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REVERSE inquiries

Structured and market-linked product news for inquiring minds.

In This Issue

Can the SEC protect investors from themselves?

What do these stories all have in common?

- An event planner loses over $100,000 shorting a 3X inverse leveraged exchange traded note;[1]
- Individual investors lost their investments in mortgage REIT and crude oil leveraged ETNs during the real estate and crude oil collapse earlier this year;[2] and
- Retail investors poured money into an oil-futures linked ETF this Spring, many not understanding that the price of a share of the ETF was not the same as the price of a barrel of oil.[3]

Besides the obvious ("what were they thinking?"), one has to wonder why retail investors are purchasing products, many of which plainly state in their prospectuses that they are designed as short-term investments for sophisticated investors who track their portfolios on a daily basis, and that state that the products are not designed to be long-term investments.

The Securities and Exchange Commission ("SEC") responded to the dislocations in the markets for leveraged inverse products in a joint statement by Chairman Jay Clayton, Dalia Blass, Director, Division of Investment Management, William Hinman, Director, Division of Corporation Finance, and Brett Redfearn, Director, Division of Trading and Markets (the "Joint Statement").[4]

The Joint Statement noted that retail investors may not appreciate that times of "market stress … typically have a disproportionate impact on complex products, such as leveraged/inverse products …." The SEC acknowledged that these types of products "have operated in accordance with their terms," but the "pricing

[1] "Runaway ETNs Trap Investors in the 'Wild West' of Index Investing," *The Wall Street Journal* (Oct. 19, 2020).

[2] "'Bankrupt in Just Two Weeks; - Individual Investors get Burned by Collapse of Complex Securities," *The Wall Street Journal* (June 1, 2020).

[3] "Oil Market's Crisis Spreads to Individual Investors," *The Wall Street Journal* (Apr. 22, 2020).

[4] The October 28, 2020 Joint Statement is available at: https://bit.ly/32hN1AE.

and trading dynamics of these products during the spring market was not consistent with investor expectations."[5]

In other words, the issue isn't disclosure, it's investor education. With greater access to trading sites,

> "self-directed retail investors are typically making investment decisions on their own accord via online trading platforms and without the assistance of a financial professional. In other words, these self-directed investors do not have the required protections that apply when they receive investment advice from a broker or investment adviser, who must understand, and may explain if necessary, the characteristics and potential risks and rewards of the investment, and determine that it is in the best interest of the retail customer."[6]

If these investors had purchased their complex products through a broker-dealer or RIA, they would have benefitted from certain protections. However, as the SEC stated, "Regulation Best Interest and an investment adviser's fiduciary duty do not apply where a retail investor invests on his or her own accord in complex products through a self-directed account."[7]

How can the SEC protect self-directed retail investors independently selecting complex products, which they may not fully understand? The staffs of the Divisions of Investment Management, Corporation Finance and Trading and Markets will be reviewing the effectiveness of current regulations as they relate to retail investors with self-directed accounts who buy leveraged/inverse and other complex products. The results may be potential new rulemaking, guidance or other policy actions. Also, the staff "may consider … additional obligations for broker-dealers and investment advisers relating to complex products … point of sale disclosures and procedures tailored to the risks of complex products."[8]

Regulation S-K Transitional FAQs

On November 5, 2020, the Staff of the SEC's Division of Corporation Finance provided guidance in the form of Frequently Asked Questions (FAQs) relating to the amendments to Regulation S-K Items 101, 103 and 105, which become effective on November 9, 2020.[9]

Many market participants already have begun the process of updating their Risk Factor section disclosures in order to add subheadings as well as to add a brief summary to the section. The FAQs address the obligation to update as follows:

> (1) **Question**: A registrant has a Registration Statement on Form S-3 that became effective before November 9, 2020. If the registrant files a prospectus supplement to the Form S-3 on or after November 9, 2020, must the prospectus supplement comply with the new rules?

[5] *See* the Joint Statement at Section 2.

[6] *Id*. at Section 3.

[7] *Id*. at Section 4.

[8] *Id*.

[9] See the Frequently Asked Questions at https://www.sec.gov/corpfin/transitional-faqs-amended-regulation-s-k-items-101-103-105.

> ***Answer***: The prospectus supplement does not need to comply with new Items 101 and 103 because Form S-3 does not expressly require Item 101 or Item 103 disclosure but rather requires the incorporation by reference from Exchange Act reports containing that information. A registrant also need not amend its Form 10-K that is incorporated by reference into the Form S-3 pursuant to Item 12(a)(1) of Form S-3 to comply with new Items 101 and 103.
>
> In contrast, Securities Act Rule 401(a) requires that the form and contents of a prospectus supplement conform to the applicable rules and forms as in effect on the initial filing date of the prospectus supplement. Despite the fact that Item 3 of Form S-3 expressly requires Item 105 disclosure, the staff will not object if the prospectus supplement complies with old Item 105 until the next update to the Registration Statement on Form S-3 for Section 10(a)(3) purposes.

Many issuers rely on a layered approach to their structured products disclosures, with a base prospectus, which is accompanied by a prospectus supplement often relating to a medium-term note program, and that in turn is accompanied by a product supplement describing the features of particular structured products or of products having certain underlying reference assets. The terms of the offered products are usually contained in a pricing supplement and/or a free writing prospectus. Several of these documents may contain Risk Factors sections. Also, many issuers will offer their structured products through their affiliated broker-dealer, as well as through a number of third-party distributors, each of which may have its own preferred approach to risk factor disclosure. Consideration should be given to the totality of the disclosures relating to risks as well as the ordering or grouping of these risks into subheadings or categories.

FINRA Proposes a Retail Communication Filing Requirement for Private Placements

Financial Industry Regulatory Authority, Inc. ("FINRA") Rules 5122 (private placements of securities issued by member firms) and 5123 (private placements of securities) each require a FINRA member to file with the FINRA advertising department any private placement memorandum, term sheet or other offering document that discloses the intended use of the offering proceeds, the offering expenses and the amount of selling compensation that will be paid to the FINRA member. Because offerings covered by both rules to institutional investors are exempt from their respective filing requirements, the rules apply predominantly to private placements made to retail investors. Neither rule requires that a "retail communication," as defined in FINRA Rule 2210, be filed with FINRA. However, many of such retail communications are filed voluntarily or by new FINRA members under Rule 2210(c)(1)(A).

In the proposed rule change filed with the SEC on October 28, 2020, FINRA noted that many of the voluntarily filed retail communications for private placements are deficient and tend to raise more compliance issues than for other products.[10] Consequently, FINRA proposes to amend Rules 5122 and 5123 to require filing with FINRA any retail communication, as defined in Rule 2210, at or prior to the first time the retail communication is provided to a retail investor.

As this is an initial filing with the SEC, no effective date for the amendments was proposed.

[10] The FINRA 19b-4 Application is available at: https://bit.ly/3kXE6M9.

ARRC Provides Recommendations to US Prudential Banking Regulators to Facilitate USD LIBOR Transition to SOFR

On November 2, 2020, the Alternative Reference Rates Committee ("ARRC") sent a detailed memorandum ("Memorandum") to the Board of Governors of the Federal Reserve System ("FRB"), the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC" and, together with the FRB and FDIC, the "Agencies") that summarizes the ARRC's preliminary findings and recommendations on the potential regulatory considerations with the application of current and anticipated capital and liquidity requirements in the context of the market transition from the use of the London Interbank Offered Rate ("LIBOR") to the Secured Overnight Financing Rate ("SOFR") as a contractual reference rate in the United States (the "Transition").

The Memorandum notes that a key policy goal of the Transition is to reduce overall risk in the financial system. The treatment of SOFR-based exposures under prudential capital and liquidity standards during and after the Transition should recognize this policy goal and ensure that prudential treatment of these exposures does not dis-incentivize timely and voluntary transition to SOFR. In general, if the Transition were to lead to unintended increases in capital and liquidity requirements, this would be at cross-purposes with the macro-prudential goal of mitigating risk of the financial system as a whole. To that end, the Basel Committee on Banking Supervision ("BCBS") has issued guidance in the form of FAQs ("BCBS June 2020 FAQs") that clarify application of certain international capital and liquidity standards in light of the transitions in many of its member jurisdictions from IBORs to risk-free rates ("RFRs").

The ARRC states in the Memorandum that it believes US regulators should similarly address these principles with respect to current US capital and liquidity regulatory requirements, as well as to future such requirements, such as quantitative impact studies of the implementation of the Fundamental Review of the Trading Book ("FRTB") because past studies may not have included a robust pro forma analysis reflecting the impact of the Transition and because the BCBS June 2020 FAQs are not legally operative in the United States.

Read our complete Legal Update.

US Bank Regulators Finalize Net Stable Funding Ratio Rule

Despite attracting recent controversy from some—who have noted that if it had been in effect earlier in 2020, initial financial stress from the COVID-19 pandemic would have been worse—the long-anticipated net stable funding ratio (NSFR) rule has been finalized by the Agencies. The NSFR was developed after the 2008 financial crisis revealed that an over-reliance on short-term, less-stable funding sources could make large banking organizations more susceptible to funding changes. The NSFR rule is a quantitative liquidity standard that was originally adopted in October 2014 by the BCBS as part of the Basel III regime and was first proposed by the Agencies in 2016. The proposed and final NSFR rules differ from the standard developed by the BCBS based on US-market specific factors.

The full NSFR rule will apply to nine of the largest US banking organizations and to their consolidated subsidiaries that are depository institutions with $10 billion or more in total consolidated assets. A modified version of the NSFR rule will apply to eleven other depository institution holding companies with assets of at least $100 billion, including certain intermediate holding companies formed by foreign banking organizations (FBOs) under FRB's Regulation YY, as well as certain of their consolidated subsidiaries that are depository institutions with $10 billion or more in total consolidated assets. The NSFR rule will not apply to FBOs or US branches and agencies of FBOs.

The NSFR rule generally is similar to the proposal from May 2016, but, most notably, the scope of the NSFR rule has been recalibrated to be consistent with the Agencies' 2019 tailoring rule. Additionally, FRB indicated that it intends to propose changes to the FR 2052a to incorporate the reporting requirements under the NSFR rule. The NSFR rule will take effect on July 1, 2021.

Read our complete Legal Update.

Exempt Offering Framework Amendments

On November 2, 2020, the SEC voted to adopt amendments proposed in March 2020 that harmonize and modernize the exempt offering framework (referred to as the Amendments). As with several other recent votes to adopt rule proposals, the SEC Commissioners split their vote, with two Commissioners voting against the Amendments. Among other things, the Amendments modernize the framework relating to the integration of securities offering occurring in close proximity to one another. The Amendments include a new, simpler approach to integration consisting of four non-exclusive safe harbors guided by several overriding principles. This simpler approach is set forth in a new Rule 152, which replaces current Rule 152 and Rule 155. The provisions of Rule 152 will not have the effect of avoiding integration for any transaction or series of transactions that are part of a scheme to evade the Securities Act registration requirements. Instead of embedded integration provisions, Regulation D, Regulation A, Regulation Crowdfunding, and Rules 147 and 147A now contain references to new Rule 152.

Read our complete Legal Update.

LIBOR Transition Assistance Legislation Introduced in New York State Senate

On October 28, 2020, New York State Senator Kevin Thomas introduced Senate Bill S9070, which would add a new Article 12 to New York's Uniform Commercial Code that substantially adopts the language from the proposed legislative solution produced by the Alternative Reference Rates Committee (ARRC) in March 2020. For some market participants, this announcement may trigger hearing the Halleluiah chorus from Handel's Messiah, while others may still be asking why it took so long, and still others may be asking why bother given its potential limitations.[11]

11 Some of which we discussed in our prior Perspective US ARRC Proposes a New York State Legislative "Solution" for Legacy LIBOR Contracts Without Adequate Fallbacks—But What Does It Actually "Solve"?

Even if this is properly regarded as "good news," the political reality is that the legislation is unlikely to be taken up until the 2021 legislative session that begins in January 2021.

Meanwhile, prospects for federal legislation that may address some of the limitations of the proposed New York legislation (and would apply in all states, including New York) remains uncertain, although there are encouraging reports of Congressman Brad Sherman[12] seeking sponsors for such legislation.

Originally published on Mayer Brown's new blog, Eye on IBOR, which provides continuing regulatory and legislative announcements, trade group tools, and the status of market transition.

FINRA Study on Overconfidence and Excessive Risk Taking Among Older Investors; FINRA Proposes Amendments to Rules Affecting Seniors

In September 2020, the FINRA Investor Education Foundation published a study, "Does Overconfidence Increase Financial Risk Taking in Older Age?" that is based on a surveys completed by 1,200 adults. Financial literacy was lowest among the oldest adults in the study; however, the confidence in financial knowledge was similar across all ages. The study suggests that overconfidence may contribute to risky financial behavior. The detailed report provides a number of useful insights for broker-dealers and advisers, suggesting, for example, the benefits that may be associated with devoting additional time to understanding financial literacy among clients, spending more time addressing portfolio or investment risk when updating client information, and undertaking more educational outreach with older investors.

In October 2020, FINRA proposed amendments to Rule 2165 on Financial Exploitation of Specified Adults. In Regulatory Notice 20-34, FINRA describes the retrospective review and comments relating to senior issues. Rule 2165 allows a FINRA member firm to place a temporary hold on a disbursement of funds or securities from the account of a "specified adult" customer when the member firm believes that the customer is experiencing financial exploitation. The safe harbor under Rule 2165 allows a firm to place a temporary hold for up to 25 business days to the extent that specified criteria are satisfied. FINRA proposes to amend the rule to permit extension of the temporary hold for an additional 30 business-day period if the incident has been reported to a state agency or to a court. FINRA also proposes to extend the rule to allow for a hold on securities transactions subject to safeguards. The comment period expires on December 4, 2020.

SEC Charges Senior Index Manager for Insider Trading

On September 21, 2020, the SEC announced charges against Yinghang "James" Yang, a senior index manager at a well-recognized index provider, for perpetrating an insider-trading scheme. Yuanbiao Chen, Yang's friend, was named a co-defendant.

12 Democrat, California and Chair of the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets of the House of Representative's Financial Services Committee

The SEC alleged that between June and October of 2019, Yang, while serving on an index committee, purchased options of publicly traded companies before the public announcement of additions or deletions of these companies to the indices that Yang's employer maintained. To conceal these trading activities from his employer's supervision, Yang conducted all the trades in Chen's brokerage account. Chen opened the brokerage account about one month before these trades and misrepresented his trading experience to the brokerage firm in order to obtain options trading authorization. The SEC also alleged that many orders to purchase options were immediately preceded by logins to Chen's brokerage account by IP addresses assigned to Yang's employer. The brokerage account was also accessed by IP addresses assigned to Yang's home and Chen's restaurant.

The SEC alleged that Yang and Chen generated about $900,000 in profits through the insider trading scheme. The Department of Justice also brought criminal charges against Yang.

We usually hear about insider trading cases where unusual options activities happen before a major M&A announcement. This case, however, is possibly the first time that the SEC brought a case against an employee of an index provider, and it serves as a reminder that material non-public information is not limited to information obtained from an issuer, dealer or other distribution participant. Given that trades of this type turned out to be profitable, this case also sheds some light on the potential impact of additions or deletions of a stock to an index and their effects. As more and more investment decisions involve indices and other data aggregates, market-moving information providers may need to implement and enhance the scrutiny of their employees' conduct and the effectiveness of internal information walls that prevent such information from being misused.

Upcoming Events

- **PLI Fund Finance 2020**
  November 11, 2020 | *Register here*
  Lawrence Hamilton will speak on the panel entitled *Overview of Collateralized Fund Obligations and Principal Notes,* discussing structuring considerations; transaction benefits for sponsors and general partners; and NAIC outlook.
- **REVERSEinquiries Webinar: Emissions Linked Trading in the US and EU**
  November 12, 2020 | *Register here*
  Ed Parker and Matthew Kluchenek will discuss key issues with emissions trading, the asset class which is purely a creature of regulation and that leads to many intricacies, nuances and traps for the unwary. They will cover:
  - Relevance of the Kyoto Protocol
  - Emissions Trading Regimes
  - ISDA, EFET and EFET Documentation Platforms
  - Regulatory Treatment of Emissions Products in the US (i.e., as Swaps, Futures or Forwards)
  - Using Emissions Allowances as an Underlying Asset in Structured Products, including property rights issues in different EU Member States, and issues with taking security
  - Awareness of Fraud Issues

IN CASE YOU MISSED IT...

SEC Amends Requirements for Statistical Disclosures for Bank and Savings and Loan Registrants, Formerly Guide 3 (September 2020)

Listen to this podcast.

REVERSEinquiries Workshop: Issuing Credit Linked Notes (October 2020)

Watch this webinar.

Structured Products Association 17th Annual Conference (October 2020)

Watch select panels from this webinar.

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MAYER BROWN'S IBOR TRANSITION RESOURCES

The final countdown to the LIBOR cessation date has begun. With fewer than 500 days left until December 31, 2021, rely on Mayer Brown to assist you.

With our global presence, deep knowledge of the affected markets and products, participation in trade and industry groups and considerable experience in using technology solutions (including artificial intelligence and other technology-assisted review tools), Mayer Brown is uniquely positioned to advise financial institutions and other affected market participants.

Our IBOR Transition Task Force, composed of nearly 100 partners globally, is perhaps the best reflection of our strength and depth.

Below we provide a sampling of our resources:

IBOR Transition Digest: A compendium of global regulatory and market news as well as insights on the complex issues confronting financial market participants as they transition from LIBOR and its variants to replacement benchmark interest rates.

Recent publications, include:

FINRA LIBOR Phase-Out Preparedness Survey (August 2020)

"Comparable" Alternative Reference Rates to LIBOR: The Low Bar for Official Designation, the Much Higher Hurdle of "Fit for Use" and Implementation for Market Participants (August 2020)

IBOR Transition: It's Later Than You Think! (August 2020)

IBOR Transition Webinar Series: Detailed discussions and insights—in 30 minutes or less—on a range of topics from setting and executing an effective IBOR Transition strategy to assessing the impact of IBOR issues on specific financial products.

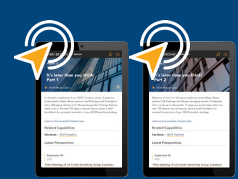
Subscribe on: Google Play Spotify

Recent webinars, include:

Part 5.1 Part 5.2

LIBOR Transition: Issues impacting Floating Rate Notes, Preferred Stock, Depositary Shares, and Capital Securities (Part 5.1 & Part 5.2) (August / September 2020)

Issues impacting Floating Rate Notes, Preferred Stock, Depositary Shares, and Capital Securities: Part 1 (August 2020)



Part 1 Part 2

It's later than you think! (Part 1 & Part 2) (August 2020)

morae

We are collaborating with Morae Global Corporation, a leading provider of legal and compliance technology solutions, to assist clients in the transition from the IBORs to alternative risk-free reference rates. To more effectively serve our client, Mayer Brown has teamed up with Morae, to offer clients data analytics and remediation, technology enablement, repapering and program management capabilities.

Our firm and our partners are ranked as leaders for capital markets, structured finance and securitization, derivatives, structured products, financial services and bank regulatory, litigation, and tax by:

TOP RANKED Chambers GLOBAL 2020	TOP RANKED Chambers USA 2020	The LEGAL 500 UNITED STATES	IFLR 1000
"Esteemed firm with excellent securitisation, structured finance and derivatives capital markets practices. Regularly sought after for advice on cross-border and transatlantic securitisation and structured finance transactions"	"A strong global reach allows the team to handle cross-border cases with ease, while the presence of several former regulatory officials provides insight into the most cutting-edge matters."	"The firm routinely leads on cross-border offerings from the US but it can also draw on its extensive network of offices for support on complex, multi-jurisdictional transactions... Among its industry sweet spots, the group is most prominent in the financial services..."	"Mayer Brown has leading structured finance, project development and project finance practices, as well as additional strengths in debt and equity capital markets."

Question? Please contact Marlon Paz, mpaz@mayerbrown.com, or see our Global IBOR Transition Task Force contacts.

Mayer Brown is pleased to have been named the European Law Firm of the Year – Transactions for *GlobalCapital*'s Global Derivatives Awards 2020.

This follows our win as US Law Firm of the Year – Transactions for *GlobalCapital*'s Americas Derivatives Awards 2020. We would like to thank *GlobalCapital* for its continued recognition and thank our friends and our colleagues for their trust in our work.

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 an update on US Tax Relief for COVID-19; Proposal to Reactivate the New York Stock Transfer Tax; IRS Delays Certain QI Certifications Due in 2020; *US v. Bittner*; and IRS Releases Final and Proposed Anti-Hybrid Tax Regulations.

LinkedIn Group. Stay up-to-date on structured and market-linked products news by joining our 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 send us suggestions/comments, please scan the QR code, which will notify us via email at REVERSEinquiries@mayerbrown.com.

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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