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REVERSE inquiries

Structured and market-linked product news for inquiring minds.

US Agencies Finalize Revisions to Volcker Rule Covered Funds Provisions

On June 25, 2020, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (collectively, the "Agencies") finalized revisions to the covered funds provisions of the Volcker Rule (the "2020 Revisions"). The 2020 Revisions address the prohibitions and restrictions regarding covered fund activities. The Agencies intend for the 2020 Revisions to clarify, streamline, and ease the compliance burden of the covered funds provisions of the Volcker Rule by:

- Codifying foreign excluded fund relief for non-US banking entities;
- Incorporating some Section 23A exemptions relating to certain transactions with affiliates into the "Super 23A" restrictions;
- Easing the compliance burden for loan securitizations, foreign public funds, and small business investment companies;
- Creating four new exclusions for banking entities to invest in or sponsor credit funds, venture capital funds, customer facilitation funds, and family wealth management vehicles;
- Narrowing the scope of the definition of ownership interest; and
- Clarifying the treatment of parallel direct investments by a banking entity in the same underlying investments as a sponsored covered fund. The 2020 Revisions are largely consistent with the notice of proposed rulemaking published six months ago and incorporate comments received to questions posed in a 2018 proposal.

However, the 2020 Revisions also reflect some important, and welcome, clarifications and other adjustments.

Read our full Legal Update here.

In This Issue

Consent Solicitations: Challenging Orthodoxies

If an issuer wants to amend the terms of an outstanding security or the indenture governing the security, it must comply with the provisions of the indenture governing supplemental indentures. For certain minor or ministerial amendments, bondholder consent is typically not required. For more significant amendments, including amendments to affirmative or negative covenants, the consent of a majority or two-thirds of bondholders is typically required under the applicable indenture. If the amendment relates to a core term, such as the interest rate, interest amount, the amount of principal or payment dates, the supplemental indenture requirement normally reads:

> "no such supplemental indenture shall, *without the consent of the Holder of each Outstanding Security affected thereby*, change the stated maturity of the principal of, or any installment of principal of or interest on, any Security, or reduce the principal amount thereof or the rate of, interest thereon …." (Emphasis added.)

Requiring the consent of each affected holder for certain payment provisions of the security is based on Section 316(b) of the Trust Indenture Act of 1939 ("TIA") (Prohibition of Impairment of Holder's Right to Payment), which reads in part:

> "Notwithstanding any other provision of the indenture to be qualified, the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected *without the consent of such holder* …." (Emphasis added.)

The requirement for the consent of each holder affected by an amendment has often been read by practitioners to require the unanimous consent of the holders of the series of securities to agree to the amendment in order for the amendment to be effective. A recent article in an industry publication suggests that the "100% consent required" reading of the supplemental indenture provision is not shared by all. The article was in response to a letter from The Credit Roundtable to Waste Management, Inc., suggesting that a consent solicitation could be used to delay a redemption date for multiple series of securities.[1] The article highlighted the supplemental indenture requirements in the Waste Management, Inc. indenture, almost exactly like the indenture language quoted above, and made the argument that if less than all of the security holders consented to the change in the redemption date, the non-consenting holders would not be affected by the amendment – their securities would be redeemed under the original terms.

The rationale that only consenting holders would be affected by a proposed amendment, with non-consenting holders not affected and thus not required to consent under the amendment provisions, has support in the learning around Section 316(b) of the TIA. Section 316(b) is a "collective action clause" designed to protect security holders from the tyranny of a majority of security holders who might, for some reason (such as during a bankruptcy workout), use their majority status to modify a core term of the indenture, such as an interest or payment provision.[2]

[1] The Credit Roundtable letter is available at: https://bit.ly/2OHqCWd.

[2] *See UPIC & Co. v. Kinder-Care Learning Ctrs., Inc.*, 793 F.Supp 448, 452 (S.D.N.Y. 1992).

The legislative history of Section 316(b) is enlightening with respect to whether unanimous consent is required to alter a note holder's right to receive interest and principal when due. The District Court of Rhode Island cited this legislative history of Section 316(b) in 1946:

> "Under subsection (b), the indenture must provide that, except as to an interest postponement consented to as provided in subsection (a), the right of any indenture security holder to receive his principal and interest when due and to bring suit therefore may not be impaired *without his consent*...This provision does not prevent the majority from binding dissenters by other changes in the indenture or by a waiver of defaults, and the majority may of course consent to alterations of its own rights."[3] (Emphasis added.)

However, no cases were found litigating this point in the context of a consent solicitation.

How these supplemental indenture provisions are read may become important to issuers with outstanding U.S. dollar LIBOR floating rate securities. Most "legacy" LIBOR floating rate securities issued prior to 2018 will, once LIBOR ceases to be published, default into fixed rate securities. That change may or may not be detrimental to security holders and/or issuers. Issuers wishing to resolve this potential problem may want to consult counsel as to whether a consent solicitation to amend the interest rate provisions of legacy LIBOR floating rate securities is a potential solution. If so, even without unanimous consent, the securities of at least the consenting holders could be moved into a new floating rate basis (e.g., the ARRC recommended secured overnight financing rate (SOFR)) while the securities of the non-consenting holders would remain in their un-amended, fixed rate status. If this were feasible, there would nonetheless be a significant number of practical challenges to overcome. For example, the one series of notes would have to subsequently be represented by two different CUSIPs, with each corresponding to a new series having different rates, but with both CUSIPs voting together as a single series.

New FINRA Notice Addresses Retail Communications in Private Offerings

On July 1, 2020, the Financial Industry Regulatory Authority, Inc. (FINRA) released Regulatory Notice 20-21 (the Notice), in which it provided guidance to member firms on compliance with FINRA Rule 2210, Communications with the Public, in the context of private placements involving retail customers.[4]

The Notice focuses mainly on offerings exempt from registration under the Securities Act of 1933 by virtue of Regulation D thereunder. Private placements, such as Regulation D offerings, sold to retail investors by FINRA member firms are generally subject to the filing requirements of FINRA Rules 5122 or 5133. Regulation D offerings offered directly by issuers without the use of a FINRA member intermediary are not subject to those rules, and neither are Rule 144A or Regulation S offerings.

For retail communications in private placements, FINRA reminded member firms that:

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[3] *Cont'l Bank & Trust Co. of N.Y. v. First Nat. Petroleum Trust*, 67 F.Supp. 859, 872 (D.R.I. 1946) (quoting the report of the Committee of Interstate and Foreign Commerce of the House of Representatives on the Trust Indenture Bill of 1939, June 30, 1939, House of Representatives Report No. 1016, 76th Congress, 1st Session, D. Analysis by Sections, at p. 56).

[4] The Notice is available at: https://bit.ly/2Wy5yWr.

- Under Rule 2210(d)(1), all member firm communications must be fair, balanced and not misleading;
- Any promotion of potential rewards must be balanced by disclosure of the associated risks;
- Communications must be accurate and provide a sound basis to evaluate the facts with respect to the products or services discussed; and
- Retail communications must be approved by a registered principal of the FINRA member.

These issues may arise even when the communication is prepared by a third party but distributed or used by the member firm. Also, if a retail communication is included in the same electronic file with an issuer-prepared private placement memorandum and distributed by a member firm, the retail communication is still subject to Rule 2210 (*i.e.*, it is still a communication by the member firm).

Retail communications must balance any discussions of benefits with a discussion of the related risks. These risk factors must be in the same retail communication; placing the risk factors in a separate document, such as the private placement memorandum, or in a different section of the website, is no substitute for disclosure integrated into the retail communication.

Under Rule 2210(d)(1)(F), retail communications may not contain any prediction or projection of performance, subject to certain exceptions, as well as any exaggerated or unwarranted claim, opinion or forecast. As an example, retail communications may not project or predict returns to investors such as yields, income, dividends, capital appreciation percentages or any other future performance. However, reasonable forecasts of issuer operating metrics, together with a sound basis for evaluating the facts and the related risks, would not be inconsistent with Rule 2210.

The Notice also discussed FINRA's guidance on the use of distribution rates and internal rate of return calculations.

Volatility-Linked Exchange Traded Products Disclosure Requirements – Recent Affirmation

A court in the Southern District of New York recently dismissed a case brought by investors against Credit Suisse related to the VelocityShares Daily Inverse VIX Medium-Term Exchange Traded Notes ("ZIV ETNs") and the sufficiency of the disclosure in the ZIV ETN offering documents. While this case was specific to the ZIV ETNs, the opinion highlights the disclosure expectations regarding volatility-linked exchange traded products that issuers should consider (in addition to the FINRA guidance regarding sales of volatility products, which we have previously discussed here).

As a result of a spike in market volatility, Credit Suisse hedged its exposure as the issuer of the ZIV ETNs in the market using, among other thing, the same futures contracts used to determine the level of the S&P 500 Mid-Term VIX Index, the index underlying the ZIV ETNs. As volatility continued to increase, this hedging activity contributed to the trading volume and adversely affected the market price of the relevant futures contracts – effects that were exacerbated by thin liquidity. Investors, as a result of the volatility spike, suffered significant losses on the ZIV ETNs.

The ZIV ETN plaintiffs brought claims under both Section 11 of, and Regulation S-K under, the Securities Act of 1933, alleging that there were material omissions in the ZIV ETN disclosure regarding key risks, including Credit Suisse's hedging activity and its effects on market levels, liquidity in futures markets for VIX contracts and investor suitability.

The court, in its review of the offering package, recognized that the ZIV ETN offering documents provided extensive disclosure regarding potential hedging activity, making clear that Credit Suisse intended to hedge its obligations through one or more affiliates and that such activity could contribute to the trading volume of the underlying futures contracts and affect the market price. Credit Suisse also made clear that it could receive positive returns on its hedging activities while the value of the ZIV ETNs declined. The disclosure also included warnings that the market price of the ZIV ETNs may be influenced by the liquidity of the underlying futures contracts or related futures and derivatives contracts and that futures markets are subject to temporary distortions due to factors including lack of liquidity. The court was clear that it viewed these disclosures as sufficient, and that it was unnecessary for Credit Suisse to state the risks with certainty (i.e., "would" rather than "could" or "may") or for it to describe prior spikes in the VIX futures market given that this information was otherwise publicly available. The lack of disclosure regarding historical performance (and forecasts of future performance based on historical performance) where that information is otherwise publicly available has been consistently supported for volatility products and, more generally, for other types of structured products.

The ZIV ETN disclosure also warned that the ZIV ETNs were inappropriate for certain investors and outlined suitability considerations. Credit Suisse specifically disclosed that the ZIV ETNs were appropriate only for sophisticated, knowledgeable investors that were willing to sustain significant or even total losses on the investment. The disclosure also specifically warned that the ZIV ETNs were only suitable for very short investment horizons and warned against long holding periods *even within the course of a single day*. As a result, the court dismissed plaintiffs' claim.

The opinion also specifically referenced the extensive warnings that an investor may lose a significant portion or all of its investment in the notes in addition to the more detailed risk discussion described above. The opinion also emphasized the prominence, based both on repetition and formatting, of this disclosure, making clear to investors that there was a potential of large or even total losses. Ultimately, due to the warnings regarding potential losses, in combination with the disclosures regarding hedging and market liquidity and investor suitability, the court dismissed the plaintiffs' claims.

US FFIEC Issues Joint Statement on Managing the LIBOR Transition

On July 1, 2020, the United States Federal Financial Institutions Examination Council (FFIEC)[5] issued its Joint Statement on Managing the LIBOR Transition (FFIEC Statement), adding its voice to the global regulatory

[5] The FFIEC is composed of the following: a member of the Board of Governors of the Federal Reserve System (FRB), appointed by the chairman of the FRB; the director of the Bureau of Consumer Financial Protection; the chairman of the Federal Deposit Insurance [5] Corporation (FDIC); the chairman of the National Credit Union Administration (NCUA); the comptroller of the Currency; and the chairman of the State Liaison Committee.

chorus[6] calling for active engagement by supervised financial institutions and effective preparation for, and management of, the expected discontinuation of the London Interbank Offered Rate (LIBOR) and transition to alternative reference rates and warning of increased regulatory scrutiny regarding LIBOR transition preparedness.

The FFIEC Statement highlights the financial, legal, operational and consumer protection risks that will result from the transition from LIBOR and encourages supervised institutions to continue their efforts to prepare for this change and address its associated risks. The risks noted in the FFIEC Statement include:

- Operational difficulty in quantifying exposure;
- Financial, valuation and model risk related to reference rate transition;
- Inadequate risk management processes and controls to support transition;
- Consumer protection-related risks;
- Limited ability of third-party service providers to support operational changes; and
- Potential litigation and reputational risk arising from reference rate transition.

While the FFIEC Statement states that the FFIEC is not establishing new guidance or regulation, the FFIEC Statement then notes a number of potential preparedness and risk management actions that institutions should factor into their planning for the transition and states that the supervisory focus on evaluating institutions' preparedness for LIBOR's discontinuation will increase during 2020 and 2021, particularly for institutions with significant LIBOR exposure or less-developed transition processes. During regularly scheduled examinations and monitoring activities, supervisory staff will ask institutions about their planning for the LIBOR transition, including the identification of exposures, efforts to include fallback language or use alternative reference rates in new contracts, operational preparedness and consumer protection considerations. The FFIEC states that at institutions with exposures to LIBOR-indexed instruments, supervisory staff will engage in discussions about transition efforts, including:

- Identification and quantification of LIBOR exposure across product categories and lines of business;
- Risk assessment of LIBOR exposures, which may include scenario testing, legal review and other analysis;
- Transition plans with milestones and key completion dates, addressing areas such as:
    - Strategies to inventory, analyze and assess risk posed by existing contracts;
    - Strategies to identify replacement rates, modify spreads and revise existing contracts, as necessary;
    - Strategies to address third-party risk management;

[6] See our prior related Perspectives at: https://bit.ly/3jeOO0p; https://bit.ly/3eHgPKA; https://bit.ly/2OBdxxQ; and http://bit.ly/3764Xif.

  - Potential impact to the institution's customers;
  - Communication plans for engaging with customers and other stakeholders; and
  - Plans to identify, monitor and resolve system and other operational constraints;
- Management's assessment of revisions that may be necessary to update the institution's policies, processes and internal control systems;
- Responsibility for LIBOR transition oversight (to a committee, team or officer); and
- Progress reporting to a supervised institution's board of directors and senior management on the LIBOR transition plan.

As the December 31, 2021, deadline for the cessation of LIBOR gets closer, regulatory warnings like the FFIEC Statement are likely to increase in number and urgency.

SEC's OCIE to Begin LIBOR Preparedness Exams

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

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

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

Upcoming Events

- **Are You Prepared for the LIBOR Summit? (Mayer Brown webinar)**
  July 22, 2020 | *Register here:* https://bit.ly/39lhCQk

  The sun is going down on LIBOR, with final phase-out of the benchmark looming just 530 days away.

  As of January 1, 2022 the Financial Conduct Authority will no longer compel banks to quote LIBOR (and its variations) as a benchmark lending rate. The required transition is shaping up to be one of the most fundamental changes to the financial services industry in recent times.

  Our new LIBOR Transition series of webinars and podcasts will provide information on the key issues and considerations you need to know about.

Please join Mayer Brown partner Paul Forrester and Joy Saphla, President, Strategic Solutions from Morae for the first webinar in this series where they will be discussing the broader landscape as well as sharing insight into the collaboration between Morae Global and Mayer Brown.

- **Convertible Bonds: Understanding the Key Benefits**
  July 23, 2020 | *Register here: https://bit.ly/3ePhhX4*
  As many issuers continue to seek access to the capital markets in light of the pandemic related downturn, our webcast will focus on convertible bonds. Converts have been among the most popular financing tools in recent months, and, for good reason.

  We will discuss the state of the market, and provide a convertible bond overview; accounting and reporting implications for issuers; accompanying antidilutive strategies, including capped call and call/warrant structures; tax considerations for the issuer; addressing busted converts; and other securities and disclosure considerations.

- **Structured Products Association 17th Annual Conference**
  October 15, 2020 | *Register here: https://bit.ly/2ZLeCte*
  Please join us on October 15 for the Structured Products Association's Annual Conference, co-hosted by Nasdaq and Mayer Brown.

  We will be discussing the following topics:

  - Recap of Regulation Best Interest, Amendments to FINRA's Suitability Rule, and Implementation Experiences
  - Volcker Rule Covered Fund Amendments and Fund-Linked Products
  - NAIC's PPN Measures
  - Tax Updates
  - Proprietary Indices, ESG-Linked Products, and US Considerations and European Considerations
  - Security-Based Swap Regulation and Structured Notes
  - The LIBOR Transition for Structured Products and Derivatives
  - How Structured Products Fared During the Pandemic Related Downturn

COVID-19 RESOURCES

All COVID-19 related alerts and events can be found on our COVID-19 web portal

IBOR TRANSITION PAGE

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

ANNOUNCEMENTS

Capital Markets Tax Quarterly. Mayer Brown's Capital Markets Tax Quarterly provides capital markets-related US federal tax news and insights.

In our latest issue, we cover some of the COVID-19 related federal tax law changes that have occurred with blinding speed since mid-March..

LinkedIn Group. Stay up-to-date on structured and market-linked products news by joining our LinkedIn group. To request to join, please email REVERSEinquiries@mayerbrown.com.

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. Please email your questions or topics to: reverseinquiries@mayerbrown.com.

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

We are also pleased to be shortlisted once again for European Law Firm of the Year – Transactions, European Law Firm of the Year – Regulatory, and Global Law Firm of the Year (Overall) for *GlobalCapital*'s Global Derivatives Awards 2020.

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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