WHAT'S THE DEAL?

3(a)(2) Bank Note Programs

Here's the deal:

- Section 3(a)(2) bank note programs are medium-term note programs with a "bank" as the issuer
- The issuer must be a "bank," as defined in Section 3(a)(2) of the Securities Act
- Bank note programs allow the issuer to access the market quickly without the delay associated with SEC review and to do so on a regular or continuous basis
- Securities issued pursuant to a Section 3(a)(2) bank note program are exempt from SEC registration

What's the Deal? – What is Section 3(a)(2)?

Section 3(a)(2) of the Securities Act of 1933 (the "Securities Act") exempts from registration under Section 5 of the Securities Act any security issued or guaranteed by a "bank." The policy underlying this exemption from the registration requirements of Section 5 of the Securities Act is that banks are highly regulated, and provide adequate disclosure to investors about their businesses and operations in the absence of federal securities registration requirements. Banks are also subject to various regulatory capital requirements that may serve to increase the likelihood that holders of their debt securities will receive timely payments of principal and interest.

What is a "bank?"

Under Section 3(a)(2), an institution must meet both of the following requirements: (1) it must be a national bank or an institution supervised by a state banking commission or similar authority and (2) its business must be substantially confined to banking. Entities that sound like banks but do not qualify include, bank holding companies, finance companies, investment banks and foreign banks. As discussed below, regulated U.S. branches and agencies of foreign banks may qualify as a "bank."

What types of securities are generally issued pursuant to bank note programs?

Common types of issuances include senior or subordinated debt securities, such as fixed or floating rate, zero-coupon, non-U.S. dollar denominated, amortizing, multicurrency or indexed ("structured" or "market-linked") debt securities. Most bank note programs are rated "investment grade" by one or more nationally recognized credit rating agencies, as further discussed below. Bank issuers often use bank note programs to issue Section 3(a)(2) structured notes, the payments on which are linked to the performance of specified reference assets not always seen in registered programs, such as complex underlying assets, credit-linked notes, small-cap stocks and non-U.S. stocks, that do not trade on U.S. securities exchanges.

Is a non-U.S. bank an eligible issuer for a Section 3(a)(2) bank note program?

Generally, no. However, U.S. branches or agencies of foreign banks are conditionally entitled to rely on the Section 3(a)(2) exemption. In 1986, the U.S. Securities and Exchange Commission ("SEC") took the position that a foreign branch or agency would be deemed a "national bank" or a "banking institution organized under the laws of any State, Territory, or the District of Columbia," if "the nature and extent of federal and/or state regulation and supervision of that particular branch or agency is substantially equivalent to that applicable to federal or state chartered domestic banks doing business in the same jurisdiction."[1] It is the responsibility of the issuer and its counsel to make the determination with respect to the requirement of "substantially equivalent regulation," as well as the determination as to whether the business of the branch or agency in question "is substantially confined to banking and is supervised by the State or territorial banking commission or similar official." As a result, U.S. branches or agencies of foreign banks are frequent issuers or guarantors of debt securities in the United States. Most U.S. branches have elected the N.Y. State Department of Financial Services ("NYDFS") as their primary regulator with their secondary regulator being the Board of Governors of the Federal Reserve System (the "Federal Reserve"). Some U.S. branches have opted for the Office of the Comptroller of the Currency ("OCC") as their primary regulator.

How does a guarantee allow a non-bank issuer to issue under Section 3(a)(2)?

Section 3(a)(2) also exempts from registration under Section 5 of the Securities Act securities guaranteed by a bank. This guarantee is not limited to a guarantee in a legal sense, but also includes arrangements in which the bank agrees to ensure the payment of a security. The guarantee or assurance of payment, however, has to cover the entire obligation; it cannot be a partial guarantee or promise of payment, and it must be unconditional. Guarantees by foreign banks (other than those of an eligible U.S. branch or agency) would not qualify for this exception. The guarantee is a legal requirement to qualify for the exemption; investors will not look to the U.S. branch for payment/credit. Investors will look to the home office. Foreign banks and finance companies, for example, can rely on the Section 3(a)(2) exemption if the securities they issue are guaranteed by a bank.

Do state or federal banking regulators impose any conditions on bank note programs?

National banks or federally licensed U.S. branches or agencies of foreign banks regulated by the OCC are subject to the OCC's securities offering disclosure rules (12 C.F.R. Part 16). The securities offering disclosure rules provide that national banks may not offer and sell their securities until a registration statement has been filed and declared effective with the OCC, unless an exemption applies.

An OCC registration statement is generally comparable in scope and detail to an SEC registration statement; as a result, most bank issuers prefer to rely upon an exemption from the OCC's registration requirements. Section 16.5 of the securities offering disclosure rules provides a list of exemptions, which includes Regulation D offerings, Rule 144A offerings to qualified institutional buyers and Regulation S offerings made outside of the United States. General solicitation would be allowed for Regulation D offerings and Rule 144A offerings; the Rule 506 "bad actor" disqualification provisions would also apply.

[1] Securities Issued or Guaranteed by United States Branches or Agencies of Foreign Banks, SEC Release No. 33-6661 SEC Docket (1973-2004), 36 SEC-DOCKET 746-1 (September 23, 1986).

Part 16.6 of the securities offering disclosure rules provides a separate partial exemption for offerings of "non-convertible debt" made to accredited investors in denominations of $250,000 or more. Federal branches or agencies of foreign banks, as issuers, may rely on this exemption by furnishing to the OCC parent bank information that is required under Securities Exchange Act of 1934 ("Exchange Act") Rule 12g3-2(b) and to purchasers the information required under Securities Act Rule 144A(d)(4)(i). The securities must be "investment grade" — the definition focuses on the probability of repayment rather than on an external investment grade rating (a Dodd-Frank Act requirement). Prior to, or simultaneously with, the sale of the securities, the purchaser must receive an offering document that contains a description of the terms of the securities, the use of proceeds and the method of distribution, and incorporates certain financial reports or reports filed under the Exchange Act. The offering document and any amendments must be filed with the OCC no later than the fifth business day after they are first used.

Are there any relevant regulations affecting securities offerings by state regulated banks?

Currently, offerings of securities made by state non-member banks are subject to the Statement of Policy Regarding the Use of Offering Circulars in Connection with Public Distribution of Bank Securities (the "1996 FDIC Policy"). The 1996 FDIC Policy affects state nonmember banks (banks that are supervised by the FDIC rather than the Federal Reserve) and state-licensed branches of foreign banks with insured deposits. The 1996 FDIC Policy requires that an offering circular include prominent statements that the securities are not deposits, are not insured by the FDIC or any other agency, and are subject to investment risk. The 1996 FDIC Policy also states that the offering circular should include detailed prospectus-like disclosure, similar to the type contemplated by Regulation A or the offering circular requirements of the former Office of the Thrift Supervision ("OTS"). The 1996 FDIC Policy has not been updated to reflect the elimination of the OTS. In practice, bank issuers include offering circular disclosure that is more detailed than that required by the 1996 FDIC Policy due to liability concerns.

On January 19, 2021, the FDIC proposed rescinding the 1996 FDIC Policy and replacing it with a new regulation to be codified in Subpart A of 12 C.F.R. Part 335, as "Securities of State Nonmember Banks and State Savings Associations" (the "Proposed Rule").[2] The Proposed Rule is limited in its scope as opposed to the 1996 FDIC Policy, which applies to all state nonmember banks. The Proposed Rule applies to offerings of bank securities in the following circumstances: (1) FDIC-supervised institutions (*i.e.,* state nonmember banks and state savings associations) in organizations; (2) FDIC-supervised institutions subject to an enforcement order or capital restoration plan that intend to issue securities; (3) FDIC-supervised institutions converting from a mutual to stock form of ownership; and (4) subsidiaries of state savings associations in any of (1)-(3).

Unlike under the 1996 FDIC Policy, an insured state nonmember bank issuing debt securities outside of (1)-(3) above would not be subject to the Proposed Rule. However, the Proposed Rule is instructive as to the type of disclosure to include in an offering circular for an offering of bank securities by a state nonmember bank and the FDIC indicates that, in its experience, many state nonmember banks comply with federal securities offering rules even if they are not legally required to do so.

[2] The Proposed Rule is available at: Federal Register: Transferred OTS Regulations Regarding Securities Offerings of State Savings Associations, Statement of Policy on the Use of Offering Circulars, Proposed Rulemaking Regarding Securities Offerings by State Nonmember Banks and State Savings Associations, and Other Technical Amendments.

State nonmember banks and state savings associations subject to the Proposed Rule would be required to file a registration statement, including a prospectus, with the appropriate regional FDIC office, notwithstanding the availability of the Section 3(a)(2) exemption. The registration statement and prospectus would need to conform to Regulation C under the Securities Act unless provided otherwise in the Proposed Rule. With respect to disclosure, the documents would need to conform to the requirements of Regulations S-K and S-X under the Securities Act. As in the 1996 FDIC Policy, the standard legends (*i.e.,* the securities are not deposits, not FDIC-insured, no approval by the FDIC is implied and debt securities are subordinated to deposits) would need to be included in the offering circular in bold capital letters.

New York branches or agencies of foreign banks should contact the NYDFS prior to issuing bank notes. An agency of a foreign bank subject to New York banking regulations should obtain a pre-offer no-objection letter from the Superintendent of the NYDFS, and would be able to sell only to certain authorized institutional purchasers in minimum denominations of $100,000. New York branches of foreign banks typically issue bank notes in high minimum denominations in order to avoid the notes being viewed by a regulator as an impermissible retail deposit. This limitation does not apply when the New York branch is a guarantor and the issuing entity is the foreign bank.

Are there any FINRA filing requirements?

Even though securities offerings under Section 3(a)(2) are exempt from registration under the Securities Act, public securities offerings conducted by banks must be filed with the Financial Industry Regulatory Authority, Inc. ("FINRA") for review under Rule 5110(b)(9), unless an exemption is available. The exemption most used for bank note programs is that the issuer has outstanding investment grade rated unsecured non-convertible debt with a term of issue of at least four years or the non-convertible debt securities to be issued under the bank note program are so rated.

If an affiliated dealer is an agent for the offering, there is "prominent disclosure" in the offering document with respect to the conflict of interest caused by that affiliation and the bank notes are rated investment grade or in the same series that have equal rights and obligations as investment grade rated securities, then no qualified independent underwriter will be required.

Is there a minimum denomination requirement?

The Section 3(a)(2) exemption is not conditioned on a specific minimum denomination. However, for a variety of reasons, denominations may at times be significantly higher than those for retail transactions:

- offerings targeted to institutional investors;
- complex securities; and
- the relationship to Part 16.6's requirement of $250,000 minimum denominations.

Is any action required under the state securities, or blue sky, laws?

Securities issued under Section 3(a)(2) are considered "covered securities" under Section 18 of the Securities Act. However, because bank notes are not listed on a national securities exchange, states may require a notice filing and a fee in connection with an offering of bank securities. Generally, blue sky filings are not needed in any state in which the securities are offered. State blue sky laws should be

examined to ensure that either no notice filing or fee is required or if the state's existing exemption for securities issued by banks does not require a filing. A state may not view an agency of a foreign bank, the securities of which are eligible for the Section 3(a)(2) exemption, as within the state's exemption for securities issued by banks.

What kind of offering documentation is used in bank note programs?

The offering documentation for bank notes is similar to that of a registered debt offering. Issuers use a base offering document, which may be an "offering memorandum" or an "offering circular" (instead of a "prospectus"). For foreign issuers, International Financial Reporting Standards ("IFRS") financials or "home country" GAAP financials are acceptable. However, offering documents of foreign issuers will need a reconciliation footnote or explanation if non-U.S. GAAP or non-IFRS is used. U.S. GAAP financials are preferable. The market demands annual audited and at least semiannual unaudited financial statements. Typically, the equivalent of Industry Guide 3 statistical disclosures (now, Regulation S-K subpart 1400) or something similar are included.

The base document is supplemented for a particular offering by one or more "pricing supplements" and/or, in the case of structured notes, "product supplements." These offering documents may be supplemented by additional offering materials, including term sheets and, for structured products, brochures.

How does a bank initiate a bank note program?

One threshold question is whether the bank has an affiliated dealer that may be the lead dealer for the program. If the affiliated dealer does not have expertise in the particular market (*e.g.*, structured products), an unaffiliated dealer with expertise should be brought in. If the bank plans to issue structured products, it should engage a dealer that is familiar with FINRA's suitability rules and Regulation Best Interest under the Exchange Act and has internal compliance procedures in place for sales of structured products.

If a foreign bank is the issuer, the dealer may have particular views as to acceptable financial statements. If the dealer plans on distributing through third-party dealers, the issuer should inquire about the dealer's "know your distributor" policies. If the issuer uses an affiliated dealer, the appropriate FINRA filing exemption must be used. Dealer's counsel will want to start its diligence early in the process in order to identify any potential issues.

The offering circular tends to have information similar to that in a registered offering due to liability concerns. As a guide, one could look to the content requirements in Part 16.6 of the securities offering disclosure rules:

- description of the business of the issuer similar to that included in a Form 10-K;
- description of the terms of the notes;
- use of proceeds; and
- method of distribution.

A U.S. bank will incorporate by reference into the offering circular the Exchange Act reports filed by its parent bank holding company, together with the bank's Call Reports.

Branches or agencies of foreign banks' disclosure is very limited – usually the address, primary business lines and the date of establishment. Disclosure about the parent or headquarters is usually sufficient. If a guarantee structure is used, a description of the guarantee will be included. Bank note programs for structured products will have product and pricing supplements for particular structures.

The distribution agreement is very similar to a distribution agreement for a registered medium-term note program. In negotiating the distribution agreement, attention should be paid to the required deliverables (comfort letters, officers' certificates and opinions) and when they will be delivered. Generally, these deliverables are delivered at the program launch and may also be delivered on a quarterly basis for active bank note programs. If there is a large, benchmark-size takedown from the bank note program, the agents on the program will require a full set of deliverables for that takedown.

The scope of the opinions should be negotiated early in the process. Consider whether there will be multiple counsel delivering legal opinions (U.S., non-U.S., internal, dealers' counsel). Issuers should plan for future, regular diligence sessions with the agents. If the issuer has designated dealers' counsel, they will have a preference as to the form of the distribution agreement.

Unlike registered medium-term note programs, bank note programs generally do not use an indenture. Qualification of an indenture under the Trust Indenture Act of 1939 is not required for an exempt offering. Instead, a fiscal and paying agency agreement is generally used. Disclosure in the description of the notes should clearly point out the differences between an indenture and a fiscal and paying agency agreement; *i.e.,* there is no trustee in a fiduciary relationship with the note holders and note holders have to accelerate their own note if there is an event of default.

What liabilities flow to the issuer from offerings under a bank note program?

Securities offerings of, or guaranteed by, a bank under Section 3(a)(2) are not subject to the civil liability provisions under Section 11 and Section 12(a)(2) of the Securities Act. These offerings are subject to Section 10(b) of the Exchange Act and the anti-fraud provisions of Rule 10b-5 of the Exchange Act. This has an impact on the content of offering documents and the use of offering circulars to convey material information and risk factors.

Rule 10b-5 applies to registered and exempt offerings. Rule 10b-5 of the Exchange Act prohibits:

- the use of any device, scheme, or artifice to defraud;
- the making of any untrue statement of a material fact or the omission of a material fact necessary to make the statements made not misleading; or
- engaging in any act, practice, or course of business that would operate to deceive any person in connection with the purchase or sale of any securities.

To bring a successful cause of action under Rule 10b-5, plaintiffs must prove:

- that there was a misrepresentation or failure to disclose a material fact;
- that the misrepresentation was made in connection with plaintiffs' purchase or sale of a security;
- that defendants acted with "scienter," or the intent or knowledge of the violation;
- that plaintiffs "relied" on defendants' misrepresentation or omission; and
- that such misrepresentation or omission caused plaintiffs' damages.

Checklist of Key Questions

- Is the issuer or the guarantor a bank?
- Does the issuer have an affiliated broker-dealer that will be involved in the bank note program?
- If the issuer is a foreign bank is there a guarantee by a U.S. branch or agency?
- Will the issuer's financial statements be prepared in compliance with IFRS or U.S. GAAP?
- If the bank note program is intended to be used to offer and sell structured products, does the lead dealer have experience in this area?
- Will the bank note program be rated investment grade or be *pari passu* with securities of the same issuer that are so rated?