MAYER | BROWN

VOLUME 05, ISSUE 02 | June 21, 2022

REVERSE inquiries

Structured and market-linked product news for inquiring minds.

In This Issue

SEC Request for Comment on "Information Providers"

On June 15, 2022, the US Securities and Exchange Commission ("SEC") issued a request for comment to "help determine which 'information providers,' such as index providers, model portfolio providers, and pricing services, might come under the [SEC's] definition of an investment adviser." The request for comment discusses the roles played by these entities in, for example, the construction and calculation of indices, and analyzes the factors used to determine whether an entity is providing investment advice within the meaning of the Investment Advisers Act of 1940. The SEC is concerned about what it terms "significant discretion" in index methodologies, citing a law review article.[1]

We will publish a detailed analysis of the request for comment at a later date.

Chair Gensler Warns about Structured Investment Company Act Products

In a May 11, 2022 speech before the International Swaps and Derivatives Association's annual meeting, SEC Chair Gary Gensler called attention to the use of derivatives within structured and complex products.[2] His comments focused on the use of derivatives by investment companies registered under the Investment Company Act of 1940 (the "1940 Act").

Chair Gensler gave examples of derivatives being used in different products, some available to retail investors, mixing and matching in his remarks 1940 Act instruments, as well as more traditional debt securities registered under the Securities Act of 1933 (the "Securities Act"): bitcoin futures exchange-traded funds

[1] Chair Gensler's statement is available at: SEC.gov | Statement on Request for Comment on Certain Information Providers. The request for comment is available at: https://www.sec.gov/rules/other/2022/ia-6050.pdf.

[2] Chair Gensler's remarks are available at: SEC.gov | "A 'New' New Era:" Prepared Remarks Before the International Swaps and Derivatives Association Annual Meeting.

("ETFs"), "SEC-registered funds wrapping these products in publicly offered strategies," exchange-traded products, ETFs (including leveraged and inverse ETFs), and exchange-traded notes. He said these products "can pose risks even to sophisticated investors, and can potentially create system-wide risks by operating in unanticipated ways when markets experience volatility or stress conditions."[3]

Chair Gensler also noted that although some of these products are listed and traded in accordance with federal securities laws, they may not be right for every investor.

Significantly, Chair Gensler asked the SEC's Division of Investment Management and the Division of Examinations to "take a renewed and focused look at the use of derivatives by registered investment companies so that they're compliant with our rules."[4]

Registered Index-Linked Annuities – Creating a Flexible Platform

The market for registered index-linked annuities ("RILAs") is small but growing. RILAs are annuity contracts, the payout of which is linked to the performance of an underlier, such as an equity index. In today's market, we see an intersection of some features of structured products and RILAs. In particular, both instruments increasingly use proprietary indices as a reference asset. Can insurance companies that issue RILAs learn from the structured products marketplace?

Issuers of registered structured products are generally bank holding companies or their finance company subsidiaries or non-US banks eligible to use Form S-3 or F-3. These forms allow for the use of product supplements, which allow the preliminary or final prospectus (or pricing) supplement to be relatively short and easier for an investor to work through, as many of the "boilerplate" provisions, such as market disruption events and a full tax section, are in contained in the underlying supplement. Forms S-3 and F-3 also allow for forward incorporation by reference of material disclosure in the issuer's reports filed under the Securities Exchange Act of 1934 (the "Exchange Act").

Offerings of RILAs are generally registered with the SEC on Form S-1. One approach for S-1 RILA issuers is to obtain a no-action letter from the SEC staff, under which the issuer's financial statements are presented in accordance with statutory accounting principles ("STAT"), rather than US GAAP (as required by Form S-1). STAT financials are required by state insurance regulators and are the norm for RILA issuers.

Under Section 15(d) of the Exchange Act, any issuer that has had a registration statement under the Securities Act declared effective must file Exchange Act reports. Under the Securities Act and the Exchange Act, the financial statements in these reports must be prepared in accordance with US GAAP or International Financial Reporting Standards ("IFRS"). Exchange Act reports also require that the issuer's chief executive officer and chief financial officer complete and file Sarbanes-Oxley certifications.

To avoid burdening an insurance company issuer that is already required under state insurance regulations to report its results under STAT, Rule 12h-7 under the Exchange Act provides an exemption for insurance company issuers from the Section 15(d) reporting requirement. Rule 12h-7, in brief, exempts an insurance

[3] *Id.*
[4] *Id.*

company that is state-regulated and also files an annual statement of its financial condition with, and is supervised and its financial condition is examined periodically by, the state insurance commissioner or equivalent official, among other requirements.

Having no-action letter relief allows use of STAT financials and reliance on Rule 12h-7 allows RILA issuers to enter the market with the least impact on how they run their business. However, there are some drawbacks to this approach.

Form S-1 filings require a full SEC review, which can take several months if there are multiple rounds of SEC comments. Once declared effective, and if the offering of the RILA continues over a period of time, the issuer would have to supplement the prospectus for any material changes in the disclosure. If the offering extends into a new fiscal year and new fiscal year-end financial statements are required, a post-effective amendment to the Form S-1 will have to be filed with the new financial statements, together with an auditor’s consent. This may result in some delay in the offering process, given that a post-effective amendment might be subject to a new review by the SEC and to a declaration of effectiveness by the SEC.

No separate product supplements can be used with a Form S-1. In other words, the terms of the offering are locked into the S-1 prospectus, with whatever options are described in that prospectus. For example, a Form S-1 registering the offering of a RILA linked only to the S&P 500 could not be used to offer a similarly structured RILA linked to the Russell 2000.

How could a RILA issuer get to the flexibility in offerings available to issuers of registered structured notes? For issuers willing to provide US GAAP financial statements and file Exchange Act reports, the issuer could commence an offering on Form S-1 and then timely file its Exchange Act reports. After a year of reporting, the issuer could file a Form S-3 with the SEC, which would be reviewed. Once declared effective, the RILA issuer would be able to commence offerings on its own timetable and have the flexibility of using product supplements to describe the distinctive features of each its offerings. These product supplements could describe different underliers (indices, ETFs) or various payoff structures. A RILA issuer using Form S-3 could conduct offerings in much the same way as an issuer of structured notes.

RILA issuers that are subsidiaries of well-known seasoned issuers (“WKSIs”) may be able to make an initial offering on Form S-3, provided that they meet the requirements for use of that form. In order to take full advantage of Form S-3, the subsidiary should initially file a Form 10-K, which would be incorporated by reference into the Form S-3. Otherwise, the company disclosure in the Form S-3 will be just as lengthy as the disclosure in a Form S-1.

SEC Proposes Amendments to the Names Rule and ESG Disclosure

In an open meeting held on May 25, 2022, the SEC approved two new proposals: (1) a proposal to amend Rule 35d-1 under the of 1940 Act (the “Names Rule”), and (2) an enhanced environmental, social, and governance (“ESG”) disclosure proposal.

The proposed Names Rule amendment expands the scope of the rule to funds with a particular focus or issuers with certain characteristics.[5] It seeks to modernize the "80 Percent" requirement, or the rule that a fund must invest at least 80% of its assets in accordance with the investment focus indicated in its name. The amendment specifically focuses on names that include "growth" and "value," as well as names that include one or more ESG factors. In relation to derivatives investments, the proposed amendment clarifies that in applying the 80% requirement, a fund should use a derivative investment's notional amount, not its market value. The proposed amendment would also require funds to adopt an 80% policy under the Names Rules in connection with its underlying investments.

In addition, Integration Funds that consider ESG factors alongside non-ESG factors would be prohibited from using ESG terminology in the Fund's name. Along with naming considerations, the second proposed amendment calls for increased fund ESG disclosure requirements.[6] The proposals include a layered approach with different requirements for (1) Integration Funds, (2) ESG-Focused Funds, and (3) Impact Funds. Integration Funds would be required to describe in their prospectus how ESG factors are incorporated into the investment process. Meanwhile, ESG-focused Funds would be subject to higher level disclosure requirements. ESG-Focused Funds are those that use one or more ESG factors as significant or main considerations in selecting investments or engagement strategy. This definition includes funds that track an ESG-focused index or industries focused on ESG factors; these would be subject to more detailed disclosure, specifically which and how ESG factors are used in determining investments. Finally, the proposed amendments would require Impact Funds, which seek to achieve ESG objectives, to provide disclosure of how progress to achieve the stated objective is measured.[7] Given that many structured products reference underlying ETFs as well as indices that have ESG objectives, and that the SEC is also stepping up its enforcement activity in respect of entities it alleges market products that misleadingly claim to be ESG-oriented, market participants may want to keep a close eye on these developments.

SEC RIA Enforcement Action

On May 17, 2022, the SEC charged a registered investment advisor ("RIA") and three former senior portfolio managers with fraud involving concealment of the downside risks of a complex options trading strategy (the "Strategy"). Following the COVID-19 market crash in March 2020, the scheme was exposed. The Strategy was sold to 114 institutional investors, including pension funds. The RIA has agreed to pay $1 billion to settle SEC charges and with its parent over $5 billion in victim restitution.

The SEC's complaint alleges the Strategy's lead portfolio manager orchestrated the scheme and, with assistance from other senior portfolio managers, manipulated financial reports and information. They allegedly manipulated information to present lower-than-accurate losses in a market crash scenario and smoothed performance data. Furthermore, the complaint alleges that the lead portfolio manager and other senior portfolio managers made multiple efforts to conceal their conduct from the SEC. The RIA plead guilty and admitted that its conduct violated federal securities laws. The RIA agreed to a cease-and-desist order, and certain financial penalties and disgorgement. As a result, the RIA is automatically disqualified from providing advisory services to US-registered investments for 10 years and will exit these businesses subject to brief

[5] See the SEC fact sheet: https://www.sec.gov/files/ic-34593-fact-sheet.pdf; see the full amendment text: https://www.sec.gov/rules/proposed/2022/ic-34593.pdf.
[6] See the SEC fact sheet: https://www.sec.gov/files/ia-6034-fact-sheet.pdf; see the full amendment text: https://www.sec.gov/rules/proposed/2022/ia-6034.pdf.
[7] For a discussion and summary of other areas of the proposed amendments, see Mayer Brown LLP's Legal Update (May 26, 2022).

transition periods. The SEC's complaint also seeks additional penalties against the leading portfolio managers, including permanent injunctions, disgorgement, plus interest and penalties. In tandem, the US Southern District of New York has also announced criminal charges against the RIA and the leading portfolio managers of the Strategy.

In response to this action, SEC Chair Gary Gensler called for further investor protections. He said, "[t]his case once again demonstrates that even the most sophisticated institutional investors, like pension funds, can become victims of wrongdoing. Unfortunately, we've seen a recent string of cases in which derivatives and complex products have harmed investors across market sectors." Chair Gensler continued, "The Commission stands ready to use all appropriate tools to protect investors, including upholding prohibitions against certain activities by the guilty parties."

The SEC's Proposed Amendments to Regulation M

On March 23, 2022, the SEC proposed amendments to remove references to credit ratings from Regulation M.[8] The proposed amendments would replace such references with alternative measures of creditworthiness and add recordkeeping obligations for broker-dealers. This aligns with the SEC's direction under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 to remove reference or reliance on credit rating and substitute, as appropriate.

Regulation M limits the activities of certain participants in a distribution which activities may manipulate the market for an offered security. There are certain exceptions in Rules 101 and 102 of Regulation M, which apply to nonconvertible debt, nonconvertible preferred securities, and asset-backed securities referenced herein as "Investment Grade Exceptions." The proposed amendments would replace the Investment Grade Exceptions in Rule 101(c)(2) with two alternatives: (1) Rule 101(c)(2)(i), which would address nonconvertible securities, and (2) Rule 101(c)(2)(ii), which would address asset-backed securities.

Rule 101(c)(2)(i) would exempt nonconvertible securities of issuers having a probability of default of less than 0.055% as determined by the distribution participant using a "structural credit risk model" and measured as of pricing day over a 12-calendar month period. Under the proposed amendments, a "structural credit risk model" is defined as "any commercially or publicly available model that calculates the probability that the value of the issuer may fall below a threshold based on an issuer's balance sheet."[9]

Rule 101(c)(2)(ii) would replace the existing exception for asset-backed securities offered pursuant to Form SF-3. There are certain safeguards in Form SF-3 for asset-backed securities that the SEC believes are sufficient to replace the existing rule. Under Form SF-3, the principal focus of investors is the structure of securities and the nature of the assets pooled to serve as collateral, as opposed to the issuer's identity. Form SF-3 addresses this focus because it permits only a limited percentage of delinquent assets; they cannot constitute 20% or more of the asset pool. Form SF-3 also includes transactional requirements. The aforementioned requirements of Form SF-3 are viewed by the SEC as incentive for parties to consider the assets in the pool and do not require an assessment of creditworthiness of the issuer. In addition, the proposed amendments would eliminate the Rule 102(D)(2) exception. This rule applies only to issuers and selling security holders. The SEC noted that there was limited reliance on this exception and those to which it applies continue to have

[8] See the SEC Proposed Amendments in Release No. 34-9449 at: https://www.sec.gov/rules/proposed/2022/34-94499.pdf.
[9] See Release No. 34-9449, page 98, at: https://www.sec.gov/rules/proposed/2022/34-94499.pdf.

an incentive to manipulate the market regardless of their credit quality, which justifies the removal of the current exception without replacement.

With regard to the proposed amendments, the SEC proposes to amend Rule 17a-4(b) under the Exchange Act to require broker-dealers who are distribution participants or affiliated purchasers to keep written records of their probability of default determination. The proposal would add an additional paragraph to Rule 17a-4(b) requiring broker-dealers to retain written probability of default and to preserve it for a period no less than three years and with the first two years readily accessible. Provided that a broker-dealer uses a vendor to determine the probability of default threshold, they can satisfy this requirement by maintaining documentations of the assumptions and output of the vendor model. Our recent Legal Update[10] outlines practical considerations of these recordkeeping requirements for broker-dealers.

Although the SEC has stated that broker-dealers can reprogram their systems to calculate probability of default, many of the calculations required are not currently undertaken by debt capital markets and add additional risks associated with determining the default threshold on the date of the deal's launch. These concerns are related to the proposed Rule 101(c)(2)(i), however, they do not exist in connection with the proposed new Rule 101(c)(2)(ii).

The comment period for the proposed amendments ended on May 22, 2022.

Panel Discussion Regarding Ethical Artificial Intelligence and "Roboadviser" Fiduciary Responsibilities

On March 10, 2022, the Investor Advisory Committee ("IAC") of the SEC held a morning panel that discussed the ethical issues and fiduciary responsibilities relating to the use of artificial intelligence ("AI") in the development and deployment of "roboadvisers" to provide investment recommendations. Generally, a "roboadviser" is an asset management service that uses portfolio management algorithms or artificial intelligence to provide investment advice to customers, thereby facilitating lower costs, account minimums, and fees as compared to services provided by human investment advisers.[11] The panel provided updates on the current use of AI in roboadvising, discussed the technical differences and tradeoffs between AI-powered advice versus recommendations provided by a human adviser, examined how roboadvisers may be subject to bias and blind-spots, and reviewed new developments in the larger-related industry.

One of the panelists noted that while the benefits of AI are being recognized at an expedited pace, there are also risks to using AI in the financial sector. There is a lack of clear "guardrails and standards" to guide AI adoption, which may result in decades of progress being erased in a few lines of code. To prevent this, she noted that the SEC could be helpful in establishing norms and expectations for routine AI testing. The panelist also outlined steps that corporate leadership could take to reduce their potential liability and enhance the benefit of the AI systems they are using; these included, establishing an AI governance framework, identifying the designated point of contact in the C-suite responsible for AI governance, communicating stages of the AI lifecycle where testing will be conducted, documenting relevant findings at the completion of each stage, and implementing routine auditing of AI technology used by the company.

[10] For further discussion and summary on the proposed amendments, see Mayer Brown LLP's Legal Update (April 5, 2022).
[11] See http://schueffel.biz/wp-content/uploads/2017/09/Schueffel-2017-The-Concise-FINTECH-COMPENDIUM.pdf

Another way to mitigate bias is to develop new algorithms and models from an "explainable AI" perspective. Before roboadvisers used AI, human advisers applied advanced analytics and statistics to understand customer behavior, which can be tangibly understood and explained, whereas, a machine learning AI uses a "black box," making it difficult or impossible to understand the basis of the AI's decisions. The new "explainable AI" movement in the industry seeks to mitigate this issue with new sets of models and algorithms fundamentally designed to be explainable, like a new type of AI model called an "explainable boosted machine." Additionally, there are two different ways AI can be used: to augment human decision making or to fully replace a human decision maker. One of the panelists advised that keeping a human in the loop provides a check and balance on the results of an AI model, reducing the risk of failure and impractical outcomes. Conversely, in cases where an AI replaces a human decision maker entirely, there is usually a greater need for scrutiny. Since machine-learning products can have an error rate expressed as a percentage, companies must decide at what threshold they can offer the roboadviser for the product. Given the increasing use of AI to develop financial products and to render financial advice, we can expect to see continued debate on topics related to governance and risk controls.

FINRA Releases Notice on Complex Products and Options

On March 8, 2022, the Financial Industry Regulatory Authority, Inc. ("FINRA") issued Regulatory Notice 22-08 (Complex Products and Options)[12] (the "Notice"). The Notice is FINRA's most significant statement on sales of complex products since 2012.

FINRA notes that the number of accounts trading in complex products and options has increased significantly in recent years and that important regulatory concerns arise when investors trade such products without understanding their unique characteristics and risks. Further, these concerns may be heightened when retail customers access these products through self-directed platforms without the assistance of a financial professional. In light of these concerns, FINRA cautions that trading in complex products and options requires member firm scrutiny and supervision.

The Notice (i) reminds member firms of their regulatory obligations with respect to these products, including the application of Regulation Best Interest when recommending securities or investment strategies involving securities to retail customers, and (ii) solicits comment on effective practices and potential enhancements to FINRA rules to address concerns raised by these products. FINRA intends to coordinate its response to this request for comment with the SEC's development of its regulatory approach.[13]

Continue reading our complete Legal Update authored by Brad Berman, Steffen Hemmerich, Anna Pinedo, and Stephen Vogt (March 11, 2022).

Filing Fee Table Changes

Effective Monday, January 31, 2022, the filing fee table exhibit requirements changed for many Securities Act and Exchange Act filings.[14] For capital markets practitioners, it is important to know that all Rule 424 final prospectus filings for shelf takedowns, from either Form S-3 or Form F-3, will require a separate filing fee exhibit, whether or not fees were prepaid. For "pay-as-you-go" filers relying on Rule 456(b), amended Rule

[12] See the FINRA Notice: https://www.finra.org/sites/default/files/2022-03/Regulatory-Notice-22-08.pdf.
[13] See SEC Chair Gary Gensler's Statement on Complex Exchange-Traded Products (Oct. 4, 2021).
[14] The "Filing Fee Disclosure and Payment Methods Modernization" release is available at: https://www.sec.gov/rules/final/2021/33-10997.pdf.

424(g)(1) and the relevant form (S-3 or F-3) requires a very specific table format. General Instruction II.F. and Item 16(b) of Form S-3 have been amended, as have been General Instruction II.G. and Item 9(b) of Form F-3. Examples of the new tables and detailed instructions are in Item 16(b) of Form S-3 and Item 9(b) of Form F-3.

The amendments move the filing fee table update for "pay-as-you-go" from the cover of the prospectus supplement to a separate exhibit. For Rule 424 filings that are not using "pay-as-you-go," Rule 424(g)(2) does not require the use of a table, but the maximum aggregate amount or maximum aggregate offering price of the securities to which the prospectus relates, and a statement that the prospectus is the final prospectus for the offering, are required to be included in the narrative.

The new requirements also affect filings where unused securities or fees are being carried forward from an existing registration statement to a newly filed registration statement, and also when a combined prospectus is being used under Rule 429.

The new changes affect Forms S-1, S-3, S-4, S-8, S-11, F-1, F-3, F-4, F-10, N-14, SF-1, and SF-3 under the Securities Act, Schedules 13E-3, 13E-4F, 14A, 14C, TO, and 14D-1F under the Exchange Act, and Forms 24F-2 and N-2 under the Investment Company Act.

Events

UPCOMING

- **8th OTC Derivatives Seminar** | July 5, 2022 | Register
- **Medium-Term Note Programs** | July 12, 2022 | Register
- **Structured Investments Summer Summit** | July 14, 2022 | *Co-hosted with the Structured Products Association (SPA)* | Mayer Brown LLP Office, 1221 Avenue of the Americas, New York, NY 10020 | See the complete agenda and register for the in-person-only event

IN CASE YOU MISSED IT…

- **Proposed Amendments to Beneficial Ownership Reporting Rules and Impact to Stakeholders** | March 11, 2022 | Materials | Recording
- **Fundamentals of Swaps & Other Derivatives 2022** | March 14, 2022 | *Hosted by the Practising Law Institute (PLI)*

New ISDA Definitions in Effect as of October 4, 2021

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

Mayer Brown is excited to share that we have been nominated for **European Law Firm of the Year** and **US Law Firm of the Year** for GlobalCapital's **2022 GLOBAL DERIVATIVES AWARDS**.

We greatly appreciate the support of our clients and friends!

This follows on having been named **European Law Firm of the Year – Transactions** at *GlobalCapital's* **GLOBAL DERIVATIVES 2021 AWARDS**, and **US Law Firm of the Year – Regulatory** at *GlobalCapital*'s **AMERICAS DERIVATIVES AWARDS 2021**.

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: Billionaire's Minimum Income Tax—Summary of Proposal/How it Differs from Wyden Proposal; IRS Fact Sheet on Crowdfunding; IBOR Legislation and the Final Regulations; Revocation of IRS REIT PLR; PLR 202211008: Stock Not Participating Preferred; BATS Global Markets Holdings, Inc. and Subsidiaries v. Commissioner; California Proposes 'Extreme Wealth' Net Worth Tax; and Notice 2022-23: Proposed Updates to Qualified Intermediary Agreement.

Derivatives Blog: *The Long and Short of It*. Mayer Brown's "The Long and Short of It," blog provides 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.

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. Each episode discusses 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'll answer on our LinkedIn anonymously or send us topics for future newsletter issues.

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

Bradley Berman
T: +1 212 506 2321
bberman@mayerbrown.com

Mark Leong
T: +1 212 506 2468
mleong@mayerbrown.com

Anna Pinedo
T: +1 212 506 2275
apinedo@mayerbrown.com

G. Nicole Veru
T: +1 212 506 2237
gveru@mayerbrown.com