geographical areas benefitting from more coverage than others, thereby leading to gaps for investors seeking to follow certain investment strategies;
- there may be concerns about the management of conflicts of interest where the ESG ratings and data products provider or an entity closely associated with the provider performs consulting services for companies that are the subject of these ESG ratings or data products; and
- better communication with companies that are the subject of ESG ratings or data products was identified as an area meriting further attention given the importance of ensuring the ESG ratings or other data products are based on sound information.

Continue reading the complete Legal Update by Paul Forrester and Christina Thomas here.

The CFA Institute releases Global ESG Disclosure Standards for Investment Products

The sheer volume of capital flows into sustainable, or ESG-focused, funds and products over recent months reflects the rapidly increasing number of investors with ESG-related preferences, or demands, when selecting those investments. Evaluating, and comparing, the ESG credentials of different investment products presents significant difficulties, however, in circumstances where information and disclosures about those products – and even the terminology used – are, at best, inconsistent, and often incomplete; and, at worst, may attract accusations of "greenwashing", by using marketing materials to mislead investors about the ESG approaches used in their products.

In a welcome development in the move towards addressing these issues, on 1 November 2021, the CFA Institute, a global association of investment professionals, published its first voluntary Global ESG Disclosure Standards for Investment Products (the "Standards").

The Standards aim to assist investors in better understanding, comparing and evaluating investment products, and to reduce the risks of "greenwashing" by facilitating fuller disclosure of ESG-related issues within the objectives, investment process, and stewardship activities of investment products. In furtherance of these aims, the Standards set out specific disclosure requirements for investment products which promote their ESG-related features, and which creators of investment products will be required to observe if they choose to adopt the Standards.

In this Legal Update, we consider the disclosure requirements under the Standards, and the implications for creators of investment products as they prepare, and position themselves, to make compliant disclosures.

Events

IN CASE YOU MISSED IT…

- **LIBOR Transition: How will the pieces come together in time?** | December 9, 2021 | *Hosted by the ABA*
- **The Last 100 Days of LIBOR: The Syndicated Loan Market and CLOs** | December 2, 2021 | Podcast
- **REVERSEinquiries Workshop: Where are we now and where are we going? The Transition Away from IBORs** | November 10, 2021 | Materials
- **The Last 100 Days of LIBOR: The Derivatives Market** | November 15, 2021 | Podcast

Mayer Brown is pleased to have been named **European Law Firm of the Year – Transactions** at *GlobalCapital's* **GLOBAL DERIVATIVES 2021 AWARDS**, following our win earlier this year as **US Law Firm of the Year – Regulatory** at *GlobalCapital's* **AMERICAS DERIVATIVES AWARDS 2021**. This is the second year in a row we have received both European and US transactional awards and the sixth consecutive time *GlobalCapital* has recognized Mayer Brown at its Global and Americas Derivatives Awards.

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 Renaissance Settles "Basket Option" Case; Reconciliation and REITs; IRA Investment Restrictions in Proposed Legislation—No More Private Placements in IRAs?; Singapore Considering Wealth Tax but Consults the Wealthy First; What's New? – IRS Releases Revised Forms W-8; Notice 2021-51: Further Delay of Withholding Regulations Under Section 1446(f); and Capital Markets Highlights in IRS Priority Guidance Plan.

Derivatives Blog: *The Long and Short of It*. Mayer Brown has launched "The Long and Short of It," a 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, to 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 make regular contributions. Content ranges from detailed and technical to practical and digestible, appealing 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. "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*: help legal and compliance departments protect their organizations in an increasingly rigorous regulatory environment.

LinkedIn Group. Stay up to date on structured and market-linked products news by joining our REVERSEinquiries LinkedIn group.

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.

To request 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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