

Considerations for Foreign Banks Financing in the United States 2014 Update

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Introduction

Financial institutions, including foreign banks, regularly access the capital markets and seek to diversify their funding alternatives. Foreign banks may seek to access the US capital markets without subjecting themselves to registration with, and oversight by, the US Securities and Exchange Commission (SEC).

This brief summary is intended to outline the most common capital raising approaches used by foreign banks, and the issues that foreign banks should consider in structuring offerings of securities, certificates of deposit, or commercial paper in the United States.

We also discuss continuous offering programmes, such as bank note and medium-term note programmes, since these are frequently used by foreign banks that are frequent issuers. Finally, we address issuances of covered bonds and structured products into the United States. We hope that this overview provides a helpful guide.

Contents

Introduction	1
About the authors and contributors	5
About the firm	7
CHAPTER 1	
General overview of securities registration and disclosure requirements	9
CHAPTER 2	
Overview of financing through exempt offerings	14
CHAPTER 3	
Overview of continuous issuance programmes	22
CHAPTER 4	
Mechanics of a Section 4(a)(2) offering	28
CHAPTER 5	
Mechanics of a Rule 144A/Regulation S offering	35
CHAPTER 6	
Section 3(a)(2) and considerations for foreign banks financing in the United States	42
CHAPTER 7	
Bank deposit products versus securities	49

CHAPTER 8	
Considerations related to commercial paper	53
CHAPTER 9	
Exchange Act Registration	60
CHAPTER 10	
Foreign banks and the Investment Company Act	69
CHAPTER 11	
Blue sky laws	74
CHAPTER 12	
Regulation by the Financial Industry Regulatory Authority	77
CHAPTER 13	
Special considerations related to structured products	83
CHAPTER 14	
Special considerations related to covered bonds	90
CHAPTER 15	
Schedule B filers	96

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About the firm

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CHAPTER 1

General overview of securities registration and disclosure requirements

Foreign issuers, including foreign banks, that are considering accessing the US capital markets have a number of financing alternatives. As a preliminary matter, a foreign issuer must choose between undertaking a public offering in the United States, which would have the result of subjecting the issuer to ongoing securities reporting and disclosure requirements, or undertaking a limited offering that will not subject the issuer to US reporting obligations.

Registration requirements

An issuer may conduct a public offering in the United States by registering the offering and sale of its securities pursuant to the Securities Act of 1933, as amended (Securities Act), and also registering its securities for listing or trading on a US securities exchange pursuant to the Securities Exchange Act of 1934, as amended (Exchange Act). Section 5 of the Securities Act sets forth the registration and prospectus delivery requirements for securities offerings.

In connection with any offer or sale of securities in interstate commerce or through the use of the mails, Section 5 requires that a registration statement must be in effect and a prospectus meeting the prospectus requirements of Section 10 of the Securities Act must be delivered prior to sale. As we discuss further below, the Securities Act is a disclosure statute. The purpose of the Securities Act is to ensure that an issuer provides investors with complete disclosure about the securities that it is offering. The registration and prospectus delivery requirements of Section 5 require filings with the SEC and are intended to protect investors by providing them with sufficient information about the issuer and its business and operations, as well as about the offering, in order that they may make informed investment decisions.

As a result, in connection with a public offering of securities, an issuer must provide extensive information about its business and financial results. The preparation of the principal disclosure document (the registration statement) is a time-consuming and expensive process. We do not discuss the factors to be considered in connection with preparing a registration statement, nor do we discuss the steps required in connection with the preparation of the document. Once filed with the SEC, the SEC will review the document closely and provide the issuer with detailed comments. The comment process may take as

long as 60 to 90 days once a document has been filed with the SEC.

Once all of the comments have been addressed and the SEC staff is satisfied that the registration statement is properly responsive, the registration statement may be used in connection with the solicitation of offers to purchase the issuer's securities. Depending upon the nature of the issuer (whether it is a domestic or foreign private issuer) and the nature of the securities being offered by the issuer, the issuer may use one of various forms of registration statement.

Once an issuer has determined to register its securities under the Securities Act, the issuer usually also will apply to have that class of its securities listed or quoted on a securities exchange and, in connection with doing so, will register its securities under the Exchange Act. The Exchange Act requires registration of securities for the benefit of investors that purchase securities in the secondary market. The Exchange Act imposes two separate but related obligations on issuers: registration obligations and reporting obligations. Section 12 of the Exchange Act sets forth the requirements for registration of securities under the Exchange Act and requires that an issuer register a class of its securities with the SEC under two circumstances, pursuant to either Section 12(b) or 12(g). Pursuant to Section 12(b) of the Exchange Act, an issuer must register a class of its equity or debt securities under the Exchange Act prior to the listing of those securities on a national securities exchange.

The Section 12(b) registration requirement is applicable regardless of whether the securities previously have been registered under the Securities Act. Section 12(g) of the Exchange Act requires registration when the issuer has total assets exceeding \$10 million and a class of equity security held of record by 2,000 or more persons or 500 or more persons who are not accredited investors (AIs), as defined in Rule 501(a) under the Securities Act. Section 13(a) of the Exchange Act imposes reporting obligations on an issuer that has registered a class of securities under Section 12 of the Exchange Act. Section 15(d) of the Exchange Act requires registration when the issuer has filed a registration statement that has become effective pursuant to the Securities Act. Registration under either Act will subject the issuer to the periodic reporting requirements and other requirements under the Exchange Act.

The federal securities laws are intended to protect

investors by ensuring that adequate information is available to them prior to their making an investment decision. The Securities Act and the rules and regulations promulgated under the act set forth detailed disclosure requirements applicable to public offerings. Reporting issuers must adhere to the disclosure requirements of the Exchange Act in relation to their periodic filings. Disclosures required pursuant to the Securities Act, which relate to specific offerings, are integrated with those required under the Exchange Act. For foreign private issuers, the SEC has provided a separate integrated disclosure system, which provides a number of accommodations for foreign practices and policies.

What is a foreign private issuer?

A foreign private issuer (FPI) is any issuer (other than a foreign government) incorporated or organised under the laws of a jurisdiction outside of the United States, unless more than 50% of the issuer's outstanding voting securities are held directly or indirectly by residents of the United States, and any of the following applies: (1) the majority of the issuer's executive officers or directors are US citizens or residents; (2) the majority of the issuer's assets are located in the United States; or (3) the issuer's business is principally administered in the United States.¹

Current SEC rules ease the disclosure burdens imposed upon FPIs and reduce the ongoing costs of securities reporting obligations for FPIs. Below we list some of the main benefits available to FPIs:

- *Annual report filing.* Foreign private issuers are required to file annual reports on Form 20-F within four months from the issuer's fiscal year-end.² In contrast, US domestic issuers generally must file their annual reports on Form 10-K within 60 to 90 days following the end of their fiscal year.³
- *Quarterly financial reports.* A FPI has no legal obligation to file quarterly reports. By contrast, US domestic issuers must file a quarterly report on Form 10-Q. A FPI may choose to furnish quarterly financial information on a voluntary basis under cover of Form 6-K.
- *Proxy solicitation statements.* Unlike a US domestic issuer, a FPI has no legal obligation to file proxy solicitation materials on Schedule 14A or 14C in connection with annual or special meetings of its security holders.⁴
- *Audit committee.* A FPI also has no legal obligation to establish an audit committee. However, in the absence of such a committee, for certain US federal securities law purposes, issuer's entire board of directors may act as the audit committee.⁵
- *Internal control reporting.* A FPI only has to file annually regarding its financial reporting internal controls while a US domestic issuer must do so on a quarterly basis.⁶
- *Executive compensation.* A FPI is exempt from the SEC's disclosure rules for executive compensation on an individual basis, but is required to provide certain

information on an aggregate basis. In addition, individual management contracts and compensatory plans must be filed as exhibits unless the issuer's home country does not require such filings to be made and are not otherwise publicly disclosed by the issuer.⁷

- *Directors/officers, equity holdings.* Directors and officers of a FPI (in other words, insiders) do not have to report their equity holdings and transactions in such holdings under Section 16 of the Exchange Act (Forms 3 and 4).⁸ However, some directors and officers may have to report their holdings under Section 13 of the Exchange Act, if applicable, and a FPI must provide share ownership information regarding directors and officers as of the most recent practicable date in its annual report on Form 20-F and in other filings.
- *IFRS – No US Gaap reconciliation.* A FPI may prepare its financial statements in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board without reconciliation to US generally accepted accounting principles (US Gaap). In addition, a FPI using the IFRS standard is only required to file two years of financial statements for its first reporting year, rather than the previously required three years.
- *Exiting the reporting system.* Rule 12h-6 under the Exchange Act allows a US-listed FPI to exit the US capital markets with relative ease and terminate the registration of a class of securities under Section 12(g) of the Exchange Act or terminate its reporting duties under Section 15(d) of the Exchange Act. A FPI may terminate its registration or reporting duties with respect to a class of equity securities after certifying that:
 - The FPI has had reporting obligations under Section 13(a) or Section 15(d) for at least the last 12 months, has filed or furnished all reports required for that period, and has filed at least one annual report;
 - The FPI's securities have not been sold in the United States in a registered offering under the Securities Act during the last 12 months other than certain exceptions;
 - The FPI has maintained a listing of the subject class of securities for at least the last 12 months on one or more exchanges in a foreign jurisdiction, which constitutes the primary trading market for those securities; and
 - The average daily trading volume of the subject class of securities in the United States has been no greater than 5% of its worldwide average daily trading volume of the securities for the most recent 12-month period, or on a date within the last 120 days, the subject class of securities is either held of record by fewer than 300 persons on a worldwide basis or fewer than 300 persons resident in the United States.
 A FPI may terminate its registration or reporting duties with respect to a class of debt securities after certifying that:

- The FPI has had reporting obligations under Section 13(a) or Section 15(d) for at least the last 12 months, has filed or furnished all reports required for that period, and has filed at least one annual report; or
- On a date within the last 120 days, the subject class of securities is either held of record by fewer than 300 persons on a worldwide basis or fewer than 300 persons resident in the United States.
- *Exchange Act registration.* Rule 12g3-2(b) under the Exchange Act allows a FPI to exceed the registration thresholds of Section 12(g) of the Exchange Act and effectively have its equity securities traded on a limited basis in the over-the-counter market in the United States. This may be useful for FPIs that wish to accommodate a limited number of US investors without triggering ongoing registration and disclosure obligations. Rule 12g3-2(b) under the Exchange Act automatically exempts a FPI from Exchange Act registration requirements and SEC reporting obligations if:
 - its primary trading market is in a foreign jurisdiction;
 - it publishes, in English, the required disclosure documents on its website or through a generally available electronic information delivery system; and
 - it does not otherwise have any Section 13(a) or 15(d) Exchange Act reporting obligations.

Despite these important benefits, conducting a public offering in the United States, and becoming subject to ongoing registration requirements is expensive. Foreign issuers considering whether to register their securities in the United States under the Securities Act or the Exchange Act also should consider carefully the securities liabilities to which they and their directors and officers and other control persons may become subject. Similarly, issuers should consider the securities law liabilities to which they may become subject in connection with offerings exempt from the US registration requirements. As we discuss in this book, these are considerably more limited.

Exemptions from registration

Given the onerous registration requirements that are applicable to issuers that register their securities with the SEC, many issuers choose to access the US capital markets through targeted financings exempt from the registration requirements of the securities laws. Foreign bank holding companies or foreign banks may avail themselves of these exemptions to raise capital from US investors.

A number of exemptions from the Section 5 registration requirements are available, based either on the type of security being offered and sold (described in Section 3 of the Securities Act), or on the type of transaction in which the security is being offered and sold (described in Section 4 of the Securities Act), including the following:

- *Section 3(a)(2) of the Securities Act* (Section 3(a)(2)) is an exemption from registration under the Securities Act

available for securities issued or guaranteed by banks. A foreign bank may rely on this exemption to offer its securities in the United States, guaranteed by its US branch or agency, or for securities issued by its US branch or agency. See Chapter 6 (Section 3(a)(2) and considerations for foreign banks financing in the United States).

- *Section 3(a)(3) of the Securities Act* (Section 3(a)(3)) is an exemption from the registration requirements under the Securities Act for short-term commercial paper with certain characteristics, provided the proceeds are used for current transactions. See Chapter 8 (Considerations related to commercial paper).
- *Section 4(a)(2) of the Securities Act* (Section 4(a)(2)) is an exemption from registration for “transactions by an issuer not involving any public offering,” or private placements. Often issuers will rely on the safe harbor provided by Regulation D under the Securities Act (Regulation D), which provides greater certainty regarding the types of offerings that would be considered private placements. A foreign bank holding company may rely on Section 4(a)(2) to issue equity or debt securities to accredited or institutional investors in the United States. See Chapter 2 (Overview of financing through exempt offerings).
- *Rule 144A under the Securities Act* (Rule 144A) is a safe harbor available for the resale of certain qualifying securities to qualified institutional buyers (QIBs), by certain persons *other* than the issuer of the securities. See Chapter 2 (Overview of financing through exempt offerings).
- *Regulation S under the Securities Act* (Regulation S) is an exclusion from the registration requirements of Section 5 of the Securities Act for “offers and sales of securities outside the United States” by both US and foreign issuers, which can be used by foreign bank holding companies or foreign banks in combination with a private placement or Rule 144A offering to reach a broader universe of potential investors. See Chapter 2 (Overview of financing through exempt offerings).

Foreign bank holding companies may issue and sell equity, debt or hybrid (Tier 1) or structured securities in reliance on Section 4(a)(2) and Rule 144A, and may add a Regulation S component to an offering. Usually, foreign bank holding companies that do not want to list a class of securities on a securities exchange in the United States will issue non-voting preferred securities or debt securities. A foreign bank generally will rely on the Section 3(a)(2) exemption to offer its securities in the United States, guaranteed by its US branch or agency, or for securities issued by its US branch or agency. Foreign banks also may offer commercial paper in reliance on the Section 3(a)(3) exemption.

A foreign bank that anticipates that it will offer securities regularly in the United States may choose to establish a continuous issuance program, like a medium-term note

programme, bank note programme or commercial paper programme, as opposed to relying on standalone offerings of securities. An issuer will be able to realise certain efficiencies and improve its access to the capital markets by establishing a programme. Foreign banks also may issue and offer covered bonds to US investors, either on a standalone basis, or through an issuance programme. In addition, foreign issuers may issue other instruments, which are not considered securities, including, for example, certificates of deposit, to US investors. The registration requirements are not applicable to bank deposits, or other instruments that are not considered securities.

In this book, we provide an overview of the exemptions from registration that may be available to foreign bank holding companies or foreign banks that seek to access the US capital markets. We also discuss the types of products that may be offered by foreign banks. Foreign banks may offer various types of debt securities, including, but not limited to, senior unsecured debt, senior secured debt (like covered bonds), subordinated debt, structured debt (like equity-linked, currency-linked, or commodity-linked notes), hybrid debt intended to obtain favorable regulatory capital treatment, including contingent capital debt securities, and deposit liabilities. We also discuss the entities that may offer such products, such as the home offices or US branches of foreign banks or special purpose finance vehicles sponsored by foreign banks.

ENDNOTES

1. Rule 3b-4(c) under the Exchange Act. A FPI is permitted to assess its status as a FPI once a year on the last business day of its second fiscal quarter, rather than on a continuous basis, and may avail itself of the FPI accommodations, including use of the FPI forms and reporting requirements, beginning on the determination date on which it establishes its eligibility as a FPI. If a FPI determines that it no longer qualifies as a FPI, it must comply with the reporting requirements and use the forms prescribed by US domestic companies beginning on the first day of the fiscal year following the determination date. SEC Release No. 33-8959 (September 23, 2008). Note that if a FPI loses its status as a FPI, it will be subject to the reporting requirements for a US domestic issuer, and while previous SEC filings do not have to be amended upon the loss of such status, all future filings would be required to comply with the requirements for a US domestic issuer. *Financial Reporting Manual*, Division of Corporate Finance, Topic 6120.2, available at <http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml>.
2. Form 20-F, General Instruction A.(b)(2).
3. Form 10-K, General Instruction A.(2)(a)-(c).
4. Rule 3a12-3(b) under the Exchange Act.
5. Form 20-F Instruction to Item 6.C and SEC Release No. 33-8220 (April 9, 2003).
6. SEC Release No. 33-8238 (June 5, 2003).
7. Item 6.B of Form 20-F.
8. Rule 3a12-3(b) under the Exchange Act.

CHAPTER 2

Overview of financing through exempt offerings

Foreign issuers often find that they would like to access investors in the United States without subjecting themselves to the ongoing registration and reporting requirements applicable to public companies in the United States. As a result, many foreign issuers consider offering securities to investors in the United States in reliance on one of the exemptions from registration. In this chapter we provide a brief overview of the most commonly relied upon exemptions.

Section 4(a)(2)

Section 4(a)(2) provides that the Section 5 registration requirements do not apply to “transactions by an issuer not involving any public offering.” This is often referred to as the private placement exemption. The breadth of this exemption makes it useful for issuers attempting to conduct a variety of financing transactions. The rationale for this exemption from registration is that the extensive regulation applicable to public offerings is not required when offerings are made by an issuer to a limited number of offerees who can protect themselves. These exemptions are available to US and non-US public and private companies. In 1982, the SEC adopted Regulation D to provide issuers with a safe harbour for conducting Section 4(a)(2) private placements.

Securities acquired pursuant to a Section 4(a)(2) offering may be immediately resold under Rule 144A, even though they are “restricted securities,” as defined in Rule 144(a)(3) under the Securities Act. The intent to resell under Rule 144A is not inconsistent with Section 4(a)(2) and does not affect the availability of the exemption.

Regulation D provides issuers with three safe harbours for issuing securities without registration. The first, Rule 504, provides an exemption pursuant to Section 3(b) of the Securities Act for offerings of up to \$1 million. The second, Rule 505, provides an exemption pursuant to Section 3(b) for offerings of up to \$5 million. The third, Rule 506, which is the most popular, provides an exemption pursuant to Section 4(a)(2) for limited offerings and sales without regard to dollar amount, but only to 35 purchasers and an unlimited number of “accredited investors,” who are typically institutional investors or high net-worth individuals. Until recently, general solicitation was not permitted in private placements in accordance with Rule 506. However, in July 2013, pursuant to Section 201 of the Jumpstart Our

Business Startups Act (112 P.L. 106) (JOBS Act), the SEC revised Rule 506 to permit general solicitation if the issuer takes “reasonable steps to verify” that purchasers are accredited investors, all purchasers are accredited investors, or the issuer reasonably believes that they are, immediately prior to the sale, and if certain other requirements are met. As part of the revised rule, the SEC established four optional methods for verifying accredited investor status that would satisfy the accredited investor verification requirements. In addition, new disqualification provisions were added to Rule 506, prohibiting the use of the exemption by certain bad actors and felons, whether or not general solicitation is used. The amendments to Rule 506 took effect on September 23, 2013.

Section 4(a)(2) private placements are attractive to foreign issuers considering offering securities in the United States because they permit them to raise large amounts of capital without the cost and delays of registration under the Securities Act and SEC review of offering documents. Section 4(a)(2) private placements for foreign issuers are almost always for debt securities, given that most foreign issuers want to avoid having too many US holders of equity securities if the foreign issuers intend not to become subject to US reporting requirements.

Rule 144A

Rule 144A is a resale safe harbour exemption from the registration requirements of Section 5 of the Securities Act for certain offers and sales of qualifying securities by certain persons *other* than the issuer of the securities. The exemption applies to resales of securities to QIBs (or to other purchasers that the initial purchasers and any persons acting on their behalf reasonably believe to be QIBs). Issuers must find another exemption for the initial offer and sale of unregistered securities, typically Section 4(a)(2) (often in reliance on Regulation D) or Regulation S. Resales to QIBs, which are large institutional investors with securities portfolios in excess of \$100 million, in compliance with Rule 144A are not public “distributions” and, consequently, the reseller of the securities is not an “underwriter” within the meaning of Section 2(a)(11) of the Securities Act. The securities eligible for resale under Rule 144A are securities of US and foreign issuers that are not listed on a US securities exchange or quoted on a US automated inter-dealer quotation system.

There are four main conditions to reliance on Rule 144A, including only two procedural requirements (a notice and information requirement). These requirements are significantly less burdensome than those associated with an SEC registered public offering.

Why should a foreign bank consider a Rule 144A offering?

Rule 144A permits issuers to raise large amounts of capital without the cost and delay of registration under the Securities Act and SEC review of the offering documents. In addition to these benefits, Rule 144A:

- Does not require extensive ongoing registration or disclosure in the United States;
- Provides a clear safe harbour for offerings to institutional investors; and
- Provides greater liquidity for foreign issuers.

Rule 144A provides increased liquidity in several ways for foreign issuers. A foreign issuer may avail itself of Regulation S for offers and sales of securities outside the United States. Purchasers of such securities may then resell the securities to US persons (as defined in Regulation S) in reliance on Rule 144A. A foreign issuer may also sell its securities to a financial intermediary that acts as an initial purchaser and immediately resells the securities to QIBs in reliance on Rule 144A. The availability of Rule 144A thus provides greater liquidity for otherwise restricted securities.

How are Rule 144A transactions structured?

The following types of transactions are often conducted in reliance on Rule 144A:

- Offerings of debt or preferred securities by public companies;
- Offerings by foreign issuers that do not want to become subject to US reporting requirements; and
- Offerings of common securities by non-reporting issuers (in other words, “private” initial public offerings (IPOs)).

Most Rule 144A offerings by FPIs that are not otherwise US reporting companies are offerings of debt securities, in large measure because the issuer wants to avoid having a class of equity securities held of record by 2,000 or more persons or 500 or more persons who are not accredited investors (as defined in Rule 501(a) under the Securities Act), which could trigger the obligation to become a US reporting company. Such offerings may be conducted on a standalone basis or as a continuous offering programme. An issuer that intends to engage in multiple offerings may have a Rule 144A programme or a Rule 144A/Regulation S programme. Rule 144A offerings often are structured as global offerings, with a side-by-side offering targeted at foreign holders in reliance on Regulation S. Doing so permits an issuer to broaden its potential pool of investors.

Understanding Rule 144A

Rule 144A provides a non-exclusive safe harbour from the

registration and prospectus delivery requirements of Section 5 of the Securities Act for certain offers and sales of qualifying securities by certain persons other than the issuer of the securities. The safe harbour is based on two statutory exemptions from registration under Section 5, Section 4(a)(1) and Section 4(a)(3) of the Securities Act. In summary, Rule 144A provides that:

- For sales made under Rule 144A by a reseller, other than the issuer, an underwriter, or a broker-dealer, the reseller is deemed not to be engaged in a public “distribution” of those securities and, therefore, not to be an “underwriter” of those securities within the meaning of Section 2(a)(11) and Section 4(a)(1) of the Securities Act; and
- For sales made under Rule 144A by a reseller that is a dealer, the dealer is deemed not to be a participant in a “distribution” of those securities within the meaning of Section 4(a)(3)(C) of the Securities Act and not to be an “underwriter” of those securities within the meaning of Section 2(a)(11) of the Securities Act, and those securities are deemed not to have been “offered to the public” within the meaning of Section 4(a)(3)(A) of the Securities Act.

A Rule 144A offering usually is structured so that the issuer first sells the newly-issued restricted securities to an “initial purchaser,” typically a broker-dealer, in a private placement exempt from registration under Section 4(a)(2) or Regulation D. Rule 144A then permits the broker-dealer to immediately resell the restricted securities to QIBs (or to purchasers that the broker-dealer and any persons acting on its behalf reasonably believe to be QIBs).

In July 2013, pursuant to Section 201 of the JOBS Act, the SEC revised Rule 144A to permit general solicitation and advertising of Rule 144A offerings, provided that actual sales are only made to QIBs. This revision was designed in part to address the criticism that prior SEC rules were overly broad in limiting communications to QIBs. The amendments to Rule 144A took effect on September 23, 2013.

Rule 144A requirements

There are four conditions to reliance on Rule 144A:

- The resale is made only to a QIB (or to other purchasers that the initial purchasers and any persons acting on their behalf reasonably believe to be QIBs);
- The securities resold: (a) when issued were not of the same class as securities listed on a US national securities exchange or quoted on a US automated inter-dealer quotation system; and (b) are not securities of an open-end investment company, unit investment trust, or face-amount certificate company that is, or is required to be, registered under the Investment Company Act of 1940, as amended (Investment Company Act);
- The reseller (or any person acting on its behalf) must take reasonable steps to ensure that the buyer is aware

that the reseller may rely on Rule 144A in connection with the resale; and

- Where securities of an issuer are involved that is neither an Exchange Act reporting company, or a foreign issuer exempt from reporting pursuant to Rule 12g3-2(b) under the Exchange Act, or a foreign government, the holder and a prospective buyer designated by the holder must have the right to obtain from the issuer and must receive, upon request, certain reasonably current information about the issuer.

QIBs

Rule 144A identifies certain institutions that may be considered QIBs. In order to be considered a QIB, the following entities must own and invest on a discretionary basis at least \$100 million in securities of non-affiliates: (1) insurance companies; (2) investment companies registered under the Investment Company Act or business development companies, as defined in the Investment Company Act; (3) licensed small business investment companies; (4) certain pension plans, benefit plans and trust funds; (5) business development companies, as defined in the Investment Advisers Act of 1940, as amended; and (5) registered investment advisers. Banks and thrifts may be considered QIBs if they own and invest on a discretionary basis at least \$100 million in securities of non-affiliates and have an audited net worth of at least \$25 million. Registered securities dealers need only own and invest on a discretionary basis \$10 million in securities of non-affiliates to be considered QIBs, and they may execute no-risk principal transactions for QIBs without regard to the amount owned and invested. Any entity of which all of the equity owners are QIBs is deemed to be a QIB.

A seller must reasonably believe that the purchaser is a QIB. Rule 144A provides several non-exclusive alternatives for ascertaining QIB status, including reliance on a purchaser's annual financial statements, filings by the purchaser with the SEC or another US or foreign governmental agency or self-regulatory organisation, or a certification by an executive officer of the purchaser as to satisfaction of the financial tests. Many financial intermediaries provide QIB questionnaires to their customers in order to pre-qualify them for offerings.

Eligible securities

Rule 144A is not available for transactions in: (1) securities that, when issued, were of the same class as securities listed on a national securities exchange or quoted on an automated interdealer quotation system (for example, Nasdaq); or (2) securities of an open-end investment trust or face amount certificate company (in other words, an investment company, such as a mutual fund). Preferred equity securities and debt securities commonly viewed as different series generally will be viewed as different, non-fungible classes for purposes of Rule 144A. Convertible or

exchangeable securities are treated as the underlying security unless subject to an effective conversion premium of at least 10%. The SEC staff's position is that securities that are convertible or exchangeable at the issuer's option are "fungible" if the underlying security is fungible, regardless of the "effective conversion premium." Warrants and options are treated as the underlying security unless the warrant or option has a term of at least three years and an effective exercise premium of at least 10%.

Notice requirement

A seller and anyone acting on its behalf must take "reasonable steps" to ensure that the purchaser is aware that the seller may rely on the Rule 144A exemption. This requirement is typically satisfied by placing a legend on the security and including appropriate statements in the offering memorandum for the securities.

Information requirements for non-reporting issuers

In order for the Rule 144A safe harbour to be available, if the issuer is not: (1) a reporting company under the Exchange Act; (2) a foreign company exempt from reporting under Rule 12g3-2(b) under the Exchange Act; or (3) a foreign government, then the holder of the securities and any prospective purchaser designated by the holder has the right to obtain from the issuer, upon the holder's request, the following information:

- A brief description of the issuer's business, products, and services;
- The issuer's most recent balance sheet, profit and loss statement, and retained earnings statement; and
- Similar financial statements for the two preceding fiscal years.

This obligation to provide information pursuant to Rule 144A continues so long as the issuer is neither a reporting company nor a foreign issuer providing home country information under the Rule 12g3-2(b) exemption. In some Rule 144A offerings, especially debt offerings, the issuer may agree, in the indenture or other operative document, to provide disclosure similar to public company disclosure for as long as the security is outstanding. A FPI exempt from reporting pursuant to Rule 12g3-2(b) under the Exchange Act will satisfy the reasonably current information requirement by continuing to publish the specified Rule 12g3-2(b) information in English on its website in accordance with the requirements of the issuer's home country or principal trading markets.¹

A foreign issuer exempt from reporting under Rule 12g3-2(b) under the Exchange Act is not subject to the information requirements under Rule 144A. Rule 12g3-2(b) under the Exchange Act exempts from registration under the Exchange Act most non-US companies that are listed in their home markets (but not on a US securities exchange) and that publish certain English language financial and business information on their websites. The

rule also allows non-US companies (even those with more than 300 US shareholders) to benefit automatically from an exemption from Exchange Act reporting obligation. As a result, it is easier for security holders to resell the securities of exempt foreign issuers to QIBs pursuant to Rule 144A.

Rule 144A does not provide how the security holder's "right to obtain" the required information must be established. However, the SEC has confirmed that such a right can be created in the terms of the security, by contract, by operation of law or by the rules of a self-regulatory organisation.²

Restricted securities and resales by investors

Securities acquired in a Rule 144A transaction are "restricted securities" within the meaning of Rule 144(a)(3) under the Securities Act. As a result, these securities remain restricted until the applicable holding period expires and may only be publicly resold under Rule 144 under the Securities Act (Rule 144), pursuant to an effective registration statement, or in reliance on any other available exemption under the Securities Act. Often, investors will negotiate with the FPI to obtain resale registration rights in connection with a Rule 144A offering. However, a FPI that would like to avoid US reporting requirements will typically not grant registration rights. Consequently, in order to resell the securities, an investor either will need to hold the securities for a one-year holding period (assuming the FPI is not a reporting company), or dribble the securities out in compliance with Rule 144, or resell the securities pursuant to another exemption—including selling to another QIB. Exempt resales of restricted securities may be made in compliance with Rule 144A itself, Regulation S or the so-called Section 4(a)(1½) exemption.

Rule 144

Rule 144 has been called the dribble-out rule since it permits investors (often affiliates) to sell limited quantities of securities acquired in private transactions over a protracted period of time. The SEC adopted amendments to Rule 144 in 2007 that, among other things, shortened the holding periods for restricted securities, making it easier for Rule 144A securities to be acquired by non-QIBs once the restricted period has expired.

For non-affiliate holders of restricted securities, Rule 144 provides a safe harbour for the resale of such securities without limitation after six months in the case of issuers that are reporting companies that comply with the current information requirements of Rule 144(c), and after one year in the case of non-reporting issuers, such as many FPIs.³ In each case, after a one-year holding period, resales of these securities by non-affiliates will no longer be subject to any other conditions under Rule 144.

For affiliate holders of restricted securities, Rule 144 provides a safe harbour permitting resales, subject to the

same six-month and one year holding periods for non-affiliates and to other resale conditions of Rule 144. These other resale conditions include, to the extent applicable: (a) adequate current public information about the issuer; (b) volume limitations; (c) manner of sale requirements for equity securities; and (d) notice filings on Form 144.

The Section 4(a)(1½) exemption

The Section 4(a)(1½) exemption is a case law-derived exemption that allows the resale of privately placed securities in a subsequent private placement.⁴ This exemption typically is relied on in connection with the resale of restricted securities to accredited investors who make appropriate representations. Generally, if an accredited investor cannot qualify as a QIB under Rule 144A, the seller will seek to use the Section 4(a)(1½) exemption for secondary sales of privately-held securities. Section 4(a)(1½) also is sometimes used to extend a Rule 144A offering to institutional accredited investors.

Regulation S

Regulation S represents the SEC's position that securities offered and sold outside of the United States need not be registered with the SEC and specifies two safe harbours, an issuer safe harbour (Rule 903) and a resale safe harbour (Rule 904), which provide that offers and sales made in compliance with certain requirements are deemed to have occurred outside the United States and are, therefore, excluded from the application of Section 5. Regulation S is attractive for foreign issuers that may have operations in the United States or who choose to do a global offering because they can rely on the Regulation S "minimum jurisdictional contacts" concept for reasonable assurance that they will not inadvertently become subject to federal securities laws merely because of a Regulation S tranche. Additionally, the Regulation S resale safe harbour provides a means for non-US employees of foreign companies to resell company securities acquired through their employee benefit plans.

What types of Regulation S offerings may a foreign issuer consider?

There are several types of Regulation S offerings that US or foreign issuers may conduct:

- A standalone Regulation S offering, in which the issuer conducts an offering of debt or equity securities solely in one or more non-US countries;
- A combined Regulation S offering outside the United States and Rule 144A offering inside the United States, which, from the US perspective, is more common and usually involves debt securities; and
- Regulation S continuous offering programmes for debt securities, including various types of medium term note programmes; these programmes may be combined with an issuance of securities to QIBs (or to other purchasers that the initial purchasers and any persons acting on

their behalf reasonably believe to be QIBs) in the United States under Rule 144A.

Accordingly, issuers may use Regulation S alone as well as in combination with other offerings. A Regulation S-compliant offering can be combined with a registered public offering in the United States or an offering exempt from registration in the United States, such as a Rule 144A offering, as well as be structured as a public or private offering in one or more non-US jurisdictions.

Understanding Regulation S

Regulation S, which is comprised of Rules 901 to 905 under the Securities Act, is available only for “offers and sales of securities outside the United States” made in good faith and not as a means of circumventing the registration provisions of the Securities Act. The below parties may rely on Regulation S:

- Offering participants, including:
 - US issuers—both reporting and non-reporting issuers may rely on the Rule 901 general statement or the Rule 903 issuer safe harbour;
 - Foreign issuers—both reporting and non-reporting foreign issuers may rely on the Rule 901 general statement or the Rule 903 issuer safe harbour;
 - Distributors (underwriters and broker-dealers)—both US and foreign financial intermediaries may rely on the Rule 901 general statement or the Rule 903 issuer safe harbour;
 - Affiliates of the issuer—both US and foreign;
 - Any persons acting on the behalf of the aforementioned persons;
- Non-US resident purchasers (including dealers) who are not offering participants may rely on the Rule 901 general statement or the Rule 904 resale safe harbour to transfer securities purchased in a Regulation S offering; and
- US residents (including dealers) who are not offering participants may rely on the Rule 901 general statement or the Rule 904 resale safe harbours in connection with purchases of securities on the trading floor of an established foreign securities exchange that is located outside the United States or through the facilities of a designated offshore securities market.

Regulation S requirements

The availability of the issuer and the resale safe harbours is contingent on two general conditions:

- The offer or sale must be made in an offshore transaction; and
- No “directed selling efforts” may be made by the issuer, a distributor, any of their respective affiliates, or any person acting on their behalf.

Regulation S provides that any offer, sale, and resale is part of an “offshore transaction” if:⁵

- No offer is made to a person in the United States; and

- Either: (1) at the time the buy order is originated, the buyer is (or is reasonably believed to be by the seller) physically outside the United States; or (2) the transaction is for purposes of Rule 903, executed on a physical trading floor of an established foreign securities exchange, or for purposes of Rule 904, executed on a “designated offshore securities market” and the seller is not aware that the transaction has been pre-arranged with a US purchaser.

A buyer is generally deemed to be outside the United States if the buyer (as opposed to the buyer’s agent) is physically located outside the United States. However, if the buyer is a corporation or investment company, the buyer is deemed to be outside the United States when an authorised agent places the buy order while physically situated outside the United States. In addition, offers and sales of securities made to persons excluded from the definition of “US person,” even if physically present in the United States, are deemed to be made in offshore transactions.

Directed selling efforts

“Directed selling efforts” is defined by Regulation S as “any activity undertaken for the purpose of, or that could be reasonably expected to result in, conditioning the US market for the relevant securities.”⁶ This applies during the offering period as well as during the distribution compliance period. Violation of the prohibition against directed selling efforts precludes reliance on the safe harbour.

Additional restrictions

Offerings made in reliance on Rule 903 are subject to additional restrictions that are calibrated to the level of risk that securities in a particular type of transaction will flow back into the United States. Rule 903 distinguishes three categories of transactions based on: (1) the type of securities being offered and sold; (2) whether the issuer is domestic or foreign; (3) whether the issuer is a reporting issuer under the Exchange Act; and (4) whether there is a “substantial US market interest.”

- “Category 1” transactions are those in which the securities are least likely to flow back into the United States. Therefore, the only restrictions on such transactions are that they must be “offshore transactions” and that there be no “directed selling efforts” in the United States.
- “Category 2” and “Category 3” transactions are subject to an increasing number of offering and transactional restrictions for the duration of the applicable “distribution compliance period.”

“Distribution compliance period” is defined in Regulation S⁷ generally as the period following the offering when any offer or sales of Category 2 or 3 securities must be made in compliance with the requirements of Regulation S in order to prevent the flow back of the

offered securities into the United States. The period ranges from 40 days to six months for reporting issuers or one year for equity securities of non-reporting issuers.

Resale limitations and transfer restrictions

In terms of liquidity, a FPI should carefully consider the transfer restrictions that are imposed on securities sold pursuant to Regulation S. Securities cannot be offered or sold to a US person during the distribution compliance period unless the transaction is registered under the Securities Act or exempt from registration. The relevant distribution compliance periods in connection with securities sold in a Category 1, Category 2 and Category 3 offerings, respectively, are set forth above. The distribution compliance period begins on the later of: (1) the date when the securities were first offered to persons other than distributors; or (2) the date of the closing of the offering, and continues until the end of the time period specified in the relevant provision of Rule 903.⁸

Rule 144A/Regulation S

A FPI that would like to offer its securities to US institutional investors may not be able to accomplish this objective if it were to structure a financing transaction solely as a Regulation S offering. Rule 144A offerings are often structured as global offerings, with a side-by-side offering targeted at foreign holders in reliance on Regulation S. This dual structure permits an issuer to broaden its potential pool of investors. The issuer may sell to an initial purchaser outside the United States in reliance on Regulation S, even if the initial purchaser contemplates immediate resales to QIBs in the United States.

Compliance with both Rule 144A and Regulation S

In a global offering, the Rule 144A portion must comply with the Rule 144A requirements. Similarly, the offering of the Regulation S portion must comply with Regulation S discussed above. It should be emphasised that the Regulation S portion of any offering refers only to the portion of the offering that requires the offering participants to comply with Regulation S in order to benefit from the safe harbour. The offering itself must also comply with the requirements of applicable non-US jurisdictions and the requirements of any foreign securities exchange or other listing authority.

As we have seen, an issuer may rely on both Rule 144A and Regulation S. For example, an issuer may sell its securities in a private placement to an initial purchaser that will rely on Rule 144A for resales and contemporaneously offer its securities offshore in reliance on Regulation S. Although Regulation S imposes a distribution compliance period during which time purchasers cannot resell their securities to US persons, Rule 144A provides a non-exclusive safe harbour for resales of Regulation S securities. US broker-dealers may purchase unregistered securities

offered outside the United States under Regulation S and resell them in the United States to QIBs pursuant to Rule 144A during the distribution compliance period.⁹ In addition, a QIB that acquired securities in a Rule 144A transaction can rely on Regulation S to resell the securities to any purchaser in an offshore transaction, provided such resales do not involve any US-directed selling efforts.

In its adopting release for the revised Rule 144A, the SEC confirmed its view that concurrent offshore offerings that are conducted in compliance with Regulation S will not be integrated with domestic unregistered offerings that are conducted in compliance with Rule 506 of Regulation D or Rule 144A¹⁰ (ie, general solicitation in a Rule 144A offering will not automatically constitute “directed selling efforts” in respect of a related Regulation S offering). Therefore, engaging in a solicitation in the United States in connection with a Rule 144A offering will not result in a loss of the Regulation S exemption. However, the general solicitation must still be analysed to ensure that it does not constitute directed selling efforts under Regulation S.¹¹

Exempt securities

The prior discussions focus on transactions that are exempt from the registration requirements of Section 5 of the Securities Act. The Securities Act also provides exemptions from the registration requirements for certain types of instruments. These exemptions are contained in Section 3 of the Securities Act. There are exemptions under Section 3 for securities issued by certain types of entities. For example, there are exemptions available for securities issued by, among others: certain governmental entities, including municipalities; by certain not for profit organisations under Rule 501(c)(3) under the Internal Revenue Code of 1986, as amended; and for banks. In addition, there are exemptions available for certain types of instruments.

Section 3(a)(2)

Section 3(a)(2) exempts from registration under the Securities Act any security issued or guaranteed by a bank. This exemption is based on the notion that, whether chartered under state or federal law, banks are highly and relatively uniformly regulated, and as a result will provide adequate disclosure to investors about their business and operations in the absence of federal securities registration requirements. In addition, banks are also subject to various capital requirements that may help increase the likelihood that holders of their debt securities will receive timely principal and interest payments. Commercial paper backed by letters of credit of domestic banks are exempt under Section 3(a)(2). The SEC view is that letters of credit, in effect, are guarantees, and the commercial paper they support are therefore exempt as securities guaranteed by a bank.¹²

Section 3(a)(3)

Most commercial paper is issued in reliance on Section 3(a)(3). Section 3(a)(3) exempts from the registration and prospectus delivery requirements “any note, draft, bill of exchange, or banker’s acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.”¹³ This exemption, like that for bank securities, is not transaction based.

The SEC has construed Section 3(a)(3) to apply only to “prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper issued to facilitate well-recognized types of current operational business requirements and of a type eligible for discounting by US Federal Reserve banks.”¹⁴ In Release No. 33-4412, the SEC stated that negotiable notes that had been issued, or the proceeds of which will be used in

“producing, purchasing, carrying or marketing goods or in meeting current operating expenses of a commercial, agricultural or industrial business, and which is not to be used for permanent for fixed investment, such as land, buildings, or machinery, nor for speculative transactions or transactions in securities (except direct obligations of the United States government)”

are eligible for discounting under the regulations of the Board of Governors of the US Federal Reserve System.¹⁵ Although the SEC no longer requires that commercial paper be eligible for discounting, the rest of this statement has been construed to mean that the commercial paper must be used for “current transactions.”

The current transaction requirement is not satisfied where the proceeds of the commercial paper are used to: (1) discharge existing debt (unless the existing debt is also exempt under Section 3(a)(3)); (2) purchase or construct a plant; (3) purchase durable machinery or equipment; (4) fund commercial real estate development or financing; (5) purchase real estate mortgages or other securities; (6) finance mobile homes or home improvements; or (7) purchase or establish a business enterprise.¹⁶

The SEC has established through several no-action letters¹⁷ that an issuer is not required to trace the proceeds of issued commercial paper into identifiable current transactions. Instead, as long as the amount of outstanding commercial paper at any time is not greater than the amount of current transactions eligible to be financed (the commercial paper capacity), the current transaction requirement will be deemed satisfied. The SEC’s Division of Corporation Finance has stated that an issuer should use a balance sheet test for determining

commercial paper capacity.¹⁸ This test involves determining the capital an issuer has committed to current assets and the expenses of operating its business over the preceding 12-month period.¹⁹

ENDNOTES

1. Rule 144A(d)(4)(ii)(C) under the Securities Act. *See also* Rule 12g3-2(b) under the Exchange Act.
2. Securities Act Release No. 33-6862 (April 23, 1990).
3. For a non-reporting issuer, compliance with the adequate current public information condition requires the public availability of basic information about the issuer, including certain financial statements.
4. The seminal case involving the so-called Section 4(a)(1½) exemption was the Second Circuit Court of Appeals decision in *Gilligan, Will & Co. v. SEC*, 267 F.2d 461 (2d Cir. 1959).
5. Rule 902(h) under the Securities Act.
6. Rule 902(c) under the Securities Act.
7. Rule 902(f) under the Securities Act.
8. *Id.*
9. *See* Rules 144(a)(3)(iii) and 144A(b)–(c) under the Securities Act; Preliminary Note 2 to Rule 144A; Preliminary Note 5 to Regulation S; Securities Act Release No. 33-7505, (February 17, 1998); Securities Act Release No. 33-6863 (April 24, 1990).
10. Securities Act Release No. 33-9415 at 57 (July 10, 2013).
11. SEC Compliance and Disclosure Interpretation (C&DI) Rule 144A 138.04 (November 13, 2013).
12. *See* Chapter 6 (Section 3(a)(2) and considerations for foreign banks financing in the United States).
13. Section 3(a)(3) of the Securities Act.
14. Securities Act Release No. 33-4412 (September 20, 1961).
15. *Id.*
16. *Id.*
17. *Westinghouse Credit Corporation*, SEC No-Action Letter, 1986 WL 66748 (May 5, 1986); *Lyondell Petrochemical Co.*, SEC No-Action Letter, 1989 WL 246100 (July 19, 1989).
18. *Id.*; C&DI Securities Act Sections 219.02 (November 26, 2008).
19. *See* Chapter 8 (Considerations relating to commercial paper).

CHAPTER 3

Overview of continuous issuance programmes

Overview

A larger, more established issuer with regular funding needs may want to maximise its capital raising opportunities by establishing a continuous issuance programme. A continuous issuance programme enables an issuer to offer securities at any time, from time to time, over the term of the programme, with a modicum of documentation required for each issuance. Many foreign issuers may already be familiar with, or have established, global medium-term note (MTN) programmes, Euro medium-term note programmes or commercial paper programmes. These programmes permit the issuer to offer debt securities (in the case of an MTN programme) or short-term debt (in the case of a commercial paper programme) regularly in response to inquiries from investors (reverse inquiry transactions) or in transactions initiated by the issuer to or through a financial intermediary that acts on an agency or principal basis. An issuer may also establish a continuous offering programme pursuant to which it sells other types of securities, including covered bonds. A foreign issuer may want to consider setting up a continuous issuance programme that permits the issuer to offer securities to US investors.

Medium-term note programmes

An MTN programme enables an issuer to offer a variety of debt securities on a regular or continuous basis, in a streamlined manner. Traditionally, issuers have used their MTN programmes to fill the financing gap between short-term commercial paper, which has a maturity of nine months or less, and long-term debt, which has a maturity of one year or more. Although MTNs typically have maturities of between two and five years, they are not required to have any particular term. An issuer may specify the overall amount of debt it will offer from its MTN programme. It is important that the issuer work with its arranger to determine an appropriate size for the programme.

An MTN programme uses a master set of disclosure documents, agreements with dealers, and issuing and paying agency agreements to help minimise the new documentation (and associated costs) required for each offering. This approach enables an issuer to complete each issuance quickly and efficiently. If an MTN programme is conducted as a private placement, the issuer generally relies on the exemptions from registration afforded by Section 4(a)(2), Regulation D, Rule 144A, Regulation S or a

combination thereof. An issuer may have more than one MTN programme, and may use each programme to target a specific market. For example, an issuer may have a Rule 144A MTN programme to access the debt markets in the United States on a private basis as well as a bank note programme (at the bank level), that is exempt from registration under Section 3(a)(2).

MTN programme structures

Rule 144A programmes

As discussed in Chapter 1, Rule 144A is a safe harbor exemption from the registration requirements of Section 5 of the Securities Act for certain offers and sales of qualifying securities by certain persons other than the issuer. The exemption applies to resales of securities to QIBs. Rule 144A permits persons other than the issuer to resell, in a transaction not involving a public offering, restricted securities. Typically, a financial intermediary, such as an investment bank, facilitates the resale of securities in a Rule 144A offering. The sale of the securities to the initial purchaser is conducted pursuant to the exemption from registration under Section 4(a)(2).

Bank note programmes

A bank issuer may choose to structure its MTN programme as a bank note programme. These programmes are similar to other types of MTN programmes, except that the securities of banks are exempt from registration pursuant to Section 3(a)(2). Instead of relying on a transactional exemption from registration, these programmes rely on a securities-based exemption. However, unlike other issuers, banks are subject to regulation (that is, by the Office of the Comptroller of the Currency (OCC), if a national bank; by the Board of Governors of the US Federal Reserve System, if a member thereof; or by individual state regulators, if a state bank). These regulators may subject bank issuers to offering restrictions and limitations that may not apply to other issuers.¹

Posting and settlement

Issuances of notes under an MTN programme settle differently than underwritten offerings of notes issued on a stand-alone basis. Through programme dealers, an issuer of MTNs typically posts offering rates over a range of possible maturities: for example, nine months to one year;

one year to 18 months; 18 months to two years; and annually thereafter. An issuer may post rates as a yield spread over US Treasury securities having the same maturity. The dealers provide this rate information to investors or to other dealers. When an investor expresses interest in an MTN offering, the dealer contacts the issuer to obtain a confirmation of the terms of the transaction. Within a range, the investor may have the option of selecting the actual maturity of the notes, subject to final agreement with the issuer. DTC, Euroclear and Clearstream have established procedures for the deposit of global securities and the transfers of interests within each of the securities and between the securities held by each of them, subject to compliance with applicable legal requirements.

Arranger and dealers

An issuer looking to establish an MTN programme will engage an investment bank to assist with that process. An issuer also might engage additional investment banks to serve as dealers (or selling agents) under the programme. An arranger for an MTN programme performs many of the same functions as a lead underwriter in a traditional, public underwritten offering. The arranger assists the issuer in establishing the programme, advising on the form and content of the offering documents, including the size of the programme and the types of securities that may be offered under the programme. The arranger also assists in drafting the offering documents and related programme agreements. As part of the drafting process, the arranger negotiates the terms of the programme documents, including the distribution or programme agreement, on its own behalf and on behalf of the other dealers named in the programme.

In addition, the arranger also serves an advisory role with respect to the MTN programme. It advises the issuer of potential financing opportunities and communicates to the issuer any offers from potential investors. For each issuance, the arranger will coordinate the offering, serving as principal dealer for the programme. The arranger also coordinates settlement of the MTN issuances with the issuer and the paying agent. Lastly, the arranger typically makes a market in the securities issued under the programme (ensuring greater liquidity for investors). However, an arranger has no obligation to purchase any securities issued under the programme. An arranger may participate in a particular takedown, but has no obligation to do so.

Programme dealers

At the time a programme is established, the issuer will select both an arranger and a number of other investment banks to serve as dealers. Dealers engaged at the start of the programme typically are named in the offering materials as dealers. The dealers for an MTN programme act as selling agents for the programme, and are responsible for placing

the securities sold under the programme. The dealers, like the arranger, often make a market in the issuer's securities. It is prudent for an issuer to engage multiple dealers, because an increase in dealer price quotations may lead to more reverse enquiry transactions.

Because an issuer's needs may change, and because the value of an MTN programme lies in its flexibility, the agreement may also contain the procedures for adding new dealers, either for a particular tranche or for the MTN programme. These procedures typically include a requirement that the new dealer delivers an accession letter in which it becomes a party to the programme agreement, and agrees to perform and comply with all of the duties and obligations of a dealer under the programme agreement. The issuer then sends a letter to the dealer (or countersigns the dealer's letter) confirming its appointment to the programme.

The issuer may appoint one or more new dealers for a particular tranche. The procedures to become a dealer for a particular note issue include a requirement that the new dealer delivers an accession letter in which it becomes a party to the programme agreement, agrees to perform and comply with all of the duties and obligations of a dealer, with respect to that issue of notes, under the programme agreement. The issuer then sends a letter to the dealer (or countersigns the dealer's letter) confirming its appointment, solely with respect to that issue of notes, as a dealer under the programme agreement.

Due diligence concerns

Because takedowns from an MTN programme may be frequent, and often occur on short notice, the dealers are not likely to be able to initiate and complete a full due diligence review at the time of each offering. In order to accommodate these timing considerations, the issuer and the dealers should establish an ongoing due diligence review process. The dealers (coordinated by the arranger) and their counsel will periodically, at least once a quarter (if not more often) update their prior due diligence. This will ensure that their review is up-to-date at the time of each takedown. To facilitate this process, the issuer will designate, under the MTN programme, a law firm (designated dealers' counsel) to represent the dealers and conduct ongoing legal due diligence on their behalf. If the dealers relied on different counsel for each issuance, it would be difficult to complete takedowns quickly.

Documentation

An MTN programme makes use of a standard, or master, set of documents that are agreed to when the programme is established. The programme then relies on a streamlined set of documents for each particular issuance. For each type of MTN programme, these documents have a number of common features.

Disclosure

Market practice is to include substantial disclosure about the issuer (or its parent), although generally less than that required for a registered offering (for instance, for a financial institution, unregistered programmes may not include the SEC's Guide 3 disclosure). Issuers and arrangers rely on the SEC disclosure rules in Regulations SK and S-X as a guide. In addition, the nature of the issuer's business and its credit ratings may influence the level of disclosure.

Offering memorandum

The primary disclosure document is referred to as an "offering memorandum" or an "offering circular." The offering memorandum contains: (1) information about the issuer and its business (or incorporates this information by reference); and (2) information about the securities that will be offered under the programme and the manner in which the securities will be distributed. If the offering is conducted under Rule 144A, the offering memorandum must include a legend regarding re-sale and transfer restrictions applicable to Rule 144A offerings. In addition, the offering memorandum often states that the issuer is available to respond to questions and provide additional documents (to the extent it can do so without unreasonable effort or expense).

The offering memorandum will provide investors with a brief discussion of the issuer and its business. If the issuer is a foreign issuer, the financial statements it prepares in its home country may be incorporated by reference. If the offering memorandum will be used for offerings to US investors, the financial statements should be compliant with US Gaap or IFRS. If the offering memorandum contains non-US Gaap financial statements, consideration should be given to including a reconciliation footnote explaining the differences between the non-US Gaap numbers and US Gaap equivalents. Risk factors included in the offering memorandum may be limited in scope and focus on risks relating to the notes, including particular risks surrounding the various structured notes included in the programme, risks associated with the transfer restrictions on the notes (as discussed above), risks related to the anticipated uses of proceeds, and any new business risks. If the issuer does not file Exchange Act reports containing its business and industry risks, the risk factors may be more fulsome.

The offering memorandum will describe the general terms of the notes applicable to all series of notes, or to certain types of notes in a section usually referred to as the "description of the notes." This section will describe the various types of notes to be offered under the programme—fixed rate notes, floating rate notes, equity- or credit-linked notes, or other types of structured notes. This section also contains all of the provisions that may be applicable to the notes offered under the programme, including their status, where the notes may be presented

for payment and whether they may be redeemed, among others. An issuer may issue any type of note under its MTN programme, provided that the terms are generically described in this section (although it may be possible to issue another type of note, if the issuer, dealers and counsel are comfortable with the disclosure, which would be significantly updated in the pricing supplement).

The offering memorandum will contain a plan of distribution section describing the manner in which the notes will be sold and by whom. This section describes the relationship between the issuer and the dealers, and informs investors that notes may be sold on a principal or agency basis, among other things. In addition, this section may contain legends containing selling restrictions in the various jurisdictions in which the notes will be sold. It is essential that the issuer and arranger discuss in advance the relevant jurisdictions in which the issuer would like to issue notes, and the types of debt securities the issuer would like to issue in each jurisdiction.

The offering memorandum may also include a discussion of the tax consequences of investing in the notes, at least on a generic level. The tax discussion may need to be supplemented in connection with specific issuances of notes.

Pricing supplement/final terms

Pricing supplements are intended to supplement the disclosure about the issuer and the notes contained in the offering memorandum. The pricing supplement typically is used to disclose the specific terms of the series of securities and the manner in which they will be offered. In addition, from time to time, additional or updated information about the issuer may be included in this document. An issuer may use a pricing supplement or the final terms to provide investors with the specific terms of the notes being issued.

Programme agreement

A programme agreement (also referred to as a distribution agreement or a sales agency agreement) is a contract between the issuer and the dealers. A programme agreement serves the same purpose as an underwriting agreement for an underwritten public offering, but is designed to apply to multiple offerings, as opposed to a single offering, during the life of the programme. Each offering under the programme is governed by the programme agreement, eliminating the need to draft, negotiate and execute a new agreement at the time of each takedown.

An administrative procedures memorandum is typically attached as an exhibit to the programme agreement and/or the fiscal and paying agency agreement. This memorandum details the procedures for offering notes under the programme, including the exchange of information, settlement procedures, and responsibility for preparing documents (among the issuer, the dealers, the paying agent, and the applicable clearing system) for each

issuance under the programme. Although counsel drafts this document, it is critical that it be reviewed by the issuer, the dealers, and the fiscal and paying agent's back office personnel to ensure that it accurately reflects the settlement procedures for the programme.

Fiscal and paying agency agreements

A fiscal and paying agency agreement governs the relationship between the issuer and the fiscal and paying agent. The agreement sets forth their arrangements for issuing notes, making payment of principal and interest, and other related matters. The fiscal and paying agent is responsible for the following:

- Authenticating notes at the time of issuance and, in some cases, serving as “custodian” or “safekeeper” for the executed notes;
- Processing payments of interest, principal, and other amounts on the securities from the issuer to the investors;
- Communicating notices from the issuer to the investors;
- Coordinating settlement of the MTNs with the issuer and the dealers; and
- Processing certain tax forms that may be required under the programme.

Unlike an indenture trustee in a US registered offering, the fiscal and paying agent solely performs ministerial functions and has no fiduciary duty to note holders and does not act on their behalf. For example, if an event of default occurs under the terms of the notes, each note holder is individually responsible for accelerating payment on its own note, whereas an indenture trustee would accelerate payment on all defaulted notes on behalf of the note holders. As in the case of a programme agreement, this agreement applies to all issuances of securities under the programme, so that a new agreement is not needed at the time of each takedown.

Calculation agent

The fiscal and paying agent is also often engaged to act as the calculation agent for an MTN programme. This engagement may be pursuant to a separate calculation agency agreement, or pursuant to the fiscal and paying agency agreement. The calculation agent calculates the interest payments due in respect of floating rate notes, as to each relevant interest period. The calculation agent also may calculate the returns payable on a structured note. However, in the case of structured notes, given the type of information needed to calculate the payments (information regarding equity securities or indices, for example), a broker-dealer (usually, the arranger or a dealer) is more likely to serve as calculation agent.

Exchange rate agent

Often, another function of the fiscal and paying agent is to serve as an exchange rate agent for the programme. In this capacity, the fiscal and paying agent will convert the payments made by the issuer on foreign currency-denominated MTNs into US dollars amounts for the benefit of US investors.

Closing deliverables

In connection with the programme signing, the issuer is obligated to deliver to the arranger and the other dealers certain documents. Many of these deliverables are also required in connection with a large, syndicated programme takedown. The issuer will deliver to the dealers an officers' certificate as to the accuracy of the information contained in the offering documents, an opinion of counsel and a comfort letter.

Commercial paper

Commercial paper generally consists of short-term unsecured promissory notes issued by US financial and non-financial companies. Many companies issue commercial paper to raise capital in order to fund their day-to-day operations, because it can be a lower-cost alternative to bank loans or other debt securities. Commercial paper maturities can range up to 270 days, but average approximately 30 days. Issuers also establish commercial paper programmes, usually naming one or more dealers, to sell commercial paper on a continuous basis. We discuss the exemptions applicable to commercial paper in Chapter 8 (Considerations related to commercial paper) and also discuss the documentation requirements associated with the establishment of a commercial paper programme.

Integration issues

Continuous private placements and Regulation D offerings

In a 1962 release, the SEC stated that, when determining whether an offering is public or private, it will consider whether the offering was part of a larger offering. The SEC set forth a number of factors that it would consider in making this determination—these are the same factors set forth in Rule 502(a) under Regulation D. However, it is unlikely that a private placement made pursuant to Regulation D will be integrated with an issuance off of an unregistered MTN programme, because most Regulation D offerings are of common stock and MTN programmes are for non-convertible debt (or non-convertible preferred stock).

Continuous private placements and the Section 3(a)(3) commercial paper programme

Another integration issue that arises in connection with continuous private placements is whether the SEC would

view as integrated an issuance off of an unregistered MTN programme or Section 4(a)(2) commercial paper programme with a concurrent Section 3(a)(3) commercial paper programme.

The SEC has addressed the simultaneous private placement of notes and Section 3(a)(3) commercial paper offerings in a series of no-action letters. It permits the offerings, even where the maturities of the securities overlap and the same dealers are used. In these cases, however, the issuers represented to the SEC that the proceeds of the two offerings would be used appropriately (for current transactions only, in the case of the commercial paper proceeds, and for non-current transactions, in the case of the privately placed notes).

Integration issues can also arise if an issuer decides to convert a commercial paper programme from a Section 3(a)(3) programme to a Section 4(a)(2) programme or conduct a concurrent registered continuous MTN programme and a Section 3(a)(3) commercial paper programme.

In a commercial paper programme, dealer agreements usually address integration by requiring that the issuer represent that the proceeds of the commercial paper programme under Section 3(a)(3) will be segregated and that it will implement appropriate corporate controls to prevent integration. The overlapping maturities alone should not result in integration, provided the programmes can be distinguished by their use of the proceeds, or the issuer can establish a reasonable distinction regarding the MTNs issued under the continuous programme and the Section 3(a)(3) commercial paper programme.

ENDNOTE

1. For more information on bank note programmes, *see* Chapter 6 (Section 3(a)(2) and considerations for foreign banks financing in the United States).

CHAPTER 4

Mechanics of a Section 4(a)(2) offering

Section 4(a)(2) provides that the registration requirements of Section 5 do not apply to “transactions by an issuer not involving any public offering.” This is often referred to as the private placement exemption for issuers. The breadth of this exemption makes it useful for issuers attempting to conduct a variety of financing transactions. The rationale for this exemption from registration is that the extensive regulation applicable to public offerings is not required when offerings are made to a limited number of offerees who can protect themselves. These exemptions are available to US and non-US public and private companies. In 1982, the SEC adopted Regulation D to provide issuers with safe harbours for conducting Section 4(a)(2) private placements.

A Section 4(a)(2) private placement provides an attractive capital-raising alternative for a foreign issuer considering offering securities in the United States. A private placement permits a foreign issuer to raise significant capital without the cost and delays of registration under the Securities Act and SEC review of offering documents. In addition, Section 4(a)(2) private placements also have the advantage of providing greater liquidity for foreign issuers and not requiring or triggering extensive ongoing registration or disclosure for foreign issuers. Section 4(a)(2) private placements for foreign issuers almost always involve the sale of debt securities given that many foreign issuers seek to avoid having a base of equity holders in the United States.

Section 4(a)(2) private placements

There are a number of ways FPIs can raise capital in the United States, including private placements under Section 4(a)(2) and Rule 144A offerings. Foreign companies that are registered in the United States may also raise capital through these means. Under Section 4(a)(2), the registration and related prospectus delivery requirements under Section 5 of the Securities Act do not apply to “transactions by an issuer not involving any public offering.” The statute itself provides little guidance as to the types of transactions that fall within the scope of Section 4(a)(2). However, judicial and regulatory interpretations have produced a fact-specific analysis of the types of transactions that could be deemed a private offering, based on the following factors.¹ The factors are flexible, and no single factor is determinative.

- *The number of offerees and their relationship to each other and to the issuer:* This factor is significant. There is no maximum permitted number of offerees; however, the larger the number of offerees, the greater the difficulty sustaining the evidentiary burden. Offering to a large and diverse group with no preexisting relationship to the issuer suggests a public offering.
- *The number of securities offered:* The smaller the number, the less likely the offering will be deemed a public offering.
- *The size of the offering:* The smaller the size of the offering, the less likely the offering will be deemed a public offering.
- *The manner of offering:* There are two general conditions: (1) the offering should be made through direct communication with eligible offerees by either the issuer or the issuer’s agent; and (2) the offering cannot include any general advertising or general solicitation.²
- *The sophistication and experience of the offerees:* General business knowledge and experience usually are sufficient. Important factors to consider are education, occupation, business and investment experience and net worth. An investor having a sophisticated representative probably (but not always) satisfies this test. Alternatives to sophistication are the financial ability to bear risks (in other words, the investor’s wealth) and the existence of a special relationship to the issuer (for example, insider or privileged status, or personal relationship).
- *The nature and kind of information provided to offerees or to which offerees have ready access:* The disclosure need not be as extensive as that in a registered offering, but must be factually equivalent. Disclosing basic information regarding the issuer’s financial condition, business, results of operations, and management is satisfactory. All information must be made available prior to sale.
- *Actions taken by the issuer to prevent the resale of securities:* Securities must come to rest in the hands of immediate investors. Premature re-sales of securities may be deemed a public distribution and considered part of the original offering. Failure to satisfy the conditions of Section 4(a)(2) with respect to the entire transaction will result in failure to qualify for the Section 4(a)(2) exemption. Immediate investors who do not purchase with the requisite investment intent and who resell the

securities may be deemed statutory underwriters and may be unable to rely on the Section 4(a)(1) resale exemption. Issuers generally take certain precautions to prevent the resale of their securities, including obtaining a written representation from each investor that it is acquiring the securities for investment and not with a view to distribution, placing restrictive legends on the securities, and issuing stop transfer orders with respect to the securities. The nature of the securities (in other words, debt or equity) is irrelevant to the Section 4(a)(2) exemption.

These factors, while helpful, do not provide certainty for an issuer that seeks to conduct a private placement. In response, the SEC adopted Regulation D in 1982 to provide issuers with safe harbours for conducting Section 4(a)(2) private placements.

The Section 4(a)(2) exemption is available only to the issuer of the securities. This exemption is not available for the resale of securities purchased by investors in a private placement. The issuer claiming the Section 4(a)(2) exemption has the burden of establishing that the exemption is available for the particular transaction. If securities are sold without a valid exemption from registration, Section 12(a)(1) of the Securities Act (Section 12(a)(1)) gives the purchaser the right to rescind the transaction for a period of one year after the sale. The rescissionary right may be exercised against anyone who was involved in the sale of the security, including the issuer and any broker-dealer that may have acted as a financial intermediary or placement agent in connection with the offering. Further, transactions that are not deemed exempt under Section 4(a)(2) will be treated as an unregistered public offering, and the issuer may be subject to liability under US federal securities laws.

Regulation D

Regulation D provides issuers with greater certainty regarding the Section 4(a)(2) exemption by providing safe harbours from the Securities Act registration requirements. However, Regulation D is non-exclusive, which means an issuer that fails to satisfy the objective criteria of Regulation D still may rely on Section 4(a)(2). Regulation D is available only to issuers, and applies only to a particular transaction. Therefore, resales of securities must be registered or made pursuant to another exemption.

Regulation D does not exempt the issuer from any other applicable US federal or state laws relating to the offer and sale of securities. Regardless of whether an issuer relies on Section 4(a)(2) or Regulation D, an issuer must be able to document its compliance with the relevant exemption in the following ways: through record keeping with respect to investors; by controlling the distribution of the offering memoranda; and by receiving and retaining appropriate subscription documents evidencing the nature and qualification of investors. Regulation D is comprised of eight rules—Rules 501 through 508:

- Rule 501 sets forth definitions for terms used throughout Regulation D.
 - Rule 502 sets forth the general conditions relating to integration of offerings, information requirements, limitations on manner of offering, and limitations on resale.
 - Rule 503 requires notices for sales.
 - Rule 504 provides an exemption pursuant to Section 3(b) of the Securities Act for offerings up to \$1 million.
 - Rule 505 provides an exemption pursuant to Section 3(b) of the Securities Act for offerings up to \$5 million.
 - Rule 506, which is the rule most often relied on for Regulation D private placements, provides an exemption for limited offerings and sales without regard to dollar amount, and with or without general solicitation.³ Although the number of purchasers under Rule 506 is limited to 35, issuers may sell securities under Rule 506 to an unlimited number of “accredited investors” (AIs) which are typically institutional investors or high net-worth individuals.⁴ Rule 506(d) prohibits the use of the exemption by certain bad actors and felons.
 - Rule 507 states that no exemption under Rules 504, 505 or 506 will be available for an issuer if such issuer or any of its predecessors or affiliates has been subject to any order, judgment or decree of any court of competent jurisdiction temporarily, preliminarily or permanently enjoining such entity for failure to comply with Rule 503.
 - Rule 508 states that a failure to comply with a term, condition or requirement of Rules 504, 505 or 506 will not result in the loss of the exemption from registration if the person relying on the exemption shows that: (1) the failure to comply did not pertain to a term, condition or requirement directly intended to protect that particular individual or entity; (2) the failure to comply was insignificant with respect to the offering as a whole; and (3) a good faith and reasonable attempt was made to comply with all the applicable terms, conditions and requirements of Rules 504, 505 or 506. A failure by an issuer to perform a factual inquiry and provide any disclosure regarding “bad actor” events required by Rule 506 would not be considered an “insignificant” deviation, and relief would not be available under Rule 508 if this disclosure is required and not adequately provided.⁵
- The SEC used authority granted by Section 3(b) of the Securities Act to establish Rules 504 and 505 of Regulation D. Under Section 3(b), transactions can be exempted from registration based on the limited size or limited character of the offering. Therefore, Rules 504 and 505 exempt certain offerings with a total size of up to \$5 million. These exemptions were set up to help small businesses raise capital. In contrast, the SEC established Rule 506 as a non-exclusive safe harbour under Section 4(a)(2). Rule 506 provides the clearest guidance on the

availability of Section 4(a)(2). Typically, issuers try to follow Rule 506 closely to conduct Section 4(a)(2) private placements. Like securities sold under Section 4(a)(2), securities sold under Regulation D (except for certain securities sold under Rule 504 of Regulation D) are considered restricted securities for purposes of Rule 144 and cannot be freely resold to the public without registration or exemption from registration.

Questionnaires

The issuer typically uses investor questionnaires to help collect and verify information about potential investors' suitability to participate in the offering. A potential investor can qualify to participate in the offering if it is a sufficiently sophisticated investor or by using a purchaser representative. In such cases, a questionnaire is also sent to the purchaser representative to verify that it is qualified to participate.

The issuer has the burden of determining the status of potential investors. If the issuer sells unregistered securities to an unqualified investor, the issuer cannot rely on the private placement exemption. Selling without a registration statement or valid registration exemption gives each purchaser (not just the unqualified purchaser) the right to rescind or cancel its purchase and recover the purchase price (plus interest) from the issuer for one year after the sale. Under Section 12(a)(1), a purchaser no longer holding the securities can recover damages from the issuer regardless of whether or not its losses arise from the issuer's failure to register those securities. To avoid this strict liability, issuers rely on investor questionnaires to protect the availability of their registration exemptions. Together, the purchaser representative questionnaire and the investor questionnaire help the issuer establish the status of its investor base and avoid strict liability under Section 12(a)(1).

Information requirements for non-accredited investors

To use Rule 505 or 506, the issuer must give each non-accredited investor certain information. Rule 502(b)(2) of Regulation D requires disclosure similar to the type provided in a Securities Act registration statement. For example, depending on the size of the offering, issuers should provide the most recent balance sheet, income statements, statements of stockholders' equity and similar audited financial statements for the preceding two years, as well as a description of the issuer's business and the securities in the offering. The issuer must also give non-accredited investors a brief written description of any material information about the offering that is given to accredited investors. While information delivery requirements are not required for accredited investors, it is best practice to provide the same information to both accredited and non-accredited investors in light of the antifraud provisions of the federal securities laws.

Issuers must give all investors the opportunity to ask questions about the terms and conditions of the offering and to verify the accuracy of the disclosed written information. This due diligence is often done in a telephone conference call with members of the issuer's management team and counsel. For Regulation D offerings involving a business combination or exchange offer, the issuer must also provide written information about any terms or arrangements in the proposed transaction that are materially different from those for all other security holders.

The three Regulation D exemptions have the following limitations:

	Rule 504	Rule 505	Rule 506
Maximum size of offering	\$1 million per year.	\$5 million per year.	No limit on size of offering.
Issuers permitted to rely on this exemption	Non-reporting companies (including foreign private issuers that provide information under Rule 12g3-2(b) of the Exchange Act), companies that are not investment companies (as defined in the Investment Company Act of 1940, as amended) and blank check companies.	Companies that are not investment companies, subject to the following exception: Bad actor disqualification for companies where any officers, directors, general partners, 10% owners or underwriters have been convicted or subject to an SEC order within the past five to 10 years.	Any issuer. It is used by both reporting companies and non-reporting companies. Rule 506(d) prohibits the use of the exemption by certain bad actors and felons.
Types of investors that can buy the securities	Any investor. No limitation on the number of investors or requirement of sophistication.	An unlimited number of accredited investors and up to 35 non-accredited investors.	An unlimited number of accredited investors and, solely for Rule 506(b) offerings, up to 35 non-accredited investors (who alone or together with their purchaser representatives must be sophisticated investors).
Issuer to furnish certain information?	No.	Yes, to non-accredited investors.	Yes, solely in a Rule 506(b) offering to non-accredited investors.
Prohibition on general solicitation or advertisement?	Yes, subject to the two exceptions provided by Rule 504(b)(1).	Yes.	No. General solicitation is permitted if the issuer takes reasonable steps to verify that purchasers are accredited investors and certain other requirements are met.
Limitations on resale of securities?	Yes, subject to the two exceptions provided by Rule 504(b)(1).	Yes.	Yes.
Subject to integration?	Yes.	Yes.	Yes.
Form D filing?	Yes.	Yes.	Yes.

Restriction on general solicitation and advertising

Rule 502(c) of Regulation D prohibits any general solicitation or advertising of the unregistered offering by the issuer or any person acting on its behalf. General solicitation is also prohibited in a Section 4(a)(2) offering. This prohibition extends to advertisements, articles, notices or other publication in any US newspaper, magazine or similar media (including the internet), broadcasts over US television or radio (including the internet) and any seminar or meeting in the United States whose attendees have been invited by any general solicitation or advertisement. Effective September 23, 2013, Rule 502(c) was amended to allow general solicitation in accordance with the newly revised Rule 506.

General solicitation is permitted under Rule 506(c) if all purchasers are accredited investors, or the issuer reasonably believes that they are, immediately prior to the sale, and certain other requirements are met. An issuer may conduct a Rule 506(b) offering without using general solicitation, in which case it may offer and sell securities to non-accredited and accredited investors.

For reporting companies offering securities to non-accredited investors, the prohibition on general solicitation is weighed against the issuer's obligation to inform its investors of material events, such as new securities offerings and the use of proceeds from such offerings. Rule 135c of the Securities Act addresses this tension by providing a safe harbour from the prohibition for certain public announcements of unregistered offerings. To use

Rule 135c, the following conditions must be met:

- The issuer must be a reporting company under the Exchange Act or claim the Rule 12g3-2(b) exemption from registration under the Exchange Act.
- The press release cannot be made to condition or prime the US market for the offered securities. Given this condition, most issuers are advised to publish the notice only after completing the solicitation phase of the offering or excluding potential investors who start communicating with the offering participants after publication of the notice.
- The type of information disclosed must be of the same general type allowed in press releases for registered offerings, such as name of the issuer, title and amount of the offering, the interest rate and maturity date of the securities, closing date of the offering, the purpose of the offering without naming the initial purchasers or parties acting as underwriters for the unregistered offering and any statements or legends required by US state or non-US law. The type of information disclosed also depends on the offering type.
- The press release must contain a restricted legend stating: “The securities have not been registered under the Securities Act and cannot be sold in the United States without registration or an applicable registration exemption.”
- The issuer must file a copy of the press release with the SEC on Form 6-K if it is a reporting issuer, or must publish it electronically in accordance with Rule 12g3-2(b).

Six-month integration safe harbour

For a valid Regulation D offering, all sales that are part of the same Regulation D offering must satisfy all of the terms and conditions of Regulation D. To determine which sales form a part of the same Regulation D offering, Rule 502(a) of Regulation D provides a six-month integration safe harbour. It provides that offers and sales made more than six months before the start, and more than six months after the completion, of a Regulation D offering are not typically integrated with each other. This six-month rule is also relevant to the Section 4(a)(2) integration analysis. Offers and sales made under employee benefit plans are allowed during this six-month period and are not integrated with the Regulation D offerings.

For offers and sales made during the six-month period, securities counsel can help determine if different offerings should be integrated. The integration analysis becomes important in certain situations, including:

- Where an issuer sells to non-accredited investors in a continuous offering, or in a series of private placements, the issuer must determine if it sold to more than 35 non-accredited investors. When computing the number of buyers under Rule 501(h), any Regulation D offerings made simultaneously, or within six months of offerings made outside of the United States in

compliance with Regulation S, are not integrated. In this case, non-US investors are not relevant to the 35 non-accredited investors limit.

- Where there may have been a violation of the prohibition against general solicitation or advertising. In this situation, the issuer must determine the scope of the offering with which the questionable communication is linked.
- Where the issuer conducts concurrent private and public offerings. Under certain circumstances, there can be a private offering under Rule 506 of Regulation D or Section 4(a)(2) and a registered public offering that are not integrated.⁶ For example, the private and public offerings would not be integrated if the investors in the private offering were not solicited through the registration statement, but rather through a substantive, pre-existing relationship with the issuer.⁷

Form D filing

Regulation D requires an issuer (whether or not it is a reporting company) to file with the SEC a notice on Form D no later than 15 days after the first sale of securities made under Regulation D. Typically, issuers often comply with Regulation D in all other respects, other than this filing requirement. However, there can be instances when issuers prefer to make a Form D filing to give the SEC notice of their unregistered offerings and ensure their private placements fall within the black letter of Regulation D.

In connection with the amendments to Rule 506 effective September 23, 2013, Form D was amended to add a check box to Item 6 for specifying the use of Rule 506(c) (offerings to accredited investors using general solicitation). The signature box was also amended to add a certification that the issuer is not disqualified from relying on Rule 506 due to the disqualification provisions of Rule 506(d).

The Form D filing is no longer a condition to the availability of Regulation D for a particular offering. However, under Rule 507, the SEC can prohibit an issuer who was previously subject to an injunction for failing to file Form D, from future reliance on Regulation D (unless the SEC determines, on a showing of good cause, that the exemption should not be denied).

Private placement documentation

Securities acquired pursuant to a Section 4(a)(2) offering may be immediately resold under Rule 144A. The intent to resell under Rule 144A is not inconsistent with Section 4(a)(2) and does not affect the availability of the issuer's exemption. In a Rule 144A transaction, an investment bank, acting as the initial purchaser, will agree to purchase on a firm commitment basis in a Section 4(a)(2) private placement unregistered securities from an issuer and the investment bank then immediately resells these securities only to QIBs (or to other purchasers that the investment

bank and any persons acting on its behalf reasonably believe to be QIBs). As a result, Rule 144A transactions are structured as principal transactions. In a Section 4(a)(2) transaction, an investment bank will agree to place the unregistered securities, on a best efforts basis, with investors who may choose to hold the securities for the long-term or resell the securities to a purchaser pursuant to another exemption from registration (usually, a Rule 144A resale to a QIB).

Some 4(a)(2) transactions are structured so that the initial purchasers are all QIBs. In these “144A qualifying” transactions, the investment bank will act on an agency basis to arrange the sale of the securities directly by the issuer to the QIB investors. Each QIB investor, in its securities purchase agreement, will make the usual representations made by a purchaser in a Section 4(a)(2) offering – including that it understands that the securities are restricted securities and cannot be freely resold, that it can fend for itself in the transaction and that it has such knowledge and experience in business matters so as to be capable of evaluating the merits and risks of the prospective investment, and that it has the ability to bear the economic risks of the investment, including the complete loss thereof. When all of the investors in a 144A qualifying Section 4(a)(2) private placement are QIBs, the securities will be eligible for transfer through The Depository Trust Company.

The following is a description of Section 4(a)(2) private placement documentation. For a discussion of documentation for a Rule 144A offering, please refer to Chapter 5 (Mechanics of a Rule 144A/Regulation S offering).

The documentation typically used in Section 4(a)(2) private placements includes a private placement memorandum, a securities purchase agreement and a placement agency agreement, along with legal opinions, comfort letters, and other ancillary documentation.

Private placement memorandum

Section 4(a)(2) does not require specific disclosure for an offering document. The information that is included in a private placement memorandum (PPM) will vary greatly depending on the type of offering. For example, an offering memorandum used for a Rule 144A offering will be very different from a PPM used for a Section 4(a)(2) offering to a small number of investors.⁸ By and large PPMs or offering circulars used in a Rule 144A offering will be detailed and may be similar to the type of the disclosure contained in a prospectus. However, a PPM for a Section 4(a)(2) offering may contain an abbreviated business description, risk factors, some financial information and possibly incorporate other publicly available information about the issuer.

Securities purchase agreement

The form, organisation, and content of a securities purchase agreement for a Section 4(a)(2) offering will differ depending on the type of offering. Many foreign issuers offer debt securities in cross-border debt private placements. The buyers in these offerings usually are institutional investors, often including insurance companies and pension funds. These cross-border private placements are often referred to as “insurance private placements.” The documentation for these cross-border private placements has become quite standardised over the years.

The securities purchase agreements in these transactions are typically based on approved forms that contain standard representations and warranties related to the issuer, the securities offered, the business and other representations designed to supplement the due diligence investigation of the placement agent (if applicable) and the purchasers. In addition, the agreement will contain representations, warranties and covenants specific to the Section 4(a)(2) offering, including, the issuer has not engaged in general solicitation or general advertising, the issuer has not engaged in other offerings that may be “integrated” with the Section 4(a)(2) offering and the offered securities qualify for the Section 4(a)(2) exemption. Unlike an underwriting agreement for a public offering, the purchasers in a Section 4(a)(2) offering will also make limited representations to, and warranties and covenants with, the issuer, including that the purchasers are accredited investors and the purchasers understand the risks of an investment in the securities.

Placement agency agreement

A placement agency agreement may be used in the context of certain private placements, although it is not common to use a placement agency agreement in the context of cross border debt private placements.

Comfort letters and legal opinions

While a comfort letter (a letter from the issuer’s independent certified accountants that the financial statements included in an offering document meet specified applicable standards) will almost invariably be delivered in connection with a Rule 144A offering, it is usually not requested in a 4(a)(2) offering to institutional investors.

In a Section 4(a)(2) offering, counsel to the issuer and, to a more limited extent, counsel to the placement agent (if applicable) or the purchasers, are required to provide standard corporate and transaction opinions. In addition, to the extent that a PPM was prepared and used in connection with the offering, financial intermediaries may require that issuer’s counsel deliver negative assurance letters (also referred to as 10b-5 letters).

ENDNOTES

1. *See* SEC Release No. 33-3825 (August 12, 1957); SEC Release No. 33-4552 (November 6, 1962); and SEC Release No. 33-5121 (December 30, 1970).
2. General solicitation is permitted in Rule 506 offerings, but not in Section 4(a)(2) offerings.
3. Rule 506 of Regulation D is based on Section 4(a)(2), while Rules 504 and 505 were promulgated under Section 3(b) of the Securities Act.
4. Rule 501 under Regulation D sets forth the definition of an “accredited investor.” In order for an individual to qualify as an accredited investor, he or she must : (1) earn an individual income of more than \$200,000 per year, or a joint income of \$300,000, in each of the last two years and expect to reasonably maintain the same level of income; (2) have a net worth exceeding \$1 million, either individually or jointly with his or her spouse; or (3) be a general partner, executive officer, director or a related combination thereof for the issuer of a security being offered. Accredited investors are not counted as “purchasers” for purposes of counting purchasers under Regulation D.
5. *See* SEC Release No. 33-9414 (September 23, 2013).
6. *See* SEC Release No. 33-8828 (August 3, 2007) and the Black Box Incorporated (June 26, 1990) and Squadron, Ellenoff, Pleasant & Lehrer (February 28, 1992) SEC no-action letters.
7. *Id.*
8. We discuss offering circulars in the context of a Rule 144A offering in Chapter 5 (Mechanics of a Rule 144A/Regulation S offering).

CHAPTER 5

Mechanics of a Rule 144A/Regulation S offering

Structuring a Rule 144A offering

Offerings structured in reliance on Rule 144A include:

- Offerings of debt or preferred securities, either of which may be convertible into common stock, by public reporting companies, structured either as standalone Rule 144A offerings, or with subsequent A/B exchange offers or resale registration rights;
- Offerings by foreign issuers of depositary receipts or debt securities in order to access US capital markets without becoming subject to US reporting requirements;
- Offerings of common stock by private, non-reporting issuers (that is, equity Rule 144A offerings);
- Offerings of high yield debt securities by private companies, structured either as standalone Rule 144A offerings or with subsequent A/B exchange offers or resale registration rights; and
- Rule 144A continuous offering programmes for debt or structured securities.

Securities acquired pursuant to a Section 4(a)(2) offering or a Regulation D offering may be immediately resold under Rule 144A. The intent to resell under Rule 144A is not inconsistent with Section 4(a)(2) or Regulation D. An investment bank, acting as the initial purchaser, will agree to purchase on a firm commitment basis in a private placement an entire issue of unregistered securities from a foreign issuer; the investment bank will then immediately resell these securities to QIBs (or to purchasers that it and any persons acting on its behalf reasonably believe to be QIBs). This is possible because purchasing from an issuer with a view to reselling under Rule 144A will not affect the availability to the issuer of the Section 4(a)(2) or Regulation D exemption.

We discuss some of these transactions in more detail below, focusing on the offering process and documentation, disclosure issues and liability concerns relevant for foreign issuers.

Standalone Rule 144A offering

A Rule 144A offering for an issuer that is not a US reporting issuer will often take the form of a standalone offering. A standalone Rule 144A transaction may be structured as a “Rule 144A-only” (or ‘Rule 144A for life’) offering or as a “Rule 144A-eligible” offering. Both begin as private placements by an issuer to a broker-dealer initial purchaser. However, the two offerings differ with respect to permitted resales. In a Rule 144A-only offering, until

the securities become freely tradable under Rule 144 or registered under the Securities Act, any resale may be made pursuant only to Rule 144A. Generally, in a Rule 144A-only offering, the initial offering is made to QIBs (or to other purchasers that the initial purchasers and any persons acting on their behalf reasonably believe to be QIBs), although some Rule 144A-only offerings permit institutional accredited investors that are not QIBs to participate. In a Rule 144A-eligible offering, resales are permitted to be made pursuant to Rule 144A as well as pursuant to other available exemptions, including the hybrid Section 4(a)(1½) exemption, Rule 144 or in a secondary private placement.

Debt offerings

Although both equity and debt can be issued under Rule 144A, the exclusion of fungible securities from Rule 144A has the practical effect of making Rule 144A offerings more common for debt or other securities, including preferred stock, that have been structured to avoid fungibility. Whether through a Rule 144A standalone offering, or a continuous offering programme as discussed below, foreign banks may consider using Rule 144A to issue different types of debt securities, including without limitation:

- Senior unsecured debt;
- Senior secured debt (including covered bonds);
- Subordinated debt;
- Structured debt (for example, commodity-linked notes);
- Hybrid debt;
- Contingent capital (CoCo) debt; and
- Deposit liabilities.

A foreign bank may issue debt securities through its “home office” entity, its US branch entities, or other affiliated entities, such as financing SPVs. A foreign issuer must always consult its US tax counsel to discuss any US federal income tax issues in structuring offerings of debt securities. The benefits of a Rule 144A offering compared to a registered offering include:

- More flexible disclosure requirements;
- No liability for a registration statement under Section 5 of the Securities Act (although the anti-fraud provisions are still applicable);
- Lower costs;
- Limited ongoing reporting obligations; and
- None of the corporate governance provisions of the US

federal securities laws and the exchanges and related liabilities, particularly those of the Sarbanes-Oxley Act.

The process of conducting a Rule 144A debt offering, whether high yield, investment grade or convertible debt, closely follows that for a registered offering as discussed below.

Rule 144A continuous offering programmes for debt or structured securities

An issuer that intends to engage in multiple offerings may have a “Rule 144A programme” or a combined “Rule 144A/Regulation S programme.” These programmes are attractive to foreign banks, and are in fact often used by financial institution and insurance company issuers to offer securities through one or more broker-dealers to institutional investors in continuous offerings. Rule 144A programmes are established to offer securities (usually in the form of MTN programmes) on an ongoing or continuous basis to QIBs, or non-US persons, in the case of a Regulation S tranche. These continuous debt programmes mirror similar publicly registered offerings and have the following benefits:

- No public disclosure of innovative structures or sensitive information;
- Limited Finra filing requirements; and
- Reduced potential for liability under the Securities Act.

A non-registered MTN programme may rely on either Regulation D (if the securities are sold directly to investors) or Rule 144A (with or without a Regulation S tranche) for the takedowns.

Combined Rule 144A and Regulation S offerings

The addition of a Regulation S tranche to a Rule 144A offering can significantly expand the potential investor pool to include non-QIBs outside the United States. The structure of a combined Rule 144A and Regulation S offering by a US or foreign issuer depends on, among other factors:

- Whether the Rule 144A domestic or the Regulation S foreign tranche of the offering predominates and the issuer is a reporting issuer in the United States (US domiciled or foreign); and
- To a lesser extent, whether the financial intermediary is US or non-US based.

Predominately, Rule 144A combined offerings are focused on the US market. In such case, the combined offering will often be structured to resemble a US public offering in many respects, but with necessary modifications based on applicable offshore jurisdiction laws and customary practices. Accordingly, Rule 144A combined offerings by a foreign issuer may include appropriate modifications, for example to the offering memorandum, as we describe below. If an issuer is primarily conducting a Regulation S offering targeting a non-US market, the issuer will instead follow the local

approach in its Regulation S capital raising activities and include the necessary safeguards to comply with both Regulation S and Rule 144A.

The offering process for a Rule 144A or combined Rule 144A/Regulation S offering

The Rule 144A offering process, with or without a Regulation S tranche, is often similar to the public offering process, particularly a firm commitment underwriting, without SEC involvement. A fully marketed Rule 144A transaction typically includes:

- Preparation of the preliminary offering memorandum and performance of necessary due diligence by the initial purchasers;¹
- Solicitation of orders using a “red herring” or preliminary offering memorandum;
- Preparation of: (1) a purchase agreement between the issuer and the initial purchasers; (2) an indenture (or fiscal and paying agency agreement), if debt securities are being offered or a certificate of designations or other instrument if preferred equity is being offered; (3) a registration rights agreement, if the securities will be registered with the SEC; and (4) other required deal and closing documents;
- Preparation and delivery of a final term sheet to investors indicating the final pricing terms;
- Execution of a purchase agreement between the issuer and the initial purchasers at pricing;
- Delivery of a comfort letter from the issuer’s auditors at pricing;
- Preparation and delivery of a final offering memorandum and confirmation of orders from investors;
- Closing within three to five business days after pricing; and
- At closing, execution, delivery and filing, as applicable, of any indenture, certificate of designations, or other instrument, and registration rights agreement; and delivery of legal opinions and other closing documents, including a bring-down comfort letter.

The process will also reflect the legal and customary requirements of the foreign jurisdictions in which the Regulation S tranche, if any, will occur.

In terms of settlement and clearance, the purchase agreement between the issuer and the initial purchasers should specify whether the securities will be issued in book-entry or certificated form. In most Rule 144A offerings, the securities are represented by a “global” security deposited with DTC and registered in the name of DTC’s nominee, Cede & Co, except for securities issued to non-QIBs in certificated form or to others who are permitted to request securities in such form. Investment grade securities, which are defined as non-convertible debt securities and non-convertible preferred stock, may clear and settle through DTC without the requirement that the securities be included within a trading system of a self-regulatory organisation, such as Portal. Use of global securities held by depositaries such as DTC, Euroclear, and

Clearstream usually results in clearance procedures and timing that, from the investors' viewpoint, are identical to those used for publicly offered securities.

The documentation for a Rule 144A or combined Rule 144A/Regulation S offering

The documentation typically used in both debt and equity Rule 144A transactions, with or without a Regulation S tranche, is similar to that used in registered offerings, including:

- An offering memorandum, similar to a prospectus;
- A purchase agreement between the issuer and the initial purchasers, similar to an underwriting agreement;
- An agreement among underwriters or syndication agreement;
- In some cases, a registration rights agreement between the issuer and the initial purchasers;
- In a debt offering, an indenture;
- Comfort letters from the issuer's auditors; and
- Closing documentation including "bring-down" comfort letters, legal opinions, a 10b-5 letter from legal counsel and closing certificates.

The issuer will work with its counsel, investment bank, investment bank's counsel and independent accountants to prepare the necessary documents.

Documentation issues

While both debt and equity Rule 144A offerings and combined Rule 144A/Regulation S offerings use documentation that resemble that used in registered public offerings, many factors affect the documents and their preparation. These factors include the nature of the issuer (US or foreign, reporting or non-reporting, ratings and the like), the nature of the initial purchasers (US or European or other foreign-based institutions) and the intended market for the offering. Combined Rule 144A/Regulation S offerings by non-US issuers or led by non-US financial intermediaries may use documents based on the country-specific practices of the relevant non-US jurisdiction or jurisdictions, particularly if the Rule 144A tranche is small. However, the disclosure documents in such a case generally will contain the same substantive information so that investors have the same "disclosure package."

In a Rule 144A programme or Rule 144A/Regulation S programme, similar to a registered MTN programme, an issuer uses a master set of disclosure documents, agreements with dealers and fiscal and paying agency agreements to minimise the new documentation needed at the time of each takedown.

Offering memorandum

Rule 144A does not mandate specific disclosure for an offering document.² In practice, most Rule 144A offering memoranda resemble in content and style a prospectus for a registered public offering under the Securities Act. This approach can bolster the defense against potential

liabilities of the issuer and the initial purchasers for violations of the antifraud provisions of US securities laws and assist in the marketing of the securities.³

As with preparing a prospectus for a public offering, the two primary reference points in preparing a Rule 144A offering memorandum are the specific requirements of Regulation S-K under the Securities Act and the fundamental concept of materiality. Regulation S-K sets forth the specific matters that the SEC requires in a registered offering by domestic issuers, and Form 20-F sets forth similar, but not wholly identical, information that the SEC requires in a registered offering by foreign issuers. The matters addressed in both Regulation S-K and Form 20-F include, among others, the issuer's business, properties, risks, financial condition and results of operations, together with management's discussion and analysis of such financial condition and results of operations, management, executive compensation, and corporate governance. In addition, Regulation S-X, which governs the financial statements included in a registered offering of US and foreign issuers, is also a useful guide. The financial statements included in a Rule 144A/Regulation S offering memorandum might not necessarily comply with all the requirements of Regulation S-X, particularly with respect to the number of years to be included in the "selected financial data" disclosure. For purposes of compliance with Regulation S, the offering memorandum for a combined Rule 144A/Regulation S offering contains extensive disclosure regarding resale limitations and transfer restrictions, and, if the securities will be held in book-entry format (as is customary), the book-entry process.

Purchase agreement

The form, organisation and content of a purchase agreement for a Rule 144A offering usually resembles a firm commitment underwriting agreement for a public offering, modified to reflect the private offering methodology. In a combined Rule 144A/Regulation S transaction, a purchase agreement will contain standard representations and warranties related to the issuer and its business and the securities offered, as well as other representations designed to supplement the due diligence investigation of the initial purchasers. In addition, the purchase agreement will contain representations, warranties and covenants specific to the Rule 144A/Regulation S offering, including:

- The issuer has not engaged in general solicitation or general advertising (unless the issuer chooses to use general solicitation or general advertising, which are now permitted for Rule 144A offerings so long as the securities are sold to a QIB or to a purchaser that the seller and any person acting on the seller's behalf reasonably believes is a QIB);
- The offered securities meet the eligibility requirements under Rule 144A;

- The issuer is not an open-end investment company, unit investment trust or face-amount certificate company;
- The issuer will not use “directed selling efforts” as defined under Regulation S, and if the securities offered are Category 2 or 3 securities, it has implemented the necessary Regulation S offering restrictions; and
- If the securities are debt securities or ADRs, the issuer will not resell any securities in which it or any of its affiliates has acquired a beneficial ownership interest.

Unlike an underwriting agreement for a public offering, the initial purchasers in a combined Rule 144A/Regulation S transaction will also make limited representations, warranties and covenants.

Debt instrument documents

In addition to the documents necessary for any Rule 144A offering, a debt offering requires an instrument to govern the terms of the debt. It is standard to use an indenture, although if the debt securities will not be registered subsequently with the SEC, particularly if the offering is a standalone Regulation S offering, a fiscal and paying agency agreement may be used to cover substantially the same matters. The parties to the indenture (or other agreement) are the issuer, any guarantors of the debt securities and the trustee. A foreign bank that engages in a continuous Rule 144A programme (with or without a Regulation S component) or MTN programme, or expects to offer additional debt securities, may also use a “universal” indenture, similar to that used in registered shelf offerings, which permits the issuance of different tranches or classes of debt securities.

It is standard to have registration rights for the common stock that is issuable upon conversion of a convertible security or exercise of a warrant, particularly if the issuer already is a reporting company. Registration rights are also common for Rule 144A offerings of high yield debt. Few Rule 144A/Regulation S offerings by foreign issuers that are non-reporting companies are done with registration rights because many foreign issuers find ongoing reporting obligations and compliance with US federal securities laws too burdensome.

Comfort letters and legal opinions

A comfort letter is a letter from the issuer’s independent certified accountants that the financial statements included in a particular document used in an offering meet specified applicable standards. It may also include the accountants’ conclusions regarding its comparison of specified financial information in the offering document to the information contained in the issuer’s financial statements or accounting records. In certain combined offerings for foreign issuers (and in Regulation S offerings), including those with separate syndicates for the Rule 144A and Regulation S tranches, foreign accountants expect to enter into an engagement letter with the investment banks acting as

agents or initial purchasers before they provide a comfort letter. The comfort letter will also not follow the standard disclosure US issuers and financial intermediaries expect because of the different regulatory scheme applicable to the foreign issuer.

In a Rule 144A/Regulation S offering, counsel to the issuer and, to a more limited extent, counsel to the initial purchasers, are required to provide standard corporate and transaction opinions. In addition, financial intermediaries will require, under most circumstances, that both issuer’s and initial purchasers’ counsel provide 10b-5 letters consistent with standard US public market underwriting practice. In a Regulation S transaction, the delivery or non-delivery of a 10b-5 letter by a US law firm can be a key factor in determining the jurisdiction into which a securities offering will be targeted. US broker-dealers will not participate in a Rule 144A offering without a 10b-5 letter from a US law firm that is based upon a due diligence investigation customary in the US market. With foreign issuers, access, cost and timing issues may arise in Rule 144A/Regulation S offerings because of the extensiveness of the due diligence investigation required by US counsel to give this opinion. Accordingly, this factor must be considered early on in the process.

Disclosure issues

Offering memorandum

Because the antifraud provisions of the US securities laws apply to Rule 144A offerings,⁴ most Rule 144A offering memoranda are similar in content and style to a prospectus for a registered offering under the Securities Act. The benefits of this more inclusive offering document are that it may be used by the initial purchasers as a marketing document for the ultimate investors and serve as a defence against potential liabilities of the issuer and the initial purchasers for violations of the antifraud provisions of the US securities laws.⁵ For an issuer that is not public in any jurisdiction, drafting a Rule 144A offering memorandum can be a difficult, expensive and time-consuming process. The fact that the offering memorandum is not subject to SEC review does afford the parties more flexibility. The issuer, its counsel and the initial purchasers might determine to include more abbreviated disclosure in a Rule 144A offering memorandum.

The main benefit for a reporting company (US or foreign) conducting a Rule 144A offering is that the disclosure for the offering memorandum can be prepared more quickly. A US reporting company can incorporate by reference into the offering memorandum its Exchange Act filings. A foreign issuer that is a reporting company may need to furnish information about the offering to the SEC under Form 6-K to the extent that such information is required to be: (1) made public under the laws of its home jurisdiction; (2) filed with a securities exchange which makes the information public; or (3) distributed to its security holders (as is typically the case with an offering memorandum).

Regulation FD?

For Regulation FD purposes, a reporting company must be careful not to disclose material information in an offering memorandum that is not otherwise publicly disclosed. Foreign issuers, unlike their US counterparts, are not subject to Regulation FD.⁶ While this is an apparent advantage for them, they must still be mindful of the antifraud provisions of the US securities laws. In addition, recipients of any material, non-public information disclosed in the offering memorandum or offering process may want the foreign issuer to disclose the information publicly in order to allow them to sell the securities being offered or any other securities that the recipients may own that would be affected by such material non-public information. Accordingly, while Regulation FD does not apply to non-US reporting companies, many consider it good practice to comply with, or take actions guided by, its requirements.

Other communication issues

Press releases

Issuers may use a Rule 135c-compliant press release to announce a Regulation S offering. Under Rule 135c of the Securities Act, an announcement that an issuer proposes to make, is making or has made an unregistered offering will not be deemed to be an offer of securities, for purposes of Section 5 of the Securities Act, if, among other things, the announcement contains certain limited information regarding the offering (eg, the name of the issuer, the basic terms and size of the offering, the timing of the offering, a brief statement of the manner and purpose of the offering and statements that the securities have not been registered) and is not used for the purpose of conditioning the market in the United States for the offered securities. A Rule 135c-compliant press release is not a “directed selling effort” and therefore will not affect the availability of the Regulation S safe harbour.

In addition, for Regulation S offerings with a Rule 144A tranche, the SEC has clarified that general solicitation and general advertising in connection with a Rule 144A offering will not be viewed as “directed selling efforts” in connection with a concurrent Regulation S offering. This is particularly relevant because general solicitation and general advertising are now permitted for Rule 144A offerings (so long as the securities are sold to a QIB or to a purchaser that the seller and any person acting on the seller’s behalf reasonably believes is a QIB). As a result, issuers are now permitted to broadly disseminate a press release regarding a proposed or completed Rule 144A offering free of the prior restrictions on the types of permitted information under Rule 135c.

Offering participants should keep in mind that Rule 135c is a non-exclusive safe harbour, and offering-related press releases may be able to satisfy a different safe harbor, such as Rule 135e under the Securities Act in respect of any offshore activities for any Regulation S tranche. Rule 135e provides that, subject to certain conditions, foreign

issuers and their representatives will not be deemed to offer any security for sale by virtue of providing any journalist with access to press conferences conducted outside the United States, conducting meetings with issuer or selling security holder representatives outside the United States, or providing written press-related materials released (and received by the recipient) outside the United States. Foreign issuers should consult their counsel in advance of making any communications, whether in or outside the United States, to carefully examine the applicability of these safe harbours.

Due diligence

General

Rule 144A and Regulation S offerings do not subject the issuer and the initial purchasers to liability under Section 11 of the Securities Act, thereby limiting the potential need to establish a formal due diligence defence. Nonetheless, a thorough due diligence investigation by lawyers, accountants, the issuer and the initial purchasers generally will result in better disclosure and a lower risk of liability or potential liability for material misstatements or omissions.⁷

The due diligence process

The due diligence process in Rule 144A and combined Rule 144A/Regulation S offerings is similar to the process followed in connection with registered public offerings. Generally, the process is divided into two parts: (a) business and management due diligence, and (b) documentary, or legal, due diligence. The actual extent of diligence required may vary based on:

- The nature of the issuer, including whether the issuer is a newer entity, a well-established company (whether public or not) or a US reporting company;
- The business of the issuer and its current risk profile; and
- The securities to be offered, whether investment grade or high yield debt securities (and the ratings, if any, of similar securities of the issuer) or preferred or common equity.

Foreign issuers contemplating an offering to US institutional investors are expected to comply with, and facilitate, the due diligence process, including making its senior management team available for discussions and opening its books and records to the initial purchasers. In order to help establish a due diligence defence, market practice generally requires the initial purchasers in Rule 144A and Regulation S offerings to condition the offerings upon receipt of documents similar to those used in an underwritten offering, including a comfort letter, legal opinions (including 10b-5 letters) and officer certificates. As with either a registered offering or a Rule 144A offering, due diligence will also be affected by the initial purchasers’ knowledge about, and any ongoing relationships with, the issuer.

Liability concerns

General

The Rule 144A safe harbour and Regulation S are exemptions from the registration and prospectus delivery requirements of the Securities Act. However, the antifraud provisions of the securities laws still apply to these transactions. Thus, while it is generally believed that Rule 144A and Regulation S offerings are not subject to the liability provisions of Section 11 or Section 12(a)(2) of the Securities Act, the issuer and the initial purchasers could, under some circumstances, be subject to liability for rescission damages under Section 12(a)(1) of the Securities Act for a sale of an unregistered security, as well as private rights of action under Section 10(b) of the Exchange Act and Rule 10b-5 under the Exchange Act for material misstatements or omissions.

The antifraud provisions of the Securities Act

In general, purchasers of an issuer's securities in a registered offering have private rights of action against various participants in the offering for materially deficient disclosure in registration statements under Section 11 of the Securities Act and in prospectuses and oral communications under Section 12(a)(2) of the Securities Act. Under Section 11, liability exists for untrue statements of material facts or omissions of material facts required to be included in a registration statement or necessary to make the statements in the registration statement not misleading at the time the registration statement became effective. Under Section 12(a)(2), sellers have liability to purchasers for offers or sales by means of a prospectus or oral communication that includes an untrue statement of material fact or omits to state a material fact that makes the statements made, based on the circumstances under which they were made, not misleading.

Purchasers also may have private rights of action under Section 10(b) of the Exchange Act and Rule 10b-5 under the Exchange Act. Claims brought under Section 10(b) and Rule 10b-5 are implied causes of action covering all transactions in securities, including private placements, and all persons who use any manipulative or deceptive devices in connection with the purchase or sale of any securities. Courts have held that claims brought under Section 10(b) and Rule 10b-5 require proof that the defendant acted with *scienter* (meaning intent or knowledge of the violation), which is not a requirement for actions brought under Sections 11 or 12 of the Securities Act.

Each of these statutes and rules has many decades of judicial interpretations explicating their elements and defenses. While the antifraud protections often frighten foreign issuers from accessing the US capital markets and litigation can always be brought, experienced counsel can be very helpful in guiding issuers and investment banks through the process in order to minimise the possibility of such litigation.

ENDNOTES

1. The offering participants should also determine whether any state's blue sky laws will apply to the proposed offering. For information regarding blue sky laws, *see* Chapter 11 (Blue sky laws).
2. Rule 144A(d)(4) is interpreted to identify the minimum information required in connection with an initial offering of Rule 144A securities. For more information, *see* "Information requirements for non-reporting issuers" in Chapter 2 (Overview of financing through exempt offerings).
3. For more information, *see* "Liability concerns" below.
4. Rule 144A is an exemption from registration under Section 5 of the Securities Act. As stated in Preliminary Note 1 to Rule 144A, it does not relate to the antifraud or other provisions of the US federal securities laws.
5. For more information, *see* "Liability concerns" below.
6. The definition of "issuer" for purposes of Regulation FD in Rule 101(b) excludes foreign governments and FPIs, each as defined in Rule 405 under the Securities Act.
7. For more information, *see* "Liability concerns" below.

CHAPTER 6

Section 3(a)(2) and considerations for foreign banks financing in the United States

Section 3(a)(2) exempts any security issued or guaranteed by a bank from registration under the Securities Act. This exemption is based on the principle that, whether chartered under state or federal law, banks are highly and relatively uniformly regulated, and as a result will provide adequate disclosure to investors about their business and operations in the absence of federal securities registration requirements. In addition, banks are also subject to various capital requirements that may help increase the likelihood that holders of their debt securities will receive timely principal and interest payments.

What is a bank?

Section 3(a)(2), broadly defines a “bank” to mean any national bank, or any banking institution organised under the law of any State, territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official. To qualify as a bank under Section 3(a)(2), the institution must meet two requirements: (i) it must be a national bank or any institution supervised by a state banking commission or similar authority; and (ii) its business must be substantially confined to banking. Therefore, securities issued by bank holding companies, finance companies, investment banks and loan companies are not exempt from registration under Section 3(a)(2). Even though many investors may think of them as banks, their businesses are not substantially confined to banking. Securities offered by any of these institutions must be registered under the Securities Act unless the offering falls under another exemption from registration.

Foreign banks and Section 3(a)(2)

Branches and agencies of foreign banks are operational arms of foreign banks conducting business in the United States under licences granted either by the Comptroller of the Currency or a state authority. However, an agency or branch is not a separate legal entity from the foreign bank itself. As a result, a foreign bank may not be a national bank or may not be organised under the laws of any state. Therefore, a foreign bank must focus on the SEC’s definition of a “bank” under Section 3(a)(2).

In 1964, the SEC reviewed the availability of the Section

3(a)(2) exemption for US branches of foreign banks, particularly with respect to their day-to-day banking operations. After review of the issues involved, particularly the comparability of regulation of these branches, the SEC was satisfied that the foreign bank branches in question were subject to the type and extent of supervision contemplated by Section 3(a)(2) for domestic banks, and authorised the Division of Corporation Finance to issue no-action letters with respect to the sale without registration of various instruments. The Division then granted the first no-action letter with respect to certificates of deposit and pass book accounts issued by a New York state branch of a foreign bank. Other letters followed.

In 1974, this no-action policy was re-examined. The SEC reaffirmed its prior position, in part as a policy decision intended to further the “principle of national treatment,” that foreign and domestic banks should be afforded the same privileges and be subject to the same rules applicable to US banks. In addition, the SEC determined that the branches and agencies in question appeared to be subject to regulatory schemes that were virtually indistinguishable from those to which their domestic counterparts were subject.

In 1978, Congress passed the International Banking Act (IBA). Prior to the IBA, the only branches and agencies of foreign banks in the United States were those licensed by states. Under the IBA a foreign bank can establish a “federal” branch or agency licensed and supervised by the Comptroller of the Currency. Congress enacted the IBA to establish “the principle of parity of treatment between foreign and domestic banks in like circumstances” (the principle of national treatment). The SEC continued to issue many no-action letters to foreign branches, permitting reliance on the Section 3(a)(2) exemption for securities issued by them.

In 1986, the SEC recognised that the passage of the IBA represented a Congressional public policy of “national treatment,” and sought to formalise its positions in an interpretive release.¹ For purposes of the exemption from registration provided by Section 3(a)(2), the SEC deems a branch or agency of a foreign bank located in the United States to be a “national bank,” or a “banking institution organised under the laws of any State, Territory, or the District of Columbia,” provided that the nature and extent of federal and/or state regulation and supervision of the

particular branch or agency is substantially equivalent to that applicable to federal or state chartered domestic banks doing business in the same jurisdiction. 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” is the responsibility of issuers and their counsel. These determinations are made with regard to the banking regulations in effect at the time the securities are issued or guaranteed.

In light of the issuance of this interpretive release, the SEC no longer grants no-action letters regarding securities issued or guaranteed by foreign bank branches and agencies. However, the approximately 100 no-action letters granted under Section 3(a)(2) prior to the 1986 interpretive release are instructive as to the consideration given by the staff of the SEC to the strength of the applicable regulatory regime, the type of instrument, the manner of offering and the denominations of the securities to be offered.

Generally, these no-action letters permitted US branches and agencies of foreign banks to issue debt securities without registration. Over time, the SEC developed a policy of conditioning its decision on the receipt of an opinion of counsel that the nature and extent of federal and state regulation and supervision of the branch or agency in question were substantially equivalent to that applicable to federal or state chartered domestic banks doing business in the same jurisdiction.

Securities guaranteed by a bank

The Section 3(a)(2) exemption is also available for securities “guaranteed” by a bank. Whether securities are guaranteed by a bank is interpreted broadly by the SEC. The staff of the SEC has taken the position in no-action letters that the term “guarantee” is not limited to a guaranty in a legal sense, but also includes arrangements in which the bank agrees to ensure the payment of a security. As a result, many US branches of foreign banks have also issued letters of credit in connection with the obligations of US commercial borrowers. Because a letter of credit is a guarantee for the purposes of Section 3(a)(2), the letter (and the obligations of the underlying commercial borrower) are exempt from registration. The guarantee must be full and unconditional. Guarantees by a foreign bank (other than those by an eligible US branch or agency) would not qualify for the Section 3(a)(2) exemption.

Types of securities

The exemption under Section 3(a)(2) applies not only to securities issued or guaranteed by a bank but also to certificates of deposit issued or guaranteed by a bank (to the extent considered securities instead of bank deposits). Structured notes linked to the performance of an index or

another underlying asset are also commonly issued by banks in reliance on the Section 3(a)(2) exemption.² In these instances, even though the return of the note is linked to an underlying asset, the investor is buying debt of the issuer and must rely on the credit of the issuer for repayment of the note, no matter how the underlying asset performs. This strengthens the argument that the structured instrument is covered under the Section 3(a)(2) exemption.

Because bank notes are not subject to the SEC’s registration requirements, structured bank notes sometimes are linked to different types of assets than registered structured notes, particularly when the investor is sophisticated and understands the relevant risks. For example, because bank notes are not subject to the “strict liability” provisions of Sections 11 and 12(a)(2) of the Securities Act, an issuer may be more comfortable linking the bank note to a complex underlying asset or investment strategy, which may be difficult to describe adequately in a registration statement. In addition, registered offerings of equity-linked structured notes are typically linked only to large-cap US stocks due to the Morgan Stanley no-action letter³ requirements. However, some bank notes may be linked to debt securities (credit-linked notes), small-cap stocks or securities traded only on non-US exchanges.

Section 3(a)(2) bank notes can be senior or subordinated, fixed or floating rate, zero-coupon, non-US dollar denominated, amortising, multi-currency or indexed (structured) securities. Common reference rates for floating rate bank notes include Libor (London Interbank Offered Rate), Euribor (Euro Interbank Offered Rate), the prime rate, the Treasury rate, the federal funds rate and the CMS (Constant Maturity Swap) rate.

OCC registration

The OCC regulates disclosure in connection with offers and sales of securities by national banks and federally licensed US branches and agencies of foreign banks (but not state banks). 12 C.F.R. Part 16, the OCC’s Securities Offering Disclosure Rules (OCC Regulations), provides that these 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. Issuers are required to follow the form requirements of the form that they would use to register securities under the Securities Act if they were not exempt from such registration.

The OCC Regulations provide an exemption from the registration requirements if the securities would be exempt from registration under the Securities Act other than by reason of Sections 3(a)(2) or 3(a)(11), or the securities are offered in transactions that satisfy one of the following exemptions under the Securities Act:

- Regulation D offerings;
- Rule 144A offerings to QIBs; and
- Regulation S offerings effected outside of the United States.

On September 23, 2013, amendments to Rule 144A and Rule 506 of Regulation D became effective, allowing general solicitation or general advertising of offers, provided that the securities are sold only to accredited investors (in the case of Rule 506 offerings) or QIBs (in the case of Rule 144A offerings). In a Rule 506 offering, the issuer must take reasonable steps to verify that the purchasers are accredited investors.

New disqualification provisions were added to Rule 506, prohibiting the use of the exemption by certain bad actors and felons. The new disqualification events apply to the issuer, persons related to the issuer and anyone who will be paid (directly or indirectly) remuneration in connection with the offering (placement agents and others).

The OCC Regulations also contain an exemption for offers and sales of nonconvertible debt securities if a number of conditions are met under Part 16.6, including:

- The issuer or its parent bank holding company has a class of securities registered under Section 15(d) of the Exchange Act, or, in the case of issuances by a federal branch or agency of a foreign bank, such federal branch or agency provides the Comptroller the information specified in Rule 12g3-2(b) under the Exchange Act and provides investors with the information specified in Rule 144A(d)(4)(i) under the Securities Act;
- All offers and sales are to “accredited investors,” as defined in Rule 501 under the Securities Act;
- The securities are “investment grade,” as discussed below;
- The securities are sold in a minimum denomination of \$250,000 and are legended to provide that they cannot be exchanged for securities in smaller denominations;
- Prior to or simultaneously with the sale of the securities, the purchaser receives 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; and
- The offering document and any amendments are filed with the Comptroller no later than the fifth business day after they are first used.

The new definition of “investment grade,” which came into effect on January 1, 2013, does not require a specific rating for the relevant nonconvertible debt securities. Rather, the condition will be satisfied if the issuer of a security has “adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected.” An existing investment grade rating could be one factor that offering participants may take into consideration in determining whether an issue of debt securities is “investment grade” for purposes of the OCC Regulations.

FDIC guidance

For state banks and state-licensed branches of foreign banks with insured deposits, the Federal Deposit Insurance Corporation (FDIC) adopted a Statement of Policy Regarding the Use of Offering Circulars in Connection with Public Distribution of Bank Securities for state non-member banks (FDIC Policy).⁴ The 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 FDIC Policy states that the offering circular should include detailed prospectus-like disclosure, similar to the type contemplated by Regulation A under the Securities Act or the offering circular requirements of the Office of the Thrift Supervision (OTS).⁵ While the Dodd-Frank financial regulatory reform bill mandated that the supervisory functions of the OTS be shifted to the OCC and also eliminated the OTS, the FDIC Policy predates the Dodd-Frank changes and therefore continues to refer to the OTS’s requirements.

The FDIC Policy further states that the goals of the Policy will be met if the securities are offered and sold in a transaction that, among other options: (i) satisfied the requirements of Regulation D of the Securities Act relating to private offers and/or sales to accredited investors; or (ii) the information and disclosure requirements of the regulations of the OTS regarding securities offerings, which require that debt securities be issued in denominations of \$100,000 or more. To the extent an offering meets these requirements, it will be deemed to satisfy the FDIC Policy requirements. Nonetheless, an issuer may still want to include more detailed disclosure, as the FDIC Policy emphasises the applicability of the anti-fraud provisions of the Securities Act and Exchange Act to offerings by banks.

Securities liability

Securities offered 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. However, offerings under Section 3(a)(2) are subject to Section 10(b) of the Exchange Act and the anti-fraud provisions of Rule 10b-5 under the Exchange Act. Moreover, investors may have a fraud-based cause of action under state common or statutory law. Therefore, when considering an offering under Section 3(a)(2), a bank (and its underwriters) must take into consideration what disclosure is necessary to avoid liability under the anti-fraud provisions, even if the document does not need to comply with the specific form requirements of the SEC or another regulator. As a result, the form and content of bank note offering documents issued under Section 3(a)(2) are similar in many respects to that used for a registered offering. Also, broker-dealers must carefully assess the suitability of the relevant investors, particularly in the case of offerings of structured products.

Blue sky laws

Securities issued under Section 3(a)(2) are considered “covered securities” under Section 18 of the Securities Act. As a result, a state may not require registration or qualification of Section 3(a)(2) bank notes or comment on the related offering document. However, states may require certain notice filings and charge filing fees in connection with an offering. Most states do not require registration for bank notes offered by a foreign bank through its US branch or agency under the principles of comity, on the theory that the domestic branch or agency is subject to oversight and regulation by US banking authorities. However, it is understood that there are a few states, including Texas, that do not extend the exemption to US branches or agencies of foreign banks.

Minimum denominations

The Securities Act contains no requirements regarding minimum denominations for securities issued pursuant to Section 3(a)(2). A review of several no-action letters reveals that the SEC has not directly conditioned the granting of any no-action letter on a bank security being issued in a denomination of \$100,000 or greater. While issuers have identified large denominations in no-action letter requests as an argument in their favour, the SEC has not issued any statement indicating that issuances under Section 3(a)(2) are or should be conditioned on compliance with any minimum denomination requirements, or particular sales restrictions. In fact, the SEC has granted no-action letters in connection with the issuance of debt securities under Section 3(a)(2) in denominations as low as \$1,000.

As referred to above, Part 16.6 of the OCC Regulations provide an exemption for offerings of “non-convertible debt” to accredited investors in denominations of \$250,000 or more. Under Part 16.6, each note or debenture must show on its face that it cannot be exchanged for notes or debentures in smaller denominations and permits sales only to accredited investors. The OCC has commented that these requirements “serve as important investor/consumer protection tools and foster safe and sound banking rules.”⁶

Some third party commentary also advocates the issuance of subordinated debt of banks only in large denominations.⁷ The reasoning behind this position is that securities issued in increments in excess of \$100,000 (the insurance limit for deposits) will clearly indicate to investors that the debt is uninsured and is specifically subordinated to the bank’s other debts. Notably, securities issued in large increments are generally issued to institutional investors who presumably understand that the securities are uninsured. Issuances of banks securities in smaller denominations marketed to less sophisticated retail investors lack a large face value that will put such investors on notice that the securities are not insured.

An agency of a foreign bank subject to New York banking regulations would have to notify the

Superintendent of the New York Department of Financial Services of any upcoming transaction. Absent objection from the Superintendent within 30 days of such notice, the agency would be able to sell securities, and only to certain authorised institutional purchasers in minimum denominations of \$100,000.⁸

Offering documents

As a result of the applicable liability provisions described above, the offering documentation for bank notes is somewhat similar to that of a registered offering. The form of these documents is not subject to the relevant SEC form rules, and may vary somewhat from those used in a registered offering. However, the content (as well as the types of documents incorporated by reference) tends to be somewhat similar.

The principal document used to describe the securities and the issuer is an offering memorandum, which may be called an offering circular. In addition to a detailed description of the securities section, an offering memorandum will either include a description of the issuer’s business and financial statements, or incorporate them by reference from the issuer’s publicly available documents in the United States or its home jurisdiction.

In addition, the issuer and the selling agents for these offerings may use a variety of term sheets to offer these securities.

A bank may choose to issue bank notes on a stand-alone basis, or to establish a bank note programme if the bank anticipates substantial issuance volume. A bank note programme will function much like other continuous offering programmes, such as medium-term note programmes. In addition to the disclosure documents, the following documents are typically used to establish a bank note programme:

- One or more paying agency agreements with a paying agent;
- A distribution agreement between the issuer and the selling agents or dealers; and
- An administrative procedures memorandum, which describes the exchange of information, settlement procedures, and responsibility for preparing documents among the issuer, the selling agents, the paying agent, and the applicable clearing system in order to offer, issue and close each series of securities under the programme.

Additional agreements for a bank note programme may include a calculation agency agreement or a currency exchange rate agency agreement. Under a calculation agency agreement, the calculation agent, which often is the same entity as the paying agent, agrees to calculate the rate of interest due on floating rate notes. This type of agreement also may be used in connection with structured notes to calculate the returns payable on the note.

In the case of structured notes, a broker-dealer (usually, the arranger or one of its affiliates) is more likely to serve

as calculation agent. Under a currency exchange rate agency agreement, an exchange rate agent (again, often the paying agent) converts the payments made by the issuer on foreign currency-denominated notes into US dollars for the benefit of US investors.

In addition, at the time a programme is established, the issuer generally is required to furnish a variety of documents to the selling agents, as would be the case in a typical underwritten or syndicated offering:

- Officer's certificates as to the accuracy of the disclosure documents;
- Legal opinions as to the authorisation of the programme, the absence of misstatements in the offering documents, the applicability of the Section 3(a)(2) exemption and similar matters; and
- A comfort letter (or agreed upon procedures letter) from the issuer's independent auditors.

Depending upon the arrangements between the issuer and the selling agents, some or all of these documents will be required to be delivered to the selling agents on a periodic basis as part of the selling agents' ongoing due diligence process. Some or all of these documents also may be required in connection with certain takedowns, such as large syndicated offerings of bank notes.

Finra requirements

Even though securities offerings under Section 3(a)(2) are exempt from registration under the Securities Act, the offering documents and distribution agreements for public securities offerings conducted by banks must be filed with the Financial Industry Regulatory Authority, Inc. (Finra) for review under Finra Rule 5110(b)(9), unless an exemption is available. For purposes of Finra Rule 5110, an offering of Section 3(a)(2) bank notes is a "public offering." One exemption from filing under Finra Rule 5110 is that the issuer has outstanding investment grade rated unsecured non-convertible debt with a term of issue of at least four years, or that the issuance of non-convertible debt securities is so rated.

A slightly different exemption is applicable to an issuance of bank notes in which a broker-dealer affiliate of the issuer participates in the offering. That participation constitutes a "conflict of interest" for purposes of Finra Rule 5121, and occurs frequently when the issuer is part of a large financial institution with an affiliated broker-dealer participating in the offering. If the offering documents have the prominent conflicts of interest disclosure required by Finra Rule 5121 and the securities are either investment grade rated or in the same series that have equal rights and obligations as investment grade rated securities, then no filing under Finra Rule 5110 would be required. "Prominent disclosure" for purposes of Finra Rule 5121 means that the offering document include disclosure on the front page that a conflict of interest exists, with a cross-reference to the discussion within the offering document, and disclosure in any summary of the offering document.

If there are no outstanding securities of a national bank (including a branch or agency of a foreign bank regulated by the OCC) in the same series that are rated investment grade and have equal rights and obligations as the bank notes to be issued, the proposed offering is to be issued under Part 16.6 of the OCC Regulations, and there is a "conflict of interest" within the meaning of Finra Rule 5121, then the issuer must obtain an investment grade rating for the offered securities in order to avoid a filing under Finra Rule 5110. This would be the case even if the national bank has made the "investment grade" determination discussed above under "OCC Registration."

There are other Finra requirements applicable to offerings of Section 3(a)(2) bank notes:

- Suitability: Finra members selling Section 3(a)(2) bank notes are subject to Finra Rule 2111, the suitability rule. Under Finra Rule 2111, a member firm or registered representative must perform a reasonable basis suitability determination before recommending a transaction or investment strategy involving a security. A reasonable basis suitability determination is necessary to ensure that a transaction or investment strategy is suitable for at least some investors. That determination will be more complicated with respect to structured bank notes, as compared to fixed or floating rate bank notes.
- Communication rules: Under Finra Rule 2210, "Communications with the Public," certain "retail communications" (as defined in the rule) published or used broadly by a new Finra member firm relating to an offering of Section 3(a)(2) bank notes would have to be filed with Finra no later than 10 business days prior to their first use.⁹ All retail communications are subject to approval by a principal of the member firm prior to first use or filing with Finra. Institutional communications must be subject to a member firm's written procedures designed to ensure that the communications comply with applicable Finra standards. All member communications, including those relating to an offering of Section 3(a)(2) bank notes, must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular bank note. The communications may not omit any material fact or qualification if the omission, in light of the context of the material presented, would cause the communication to be misleading.
- Trace reporting: Transactions under Section 3(a)(2) must be reported through the Trade Reporting and Compliance Engine (Trace).¹⁰ All brokers and dealers who are Finra members have an obligation to report Section 3(a)(2) transactions to Trace.

Conclusion

Section 3(a)(2) provides bank issuers, including branches and agencies of foreign banks, with the ability to issue

different types of securities without registering the offering with the SEC. When relying on Section 3(a)(2), an issuer must carefully consider the disclosure included in its offering document, so as not to subject itself to liability under the anti-fraud provisions of the securities laws and to comply with the regulations and other guidance adopted by the various banking regulators. Banks seeking to employ industry best practices typically utilise disclosure, and meet standards, similar to those used in the context of registered offerings.

ENDNOTES

1. *See Securities Issued Or Guaranteed By United States Branches Or Agencies of Foreign Banks*, SEC Release No. 33-6661 (September 23, 1986).
2. In addition to structured bank notes, banks may issue structured certificates of deposit.
3. *See* Morgan Stanley & Co. Incorporated, SEC No-action Letter (June 24, 1996). Under the terms of the Morgan Stanley letter, an issuer of a debt security (ELN issuer) linked to an underlying common stock only has to include summary information about the issuer of the common stock (the “linked stock issuer”), disclosure as to availability of information about the linked stock issuer and information about the underlying common stock (generally, the US national securities exchange on which the common stock is listed and the high and low quarterly sales prices for the two previous full years), *provided that* the linked stock issuer meets certain eligibility requirements. Those requirements are that (1) the linked stock issuer has a class of equity securities registered under Section 12 of the Exchange Act and (2) the linked stock issuer (i) is eligible to use Securities Act Form S-3 or F-3 *or* (ii) meets the listing criteria for issuers of the equity securities underlying equity-linked notes that are to be listed on a national securities exchange. If the linked stock issuer does not meet the eligibility requirements, the ELN issuer would have to include detailed information about the linked stock issuer, potentially exposing the ELN issuer to liability for the linked stock issuer’s misstatements or omissions.
4. *See* 61 Fed. Reg. 46808, September 5, 1996. The policy was most recently revised in September 1996, and may be found at <http://www.fdic.gov/regulations/laws/rules/5000-500.html#fdic5000statementop>.
5. These requirements can be found at 12 C.F.R. 563g.
6. Federal Register, Vol. 73, No. 80, April 24, 2008, at 22228.
7. *See* Statement of the Shadow Financial Regulatory Committee Meeting (Washington), March 2, 2000.
8. N.Y. Banking Law § 202-a(1) (McKinney 2012); N.Y. Comp. Codes R. & Regs. tit. 3, §§ 81.1-3 (2013).
9. This requirement applies to a Finra member firm for the period of one year beginning on the date reflected in the Central Registration Depository system as the date that the firm’s Finra membership became effective.
10. Trace is the Finra -developed vehicle that facilitates the mandatory reporting of over-the-counter secondary market transactions in eligible fixed income securities.

CHAPTER 7

Bank deposit products versus securities

Foreign bank branches, federally or state-licensed, may exercise banking powers such as accepting certain types of deposits. Before 1991, foreign bank branches could accept both retail and wholesale deposits. However, although foreign bank branches may receive deposits of any size from foreigners, the Federal Deposit Insurance Corporation Improvement Act of 1991 prohibited these branches from accepting deposits of less than \$250,000 from US citizens and residents. A grandfathering provision permits insured federal branches in existence on the date of act's enactment to continue accepting insured deposits of less than \$250,000.¹

Furthermore, as a result of the Foreign Bank Supervision Enhancement Act of 1991, deposits in any foreign bank branch established after December 19, 1991, are not covered by US deposit insurance. US subsidiaries of foreign banks, because they are chartered in the United States, may become members of the Federal Reserve and undertake any banking activities permitted for US-owned banks.

When is a certificate of deposit a security?

A certificate of deposit (CD) is a special type of deposit account with a bank or thrift institution that typically offers a higher rate of interest than a regular savings account. Section 2(a)(1) of the Securities Act includes “certificates of deposit” in the definition of the term “security.” However, under relevant federal judicial and regulatory guidance, a CD insured by the Federal Deposit Insurance Corporation (FDIC) is generally not considered a “security” under the federal securities laws and generally is not subject to the registration requirements of federal securities laws.

In furtherance of the concept of “national treatment,” the SEC has determined for purposes of an exemption from the registration requirements of the Securities Act that US branches of a foreign bank appear to be “virtually indistinguishable” from their domestic counterparts and have “substantially equivalent” US federal and state regulation and supervision as comparably-licensed, state-chartered banks.² However, there are limited circumstances in which courts have characterised certain CDs as securities.

In *Marine Bank v Weaver*,³ the US Supreme Court set forth the analytical framework for determining whether a

CD would be considered a “security” for purposes of the anti-fraud provisions of the Exchange Act. The Court focused on the difference between bank-issued CDs and other long-term debt obligations. According to the Court, FDIC-insured CDs are afforded protection by the reserve, reporting and inspection requirements of the Federal Deposit Insurance Act. Since holders of these deposits are guaranteed payment of principal by the US government, the Court opined that it was not necessary to provide the added protections to CD holders that are afforded under the anti-fraud provisions of the US federal securities laws. However, as a caveat, the Court added that all CDs are not automatically outside of the definition of “security” under the federal securities laws, and that “each transaction must be analysed and evaluated on the basis of the content of the instrument in question, the purpose intended to be served, and the factual setting as a whole.”⁴

The Court’s holding in *Marine Bank* set forth a relatively straightforward analytical framework with regard to CDs that was made less straightforward three years later, in *Gary Plastics Packaging v Merrill Lynch, Pierce, Fenner, & Smith Inc.*⁵ In that case, Merrill Lynch had marketed “bundled” insured certificates of deposit that it obtained from various banks. Merrill Lynch purportedly promised to maintain a secondary market to guarantee purchasers liquidity for their deposits, and represented to purchasers that it had reviewed the financial soundness of the issuing banks.

The US Second Circuit Court of Appeals began its analysis by analogising the CDs offered in *Gary Plastics* to “investment contracts.” An instrument is an “investment contract” if it evidences: (1) an investment; (2) in a common enterprise; (3) with a reasonable expectation of profits; and (4) is to be derived from the entrepreneurial or managerial efforts of others. Due to the fact that the broker’s creation and maintenance of a secondary market was a critical part of its marketing efforts, and permitted investors to make a profit from these investments, the Court held that the CDs were securities for the purposes of the anti-fraud provisions of the Securities Act and the Exchange Act. Consequently, the additional protections of those anti-fraud provisions were deemed appropriate.

As one result of this case, while brokers who offer these products indicate that they may make a secondary market

in them (and in fact many do), these issuances do not involve a commitment or an agreement on the part of any broker to do so.

Blue sky laws

CDs are usually not considered securities under the US federal securities laws, as discussed above. However, that view may not apply to an analysis under each US state's securities, or blue sky, laws.

If a particular CD were viewed as a security under the Securities Act, that CD would be a bank security exempt from federal registration under Section 3(a)(2). These types of securities are considered covered securities under Section 18 of the Securities Act, with respect to which a US state's registration or qualification provisions are preempted, and that US state may not require any particular disclosure in the offering document relating to the security. However, because bank securities generally are not listed on a national securities exchange, US states may require a notice filing and a fee in connection with an offering of bank securities.

Blue sky laws should be examined to ensure that either no notice filing or fee is required, or the US state's existing exemption for securities issued by banks does not require a filing. A US state may not view an agency of a foreign bank, whose securities are eligible for the Section 3(a)(2) exemption, as within the US state's exemption for securities issued by banks. Generally, blue sky filings are not needed in any US state in which CDs or bank securities are offered.

Structured CDs

Structured CDs are investments representing a bank deposit of a specified amount of money for a fixed period of time, which have periodic interest payments and/or a return at maturity that is linked to an underlying asset, such as an equity index, a foreign currency exchange rate, a commodity, or some combination of these. Like traditional CDs, structured CDs entitle the holder to his or her principal investment, plus one or more additional payments. However, unlike traditional CDs, which usually pay interest periodically, structured CDs generally pay an additional payment at maturity based on the underlying asset. The most common form of structured CDs issued by US-chartered banks is insured by the FDIC, however banks may offer structured CDs that are not so insured.

What sets a structured CD apart from a traditional CD is its customisable features, limited only to the issuing bank's imagination (and applicable laws). This allows investors access to a number of investment strategies, as well as the opportunity to gain upside exposure to a variety of market measures. While traditional CDs contemplate a specific fixed or floating rate of income, the income received from structured CDs is mainly derived from the performance of the underlying reference

asset. Here is a basic example of a structured CD:

Bank X issues a certificate of deposit with a two-year term and a minimum investment of \$1,000. In lieu of a fixed interest rate, Bank X has offered to pay an amount equal to the appreciation of the Dow Jones Industrial Average Index (the DJIA) over that two-year term of the note. If the DJIA increases by 20% in the two-year time period, Bank X will pay an additional \$200 for each \$1,000 invested, or \$1,200 in total. However, if the DJIA declines, Bank X will only pay out at maturity the principal amount invested.

In addition, structured CDs may or may not be interest bearing, and may offer a variety of payment calculations. For example, payments may be calculated using the percentage increase of the underlying asset based on the starting level (determined on the pricing date) and the ending level (determined before the date of maturity), or payments may be calculated using the average value of the underlying asset on a series of observation dates throughout the term of the structured CD. In addition, the payments may be subject to a cap, or ceiling, representing a maximum appreciation in the value of the underlying asset. Depending on the terms, a particular series of structured CDs may also have a participation rate, which represents the leverage or exposure of the structured CDs to movements in the underlying asset.

In short, structured CDs can be designed using many of the same features as "structured notes," with one exception: at minimum, the holder of a structured CD usually receives an amount equal to the principal at maturity. This feature arises largely from the fact that the FDIC takes the position that, in order to be insurable as a "deposit," the holder of the instrument must be entitled to at least the return of the principal amount. As a result, regardless of how poorly the underlying asset performs, at maturity, a holder will still receive the original investment amount. However, this protection is only available if the investment is held to maturity.

For deposit amounts of structured CDs that are FDIC-insured, it is important to note that the FDIC insurance is limited to the principal invested and any guaranteed interest rate, but not the "contingent" interest. Further, investors are still subject to the direct credit risk of the issuing bank for any dollar amount over the maximum applicable deposit insurance coverage – for example, if the investor holds other deposits with the applicable bank that together exceed the applicable deposit insurance limit.

Another notable aspect of many structured CDs is the estate feature (otherwise commonly known as a "death put" or "survivor's option"). To the extent provided in the terms of the particular structured CD, if at any time the depositor of a structured CD passes away (or in some cases, becomes legally incapacitated), the holder's estate or legal representative has the right, but not the obligation, to redeem the structured CD for the full

deposit amount before the maturity date, without being subject to any penalty provisions. The estate or representative also may choose not to exercise the estate feature and instead hold the structured CD to maturity.

Structured CDs possess a number of potential risks that investors should be aware of before making an investment. As mentioned above, the principal protection feature only applies if a structured CD is held to maturity. Accordingly, an investor must be prepared to commit his or her investment in a structured CD for the full term of the structured CD.

Depending on the terms of the structured CDs, there may be no assurance of any return above the deposit amount. In the end, if the market measure performs unfavorably, even though the investor may receive a return of its principal, the investor will still experience an opportunity cost as compared to investing in a traditional, interest-paying CD or another investment. Conversely, even if the market measure performs favorably, depending on the terms of the structured CD, the return on the investment may be limited by a predetermined return, a participation rate of less than 100%, or some other term specific to a particular structured CD. These types of features would cause the structured CD to perform less well than the relevant underlying asset. Further, for structured CDs that are FDIC-insured, the premiums and assessments paid by the bank issuer to the FDIC are usually passed on to the investor in the form of a lower participation rate or a lower maximum payment, as compared to non-FDIC-insured CDs and investments. In other words, a different investment, such as a non-insured structured CD or note with comparable terms, may offer greater upside potential.

Some structured CDs may also have a call feature. This provision allows the issuing bank, at its option, to redeem the structured CDs at a specified call price on one or more call dates prior to maturity. By agreeing to a specified call price, the investor effectively forgoes any possible returns that could be realized had the structured CD not been called, or had the structured CD been called on a later date. In addition, if a structured CD is called, the investor may not be able to reinvest the proceeds in a similar instrument, since interest rates and the level of the underlying asset may have changed since the structured CD was initially purchased.

Finally, structured CDs are not liquid investments. Issuing banks rarely create a secondary market for structured CDs, and even if a secondary market is created, the issuing banks are under no obligation to maintain it. As a result, if an investor decides to sell his or her structured CD prior to maturity, the amount the investor receives could potentially be lower than the initial principal amount.

Although structured and other CDs may not be considered securities for purposes of the registration

provisions of the Securities Act, as discussed above under “When is a certificate of deposit a security?,” a court could view a structured CD as subject to the anti-fraud provisions of the Exchange Act. Consequently, issuers of structured CDs generally include in their offering documents disclosure about the issuer and the product that is substantially similar to the disclosure in a registered offering of a similar structured security.

ENDNOTES

1. Section 335(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act amended Section 11(a)(1)(E) of the Federal Deposit Insurance Act (12 U.S.C. § 1821(a)(1)(E)) to increase the standard maximum deposit insurance amount from \$100,000 to \$250,000.
2. *See* SEC Release No. 33-6661 (September 23, 1986).
3. 455 U.S. 551 (1982).
4. *Id.* at 560, n.11.
5. 756 F.2d 230 (2d Cir. 1985).

CHAPTER 8

Considerations related to commercial paper

Foreign issuers may also access the US capital markets by issuing commercial paper (CP). CP is short-term, non-convertible debt typically issued by US and non-US banks, financial companies and other large, investment grade companies. CP issuers typically establish CP programmes in order to allow frequent, if not daily, issuances on short notice, similar to MTN programmes, where the main programme documentation, due diligence and deliverables are provided upon the CP programme's establishment. CP is not registered under the Securities Act and typically is issued pursuant to the exemption from registration under Section 3(a)(3) of the Securities Act. However, CP can also be issued without registration in a private placement pursuant to Section 4(a)(2) of the Securities Act or pursuant to the resale exemption provided under Rule 144A of the Securities Act.

What is CP?

CP is generally a promissory note with a maturity of nine months or less, although typically 30 days or less. CP is generally unsecured, issued in large denominations (\$100,000 or more) and sold in bearer form at a discount from face value. Although CP typically is issued as a zero-coupon security, it occasionally is interest bearing. CP is mainly purchased by institutional investors, including money market funds, insurance companies and banks. CP purchasers are almost always either QIBs or AIs.

CP is an attractive funding vehicle because it provides short-term liquidity, can be rolled over and is back-stopped. CP issuers generally use the proceeds of CP issuances to fund short-term liquidity needs, as an alternative to short-term borrowing under lines of credit from banks, including revolving credit facilities. Issuers usually roll over their CP, which means they repay maturing CP with the proceeds of new issuances.

In order to support the CP's credit rating and foster investor confidence, issuers usually maintain undrawn, revolving credit facilities or bank letters of credit in amounts equal to the maximum amounts of CP issuable under their respective programmes. CP issuers will not borrow under these credit facilities unless they are unable to repay maturing CP with new issuances or other available cash. In addition, banks that enter the CP market often do so by creating a subsidiary to act as issuer under a CP programme, in which case the parent bank

provides back-stop financing or serves as guarantor. In those instances where a CP issuer obtains a bank letter of credit, the CP and the bank letter of credit will be exempt from registration, assuming the requirements of Section 3(a)(3) are satisfied.

Although the majority of CP is plain vanilla, CP can also be asset-backed (ABCP), in which case a bankruptcy-remote special purpose vehicle (SPV) or conduit is used for issuance. The SPV uses the proceeds primarily to purchase interests in various types of assets. Repayment of the ABCP issued by the conduit depends primarily on the cash collections it receives from its underlying asset portfolio and its ability to issue new ABCP. Typically, a bank or other financial institution will provide liquidity support to bridge any gap when maturing ABCP cannot be refinanced by the issuance of new ABCP, including by reason of a market disruption. Some common assets financed with ABCP include trade receivables, consumer debt receivables, and auto and equipment loans and leases. An ABCP conduit may also use the proceeds to invest in securities (including asset- and mortgage-backed securities, corporate and government bonds, and CP issued by other entities), and to make unsecured corporate loans.

Exemptions from registration for CP

CP is not registered under the Securities Act and typically is issued pursuant to the exemption from registration under Section 3(a)(3). However, CP can also be issued without registration in a private placement pursuant to Section 4(a)(2) or pursuant to the resale exemption provided under Rule 144A. This means that a CP programme can be structured as a 3(a)(3) programme, a 4(a)(2) programme or a Rule 144A programme. In addition, CP can also benefit from the general exemption under Section 3(a)(2) of the Securities Act for securities that are either issued or guaranteed by certain banks or supported by a letter of credit from a bank.

Section 3(a)(3) exemption requirements

Section 3(a)(3) itself is brief and only exempts "any note, draft, bill of exchange or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance not exceeding nine months, exclusive of days of grace, or any renewal thereof

the maturity of which is likewise limited.” However, the adopting SEC release and subsequent no-action letters have established the following four criteria that must be satisfied:

- Be of prime quality and negotiable;
- Be of a type not ordinarily purchased by the general public;
- Have a maturity not exceeding nine months; and
- Be issued to facilitate current transactions.

The prime quality requirement has customarily been satisfied on the basis of ratings of the CP by nationally recognised rating services (for example, at least A-2, P-2 and F2 from Standard & Poor’s, Moody’s and Fitch, respectively), and such ratings depend on the creditworthiness of the issuer or the guarantor, if any. If the CP is unrated or less than investment grade, then the CP issuer could obtain a back-up bank facility, although it is unclear whether the SEC would issue a no-action letter permitting this arrangement. Alternatively, if the CP is unrated, the sponsoring dealer could provide a letter to issuer’s counsel stating that in such dealer’s view the CP would, if rated, be given a prime rating and that issuer’s counsel may use such letter as the basis for opining that the CP is entitled to the Section 3(a)(2) exemption.

With respect to the requirement that the CP be of a “type not ordinarily purchased by the general public,” the relevant factors are denomination, type of purchaser and manner of sale. The minimum denominations described in SEC no-action letters are typically \$100,000, although in practice CP is sold in much higher denominations. Purchasers of CP should be institutional investors or sophisticated individuals who would qualify as purchasers in a 4(a)(2) private placement and SEC no-action letters often refer to sales to “institutions or individuals who normally purchase commercial paper.” The marketing of CP also should be clearly aimed at such purchasers and advertising in publications of general circulation should generally be avoided. However, the SEC has not objected to tombstone advertisements announcing 3(a)(3) programme establishments or limited advertisements in publications of general circulation.

The requirement that the CP have a maturity not exceeding nine months can be satisfied by limiting the permitted maturity to 270 days in the documentation establishing the CP programme. Demand notes and notes with automatic rollover, extension or renewal provisions that extend maturity past the 270-day mark would not meet this requirement.

The current transactions requirement has been the subject of the majority of the SEC no-action letters regarding Section 3(a)(3). For corporate issuers, it is often relatively clear that the proceeds of the CP will be used for current transactions, including inventory or accounts receivable financing, recurring or short-term

operating expenses, such as the payment of salaries, rent, taxes, dividends or general administrative expenses and the interim financing of equipment or construction costs, pending permanent financing, for a period of not longer than one year.

In those cases where it is not possible to trace particular proceeds to particular uses, the SEC has accepted the use of limitations on the amount of CP issued according to formulas based on various categories of current transactions. The more expansive of these formulas include limiting the amount of CP outstanding at any one time to not more than the aggregate amount utilised by the CP issuer for specified current transactions, including in circumstances where the proceeds are loaned or advanced to a guarantor or its subsidiaries. The SEC also has indicated that a CP issuer should use a balance sheet test for determining such CP capacity, whereby the CP issuer determines the capital it has committed to current assets and the expenses of operating its business over the preceding 12 month period. The principal use of proceeds that clearly do not qualify for current transaction status include financing the purchase of securities, whether in connection with a takeover, for investment purposes or as issuer repurchases, capital expenditures such as the purchase of land, machinery, equipment, plants or buildings, and the repayment of debt originally incurred for an unacceptable purpose.

The 3(a)(3) exemption is an exemption for the CP notes themselves. Therefore, if the above conditions are met, there is no need for the issuer or secondary market resellers to ensure that each sale of CP notes is a private placement in accordance with the Securities Act. As a result, 3(a)(3) programmes are often preferred to 4(a)(2) programmes. However, the primary reason issuers are unable to use the 3(a)(3) exemption is that they plan to use the proceeds for purposes that do not clearly meet the current transactions requirement or the CP has a maturity longer than nine months. Some issuers simultaneously maintain a 3(a)(3) programme and a 4(a)(2) programme and issue CP under the 4(a)(2) programme when raising money for the purchase of a fixed asset or for takeover financing. In such cases, the SEC has issued no-action letters to the effect that it will not apply the “integration doctrine” to the CP issuances so long as the purpose and use of proceeds of the two programmes are distinct.

Section 4(a)(2) exemption requirements

4(a)(2) programmes are structured so that the sale of the CP notes by the issuer (either to the dealers as principal or directly to purchasers) is exempt under the safe harbour provided by Rule 506 under Regulation D. Resales by the dealers to QIBs (or purchasers that the dealers and any persons acting on the dealers’ behalf reasonably believe to be QIBs) are exempt under the safe harbour of Rule 144A. Resales by the dealers to AIs are

exempt under the Rule 4(a)(1½) exemption. In addition, resales to AIs are exempt under the dealer exemption under Section 4(a)(3) of the Securities Act.

Information requirements

Because resales by the dealers and secondary market transfers rely on Rule 144A, a 4(a)(2) programme issuer and guarantor must comply with the information requirements of Rule 144A(d)(4). 4(a)(2) programme issuers undertake to comply with these requirements by including such information in the PPM for the programme. However, public companies will automatically be in compliance if they continue to file reports under the Securities Exchange Act of 1934, as amended. 4(a)(2) programme PPMs include language offering purchasers the opportunity to ask questions of, and receive answers from, the issuer/guarantor about the terms and conditions of the offering or generally about the company in accordance with Rule 502(b)(2)(iv) under Regulation D.

Why would an issuer choose a 4(a)(2) programme?

An issuer may decide to structure its CP programme as a 4(a)(2) programme in order to avoid the current transactions requirement and the 270-day limitation on maturity under Section 3(a)(3). The issuer's in a 4(a)(2) programme can use the proceeds for any purpose, including to finance capital expenditures or acquisitions or to refinance existing debt originally incurred for these purposes (subject to Regulation T restrictions, which we discuss below). CP notes issued under a 4(a)(2) programme also are not subject to the 270-day limitation, although their maturity will still be limited by marketability and by concerns under the Investment Company Act. Although a 4(a)(2) programme would not be subject to the 270-day maturity limitation of Section 3(a)(3), the maturity of CP rarely exceeds 397 days. CP with a longer maturity is not marketable, in part because money market funds (which are major purchasers of CP) are restricted under Rule 2a-7 under the Investment Company Act from purchasing notes with maturities exceeding 397 days. Limiting the CP's maturity to 270 days can also be helpful with the issuer's status under the Investment Company Act.

Disadvantages of a 4(a)(2) programme

The drawbacks to a 4(a)(2) programme mostly are due to the fact that the CP notes, unlike 3(a)(3) CP or 3(a)(2) CP, are restricted securities. As a result, each resale must be exempt from registration because CP notes sold in a 4(a)(2) programme are restricted securities. Therefore, each resale of the CP, including each resale by a purchaser in the secondary market, must be made in a private placement transaction. However, the practical impact of this is somewhat lessened due to the fact that investors often hold CP until maturity and the Rule 144A market

provides significant liquidity. As a result, in 4(a)(2) programmes, deemed representations in the PPM specify that purchasers can resell their CP only to QIBs (or other purchasers that they and any persons acting on their behalf reasonably believe to be QIBs) under Rule 144A or to the issuer or a programme dealer, while the issuer or dealers can resell CP they reacquire using the same exemption used in the original sale, if desired. In addition, 4(a)(2) CP is generally sold in larger minimum denominations than 3(a)(3) CP (\$250,000 rather than \$100,000) in recognition of the heightened need to limit the types of acceptable purchasers.

The documentation for a 4(a)(2) programme also requires additional language regarding the 4(a)(2) exemption. For example, the PPM, dealer agreement and master note all include selling restrictions and restrictive legends. The PPM and master note also include the deemed representations, while the dealer agreement contains customary representations and covenants typically found in Regulation D and Rule 144A offerings.

Finally, Regulation T of the Federal Reserve Board restricts broker-dealers from extending unsecured credit if the proceeds are used to buy, carry or trade in securities. A broker-dealer's purchase of restricted securities as principal, which can occur under a 4(a)(2) programme, is subject to Regulation T, which imposes limitations on the parties. The form dealer agreement of the Securities Industry and Financial Markets Association (Sifma) for 4(a)(2) programmes contains procedures for addressing this issue, mainly by requiring the CP issuer to notify the dealers if it will or may use the proceeds to purchase or carry securities.

Rule 144A exemption requirements

Issuers generally do not rely on Rule 144A for privately placed CP because CP is typically sold to purchasers who are not QIBs. However, if the CP will be resold to QIBs (or purchasers that the sellers and any persons acting on the sellers' behalf reasonably believe to be QIBs), then CP issuers may take advantage of Rule 144A so long as they meet the other requirements, which include the following:

- The reseller (or any person acting on its behalf) taking reasonable steps to ensure that the buyer is aware that the reseller may rely on Rule 144A in connection with the resale.
- The CP resold: (a) when issued was not of the same class as securities listed on US national securities exchange or quoted on a US automated inter-dealer quotation system; and (b) are not securities of an open-end investment company, unit investment trust, or face-amount certificate company that is, or is required to be, registered under the Investment Company Act.
- In the case of a CP issuer that is neither an Exchange

Act reporting company, or a foreign issuer exempt from reporting pursuant to Rule 12g3-2(b) of the Exchange Act, or a foreign government, the holder and a prospective buyer designated by the holder must have the right to obtain from the CP issuer and must receive, upon request, certain reasonably current information regarding the CP issuer.

The documentation for a Rule 144A programme also will be very similar to a 4(a)(2) programme (for example, offering memorandum, dealer agreement, issuing and payment agent agreement, master note and the like). This means that a 3(a)(3) programme or a 4(a)(2) programme could be converted over to a Rule 144A programme with relative ease.

Establishing a CP programme

In order for CP to qualify for the exemption under Section 3(a)(3), and generally to be marketable, it must be highly rated, and therefore only investment grade issuers issue CP. This explains why CP is typically issued by US and non-US financial companies, banks and bank holding companies and other large blue chip companies, or subsidiaries of these companies. Non-US investment grade issuers who want to issue US CP often form a US corporate subsidiary to act as the issuer under a CP programme. For the subsidiary's CP to benefit from the parent's credit ratings, the parent guarantees the CP, which means that the parent is party to all the main programme documents.

CP issuers can market directly to investors, but many choose to use the services of dealers. CP programmes, like MTN programmes, may include more than one dealer. In a CP programme with more than one dealer, while one may take the lead in negotiating documents and advising the issuer, that dealer will generally not take on a formal title (such as arranger). In 4(a)(2) programmes, dealers are sometimes referred to as placement agents.

In order to establish a CP programme, the issuer will need to appoint an issuing and paying agent (IPA), which is a third-party trust company or bank that serves the same function as trustee under an indenture. The IPA plays various roles under a CP programme, including coordinating settlement of CP notes with The Depository Trust Company (DTC), processing payments under CP notes, assigning CUSIP numbers to each issuance of CP and acting as custodian of the master note representing the CP issued under the programme.

CP issuers and guarantors are expected to deliver legal opinion letters to the dealers when a CP programme is established. Typically outside New York counsel delivers many of the required opinion paragraphs, while in-house and/or local counsel qualified in the issuer's or guarantor's jurisdiction deliver others. Dealers and IPAs typically do not hire their own counsel for CP programmes. CP dealers instead rely on the opinion delivered to them by issuer's counsel, in contrast to other

types of offerings (for example, Rule 144A/Regulation S offerings, 4(a)(2) private placements and 3(a)(2) offerings). To the extent an IPA's internal policy requires a legal opinion on certain points, issuer's counsel usually allows the IPA to rely on issuer's counsel's opinion to the dealers. However, for a CP programme with unique features or where the standard form documents are expected to be negotiated for other reasons, the dealers and the IPA may hire outside counsel.

Documentation for a CP programme

The documents used in a CP programme are fairly standardised. They are generally not heavily negotiated compared to the documents for other kinds of capital markets transactions. The key documents for a CP programme are the PPM, the dealer agreement, the issuing and paying agent agreement, the master note, the guaranty and the legal opinions.

Private Placement Memorandum

The PPM is the main offering document for a CP programme. CP PPMs are much shorter than the prospectuses used in registered offerings and the offering memoranda used in other unregistered offerings. CP PPMs are much shorter because investors rely mainly on the credit ratings of the CP issuer or guarantor, rather than disclosure, when deciding whether to purchase. This is due to the fact that CP must be highly rated to be marketable and money market funds, which are major purchasers, are subject to restrictions under Rule 2a-7 of the Investment Company Act that limit their ability to invest in securities that are not in the two highest ratings categories. Nevertheless, CP PPMs incorporate by reference or include the publicly available or filed disclosure of the issuer and/or guarantor for the benefit of investors. In addition, CP PPMs typically include language stating that purchasers will have the opportunity to ask questions of, and receive answers from, the issuer or the guarantor.

A typical CP PPM includes a very short description of the CP issuer and/or guarantor. The rest of the PPM describes the CP notes themselves, including the terms, ratings, denominations, as well as the relevant exemption from registration and the use of proceeds. A brief section describing the tax treatment of payments under the CP may be included, particularly if the CP issuer or guarantor is a non-US entity. In a 4(a)(2) programme, the PPM also will include the deemed representation of the purchasers that they are AIs. Similarly, in a Rule 144A programme, the offering memorandum also will include the deemed representation of the purchasers that they are QIBs.

CP programmes may have one or more dealers. If there is more than one dealer, the CP issuer is generally expected to provide each one with a customised version of the PPM with only that dealer's name on the cover.

This is in contrast to other types of securities offerings, where the names of all the dealers or investment banks appear together on the cover of the offering document.

Dealer agreement

The dealer agreement (also sometimes called the placement agreement) governs the relationship between the CP issuer and the dealers for the duration of the CP programme and sets the terms for any sales of CP to or through the dealers. The dealers' role is to advise the CP issuer regarding potential investors and offering procedures. The dealers also coordinate with the ratings agencies as most CP is rated investment grade.

Sifma publishes model dealer agreements for 3(a)(3) programmes and 4(a)(2) programmes. These model agreements include forms of legal opinion letters and include explanatory notes. Each dealer though usually has its own standard form of dealer agreement in the same way that each underwriter has a standard form of underwriting agreement. A typical dealer agreement provides for the purchase of CP as principal or as agent, includes CP issuer representations, warranties and covenants, requires certain deliverables to be provided at closing, includes undertakings by the CP issuer to inform the dealers of material developments and provides for the CP issuer's indemnification of the dealers for certain losses. If a CP programme has more than one dealer, the CP issuer typically enters into a separate dealer agreement with each dealer.

The dealer agreement typically allows the parties to agree, on an issuance-by-issuance basis, either for the dealers to purchase CP notes from the issuer as principal (which is similar to a firm commitment underwriting) or for the dealers to simply arrange for sales from the issuer to purchasers. However, most dealers act as principal in purchasing CP from the issuer and reselling the CP to investors that the dealers have identified in advance. Investors usually hold CP to maturity, but dealers may provide liquidity to their clients by repurchasing the CP prior to maturity. The issuer compensates the dealers by paying them a fee based on the amount of CP outstanding. Alternatively, dealers may be compensated through a reselling commission.

The dealer agreement also contains representations, warranties and covenants by the CP issuer that are deemed to be made on the date the CP programme commences and again each time CP is issued or the PPM is amended. The representations, warranties and covenants, among other things, establish the factual basis for the relevant registration exemption, confirm the accuracy of the PPM and confirm the due corporate existence of the CP issuer and guarantor and the due authorisation, execution and enforceability of the CP programme documents.

The dealer agreement also requires the CP issuer to deliver closing certificates and legal opinion letters, as

well as executed versions of the other CP programme documents. The CP issuer also agrees to indemnify the dealers for losses arising from material misstatements or omissions in the PPM (which may include the CP issuer's public filings and other public information included or incorporated by reference in the PPM) and from the issuer's breach of a representation, warranty or covenant in the dealer agreement, including any CP issuer action that may invalidate the relevant registration exemption.

Issuing and paying agent agreement (IPAA)

The IPAA governs the relationship between the CP issuer and the IPA. For instance, the IPAA specifies how the CP issuer and the IPA will communicate about CP issuances and the timing of those communications, specifies the amount of the IPA's fees and contains representations and warranties and indemnification provisions designed to protect the IPA from liability to the CP purchasers. Each IPA has a preferred form of IPAA which contains standard terms that are usually market and non-controversial.

Master note

The CP issued under a particular CP programme is typically represented by a single master note, registered in the name of Cede & Co., as nominee for DTC, and held by the IPA as custodian for DTC. DTC makes available a standard form of master note for corporate CP. Most CP transactions are settled by book-entry through DTC's Money Market Instrument (MMI) programme and most CP is identified by a CUSIP number. DTC provides the dealers with a record of the transactions and the dealers provide investors with trade confirmations. Secondary market trades also are recorded with computer entries.

Unlike a global note, which represents just one issue of securities (or a portion of one issuance that exceeds \$500 million), a master note can represent all issuances under a CP programme. The terms of each particular CP issuance are recorded in the IPA's book-entry system. Those records are continuously updated by the IPA as CP matures and new CP is issued. DTC's master note form allows the attachment of riders, and typical riders include legends required for the relevant registration exemptions (in the case of a 4(a)(2) programme or a Rule 144A programme) and where a programme contemplates interest bearing CP notes, details regarding interest calculations and procedures for interest payments.

Guaranty

When an investment grade issuer establishes a CP programme through a subsidiary (as is typically the case for foreign issuers wishing to access the US market), the CP issued by the subsidiary is guaranteed by the parent. The parent executes a stand-alone guaranty. The Sifma form dealer agreements for guaranteed CP include guaranty forms, which dealers are typically reluctant to negotiate.

Legal opinions

Pursuant to the dealer agreement, before CP can be issued, counsel to the issuer and, if applicable, the guarantor must deliver legal opinions to the dealers. The Sifma dealer agreement forms include forms of these opinions. The opinion paragraphs are often given by a combination of New York outside counsel, in-house counsel and outside counsel qualified in the jurisdiction of the CP issuer and/or guarantor. The opinions typically include opinion paragraphs on: (1) the corporate existence of the CP issuer and/or the guarantor; (2) the due authorisation, execution and enforceability of the CP programme documents; (3) no requirement for the registration of the CP notes under the Securities Act; (4) the CP issuer not being an investment company under the Investment Company Act; (5) the absence of foreign withholding tax; and (6) the *pari passu* ranking of the CP.

Other considerations

Exemptions under the Investment Company Act

When foreign issuers enter the US CP market, they often do so by forming a US corporate subsidiary to act as the CP issuer under the CP programme. In such cases, it is likely that the CP issuer will fall within the definition of “investment company” under the Investment Company Act. Therefore, the CP issuer will need to find an applicable exemption from registration under the Investment Company Act. Some common exemptions used in these circumstances include Rule 3a-5 (an exemption for certain finance subsidiaries) and Rule 3a-3 (available only if the CP issuer has solely short-term CP, in other words, CP notes with maturities of 270 days or less, outstanding). However, in order to establish these exemptions, both the subsidiary and the foreign parent must meet certain requirements. In order to deliver an opinion on investment company status, counsel for the CP issuer often must analyse the parent’s unconsolidated financial statements and obtain back-up certificates confirming certain facts. Because these considerations can require structural changes to the CP programme and involve significant administrative efforts for the CP issuer, they should be discussed as early as possible in the process for establishing the CP programme.

Foreign withholding tax

Depending on the home jurisdiction of the CP issuer and/or guarantor, foreign withholding tax requirements may apply to CP payments. Foreign and US tax counsel should be involved in the planning stages of the CP programme establishment when a foreign issuer or guarantor is involved. This is particularly true when dealing with jurisdictions where at-source withholding tax relief is available only through investor certifications.

Proposed amendments to Rule 2a-7

On March 3, 2011, the SEC released a proposed rule that

would remove references to credit ratings in certain rules and forms under the Investment Company Act, including Rule 2a-7. The proposed rule implements Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 939A requires federal agencies to review how existing regulations rely on credit ratings and remove those references when appropriate. Under the proposed rule, a security having a rating in one of the two highest ratings categories would no longer be a required element in determining whether a security is a permitted investment for a money market fund. This requirement would be replaced by a new requirement that the money market fund’s board or its delegate determine that the security presents minimal credit risks.

ENDNOTE

1. For more information regarding Rule 144A, *see* Chapter 5 (Mechanics of a Rule 144A/Regulation S offering).

CHAPTER 9

Exchange Act registration

Foreign companies realise a number of benefits by being a public company in the United States. These benefits include increased visibility and prestige, ready access to the US capital markets, which are still the largest and most liquid in the world, and an enhanced ability to attract and retain key employees by offering them a share in the company's growth and success through equity based compensation structures. Foreign private issuers contemplating accessing the US markets must determine whether they are willing to subject themselves to the ongoing securities reporting and disclosure requirements, as well as the corporate governance requirements, which are part and parcel of registering securities publicly in the United States. Becoming and remaining a US public company is an expensive, time-consuming project that may force foreign companies to reorganise their operations and corporate governance in ways that such companies would not necessarily choose absent US requirements.

What is a FPI?

The US federal securities laws define a "foreign issuer" as any issuer that is a foreign government, a foreign national of any foreign country, or a corporation or other organisation incorporated or organised under the laws of any foreign country.¹ A FPI is any issuer (other than a foreign government) incorporated or organised under the laws of a jurisdiction outside of the United States, unless more than 50% of the issuer's outstanding voting securities are held directly or indirectly by residents of the United States, and any of the following applies: (1) the majority of the issuer's executive offices or directors are US citizens or residents; (2) the majority of the issuer's assets are located in the United States; or (3) the issuer's business is principally administered in the United States.² A foreign company that obtains FPI status can avail itself of the benefits of FPI status immediately.

A FPI is only required to determine its status on the last business day of the most recently completed second fiscal quarter. A FPI that obtains its issuer status is not immediately obligated to comply with US reporting obligations. Reporting obligations begin the first day of the FPI's next fiscal year, when it is required to file an annual report on Form 20-F for the fiscal year its issuer status was determined (within four months of the end of that fiscal year). However, a foreign company that obtains FPI status following an annual qualification test can avail

itself of the benefits of FPI status immediately.

How does a FPI become subject to US reporting requirements?

The term public company is most frequently used to refer to a company that has completed an initial public offering (IPO) of its equity securities in the United States and registered those securities with the SEC under the Securities Act and the Exchange Act. However, a FPI may become subject to the periodic reporting requirement of the Exchange Act in three ways:

- A FPI may voluntarily choose to list a class of equity or debt securities on a US national securities exchange (for example, NYSE, Nasdaq and the like), either in conjunction with a securities offering, or without a capital raise. In order to list a class of securities on a US national securities exchange, the FPI must register that class of securities under Section 12(b) of the Exchange Act. The FPI also must meet the specified quantitative and qualitative standards of the relevant US national securities exchange. Each US national securities exchange establishes minimum quantitative requirements regarding the number of stockholders (not solely record holders), number of shares held by non-insiders (the public float), aggregate market value of the company's public float, minimum stock price and certain financial standards. The FPI also must satisfy certain corporate governance requirements.
- A FPI also may become subject to SEC reporting requirements within 120 days after the last day of its first fiscal year ended on which it has: (1) total assets greater than \$10 million; (2) 2,000 or more holders of its equity securities worldwide or 500 holders of its equity securities worldwide who are not accredited investors; and (3) 300 or more holders of its equity securities resident in the United States. If the FPI is subject to SEC reporting requirements, it must register those securities with the SEC under Section 12(g) of the Exchange Act, unless it qualifies for the exemption from registration available under Exchange Act Rule 12g3-2(b).
- A FPI also may choose to register an offering of its securities under the Securities Act in order to execute a public offering of its securities. Immediately upon consummation of the public offering, the FPI becomes subject to periodic and current reporting requirements

under Section 15(d) of the Exchange Act for at least the fiscal year in which the Securities Act registration became effective, whether or not the FPI contemporaneously lists a class of securities on an exchange.

By registering securities under Section 12(b) or Section 12(g) of the Exchange Act, a FPI becomes subject to the reporting requirements of Section 13(a) of the Exchange Act. In addition, FPIs subject to Section 15(d) of the Exchange Act must file periodic reports and other information required by Section 13 of the Exchange Act as if they had registered securities under Section 12.

Reporting obligations of a FPI once it becomes public

Once a FPI becomes a public company, it must comply with the reporting and disclosure requirements under the SEC's rules and regulations, including an ongoing requirement to file periodic reports with the SEC. In some cases these rules and regulations include special accommodations designed to encourage foreign companies to enter the US capital markets by reducing the reporting burdens on FPIs that become public companies. FPIs are obligated to file the following Exchange Act reports with the SEC:

1. Annual Report on Form 20-F.

Form 20-F is unique to a FPI and can be used for an Annual Report similar to a Form 10-K, filed by US domestic issuers. The information required to be disclosed in a Form 20-F includes, but is not limited to, the following:

- Operating results;
- Liquidity and capital resources;
- Trend information;
- Off-balance sheet arrangements;
- Consolidated statements and other financial information;
- Significant business changes;
- Selected financial data;
- Risk factors;
- History and development of the registrant;
- Business overview; and
- Organisational structure.

Form 20-F also requires a description of the FPI's corporate governance and a statement regarding those corporate governance practices that conform to its home-country requirements and not those of the US national securities exchanges on which its securities are listed. A recent addition to the required disclosure is information relating to changes in, and disagreements with, the FPI's certifying accountant, including a letter, which must be filed as an exhibit, from the former accountant stating whether it agrees with the statements furnished by the FPI and, if not, stating the respects in which it does not agree. A FPI may also be required to disclose specialised

information. For example, a FPI must provide specified information if it, or any of its subsidiaries, are engaged in oil and gas operations that are material to its business operations or financial position.

A FPI has four months after the end of its fiscal year to file an Annual Report on Form 20-F. However, if the Form 20-F is incorporated by reference to a FPI's Securities Act registration statement, the Form 20-F should be filed no later than three months after the end of the FPI's fiscal year.³ Form 20-F may also be used for registration statements (similar to Form 10 for US domestic issuers) when a FPI is not engaged in a public offering of its securities, but is still required to be registered under the Exchange Act (for example, when it has equity securities held by 2,000 or more holders of its equity securities worldwide or 500 holders of its equity securities worldwide who are not accredited investors, and there is no other exemption available).

2. Reports on Form 6-K.

In addition to an Annual Report on Form 20-F, a FPI must furnish Reports on Form 6-K to the SEC from time to time. Generally, Reports on Form 6-K contain information that is material to an investment decision in the securities of a FPI, and may include press releases, security holder reports and other materials that a FPI publishes in its home country in accordance with home-country law or custom, as well as any other information that the FPI may want to make publicly available.

Reports on Form 6-K generally take the place of Quarterly Reports on Form 10-Q (which include financial reports) and Current Reports on Form 8-K (which include disclosure on material events) that US domestic issuers are required to file. Unlike Form 10-Q or Form 8-K, there are no specific disclosures required by Form 6-K. Instead, a FPI must furnish under cover of Form 6-K information that it:

- Makes or is required to make public pursuant to the laws of the jurisdiction of its domicile or the laws in the jurisdiction in which it is incorporated or organised;
- Files or is required to file with a stock exchange on which its securities are traded and which was made public by that exchange; or
- Distributes or is required to distribute to its security holders.

Reports on Form 6-K must be furnished to the SEC promptly after the information is made public by a FPI, as required by the country of its domicile or under the laws of which it was incorporated or organised, or by a foreign securities exchange with which the FPI has filed the information. For many of the larger FPIs, the Form 6-Ks that are filed with the SEC generally include similar types of information and are filed with the same frequency as the Form 10-Qs and 8-Ks that are filed by US domestic issuers.

FPI accommodations under US securities laws

A FPI receives certain regulatory concessions compared to those received by US domestic issuers, including:

- *Annual report filings:* Currently, a FPI must file an Annual Report on Form 20-F within four months after the fiscal year covered by the report. By contrast, a domestic issuer must file an Annual Report on Form 10-K between 60 and 90 days following the end of its fiscal year, depending on its capitalisation and other factors.
- *Quarterly financial reports:* A FPI is not required under US federal securities laws or the rules of the US national securities exchanges to file or make publicly available quarterly financial information, subject to certain exceptions. By contrast, US domestic issuers are required to file unaudited financial information on Quarterly Reports on Form 10-Q.
- *Proxy solicitations:* A FPI is not required under US federal securities laws or the rules of the US national securities exchanges to file proxy solicitation materials on Schedule 14A or 14C in connection with annual or special meetings of its security holders.
- *Audit committee:* There are numerous accommodations with respect to the nature and composition of a FPI's audit committee or permitted alternative.
- *Internal control reporting:* Both a FPI and a US domestic issuer must annually assess their internal control over financial reporting and in most instances provide an independent auditor's audit of such internal control. US domestic issuers are also obligated on a quarterly basis to, among other matters, assess changes in their internal control over financial reporting. However, if a FPI qualifies as an EGC (as defined below) and elects to be treated as such, it would be exempt from the requirement to obtain an attestation report on internal control over financial reporting from its registered public accounting firm.
- *Executive compensation:* A FPI is exempt from the detailed disclosure requirements regarding individual executive compensation and compensation plan analysis now required by the SEC. A FPI is required to make certain disclosures regarding executive compensation on an individual basis unless it is not required to do so under home-country laws and the information is not otherwise publicly disclosed by the FPI. In addition, a FPI must file as exhibits to its public filings individual management contracts and compensatory plans if required by its home-country regulations or if it previously disclosed such documents.
- *Directors/officers equity holdings:* Directors and officers of a FPI do not have to report their equity holdings and transactions under Section 16 of the Exchange Act, subject to certain exceptions. However, shareholders, including directors and officers, may have filing obligations under Section 13(d) of the Exchange Act.
- *IFRS-No US Gaap reconciliation:* A FPI may prepare its

financial statements in accordance with IFRS as issued by the International Accounting Standards Board (Iasb) without reconciliation to US Gaap.

- *Confidential submissions:* A FPI that is registering for the first time with the SEC may submit its registration statement on a confidential basis to the SEC staff (if the FPI is listed or is concurrently listing its securities on a non-US exchange, is being privatised by a foreign government, can demonstrate that the public filing of an initial registration statement would conflict with its home-country law or is a foreign government registering debt securities), until the FPI begins to market the offering using the prospectus in the registration statement. US domestic issuers must file all registration statements publicly on the Electronic Data Gathering and Retrieval system, or Edgar. If a FPI cannot submit its registration statement confidentially, it may still qualify as an "emerging growth company" (EGC) under Title I of the JOBS Act, in which case it could still submit registration statements confidentially, provided that the FPI elects to be treated as an EGC and the initial confidential submissions and all amendments are filed with the SEC no later than 21 days prior to the FPI's commencement of the road show.⁴
- *Exemption from Exchange Act reporting:* A FPI may be automatically exempt from Exchange Act reporting obligations if the FPI satisfies certain conditions.
- *Easy termination of registration/de-registration:* A FPI, regardless of the number of its US security holders, may terminate its registration of equity securities under the Exchange Act and cease filing reports with the SEC, subject to certain conditions. This rule allows a US listed FPI to exit the US capital markets with relative ease and terminate its reporting duties under Section 15(d) of the Exchange Act.

Financial disclosure

A FPI is required to make significant disclosures regarding its financial condition under Items 8 and 18 of its Annual Reports on Form 20-F. Item 8 of Form 20-F sets forth the financial information that must be included, as well as the periods covered (generally, three years of audited financial statements) and the age of the financial statements.⁵ In addition, Item 8 obligates a FPI to disclose any legal or arbitration proceedings involving a third party that may have, or have recently had, a significant impact on the FPI's financial position or profitability, as well as any significant changes since the date of the annual financial statements (or since the date of the most recent interim financial statements).

Item 18 of Form 20-F addresses the requirements for a FPI's financial statements and accountants' certificates that must be furnished with the Form 20-F. FPIs are not required to prepare their financial statements in accordance with US Gaap. A FPI may prepare its financial

statements in accordance with the English language version of IFRS as issued by Iasb in their filings with the SEC. However, in those instances where the financial statements are prepared using a basis of accounting other than IFRS as issued by the Iasb, the FPI must provide all other information required by US Gaap and Regulation S-X, unless such requirements specifically do not apply to the registrant as a FPI.⁶

Item 18(b) of Form 20-F grants a limited exemption to the above mentioned requirement for: (1) any period in which net income has not been presented on a basis as reconciled to US Gaap; (2) the financial statements provided pursuant to Rule 3-05 of Regulation S-X in connection with a business acquired or to be acquired; or (3) the financial statements of a less-than-majority owned investee.

US Gaap reconciliations may not be necessary where the financial statement information is for either a business a FPI has acquired or plans to acquire, a less-than-majority-owned investee, or a joint venture. If the target's or less-than-majority-owned investee's financial information is not prepared in accordance with US Gaap, then such target or investee must account for less than 30% of a FPI's assets or income in order to avoid US Gaap reconciliation. If, however, the target's or less-than-majority-owned investee's financial information is prepared in accordance with IFRS as issued by Iasb (even if the FPI's financial statements are not prepared in accordance with US Gaap or IFRS as issued by Iasb), the FPI is not obligated to reconcile such financial statements with US Gaap, regardless of the significance of the entity to the FPI's operations.

In the case of a joint venture, if a FPI prepares financial statements on a basis of accounting, other than US Gaap, that allows proportionate consolidation for investments in joint ventures that would be accounted for under the equity method pursuant to US Gaap, it may omit differences in classification or display that result from using proportionate consolidation in the reconciliation to US Gaap. In order to avail itself of such omissions, the joint venture must be an operating entity, the significant financial operating policies of which are, by contractual arrangement, jointly controlled by all parties having an equity interest in the entity. Financial statements that are presented using proportionate consolidation must provide summarised balance sheet and income statement information and summarised cash flow information resulting from operating, financing and investing activities relating to its pro rata interest in the joint venture.

Notwithstanding the above, compliance with Item 17 of Form 20-F is permitted for non-issuer financial statements such as those pursuant to Rules 3-05, 3-09, 3-10(i) and 3-14 of Regulation S-X, as well as non-issuer target company financial statements included in Forms F-4 and proxy statements. Item 17 compliance also is permitted for pro forma information pursuant to Article 11 of Regulation S-

X. This is significant because Item 17 requires a FPI to furnish the financial statements and accountant's certificates that are customarily furnished by US domestic issuers and requires more onerous US Gaap reconciliation.

Rule 12g3-2(b) exemption

Rule 12g3-2(b) under the Exchange Act exempts certain FPIs that have sold securities in the United States from the reporting obligations of the Exchange Act even if the FPI's equity securities are traded on a limited basis in the over-the-counter market in the United States. A FPI can claim an exemption under Rule 12g3-2(b) if:

- it is not required to file or furnish reports under Section 13(a) or Section 15(d) of the Exchange Act, which means that the FPI has neither registered securities under Section 12(b) (for exchange-listed securities) or Section 12(g) (for other trading systems) of the Exchange Act or completed a registered public offering in the United States in the prior 12 months;
- it currently maintains a listing of the relevant securities on at least one non-US securities exchange that, on its own or combined with the trading of the same securities in another foreign jurisdiction, constitutes the primary trading market for those securities, as defined in the rule; and
- it has published specified non-US disclosure documents in English on its website or through an electronic information delivery system generally available to the public in its primary trading market, since the first day of its most recently completed fiscal year.

A FPI that satisfies the Rule 12g3-2(b) exemption will also be permitted to have established an unlisted, sponsored, or unsponsored depository facility for its American Depositary Receipts (which we discuss in greater detail below).

Officer certification

The principal executive officer(s) and the principal financial officer(s) (or persons performing similar functions) of a FPI are obligated to make certain certifications in a company's periodic reports. These certifications must be included in a FPI's Form 20-F. Other reports filed or furnished by a FPI, such as Reports on Form 6-K, are not subject to the certification requirements because they are not considered periodic (unlike, for example a Form 10-Q), and not made in connection with any securities offerings. Form 20-F requires the following certifications (although certain of the certifications with respect to internal control over financial reporting are not made until the FPI has been a reporting company for at least a year):

- The signing officer has reviewed the report of the FPI;
- Based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such

statements were made, not misleading with respect to the period covered by the report;

- Based on the officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the FPI as of, and for, the periods presented in the report;
- The FPI's other certifying officer(s) and the signing officer are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the FPI and have:
- Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under their supervision, to ensure that material information relating to the FPI, including its consolidated subsidiaries, is made known to such officers by others within those entities, particularly during the period in which the report is being prepared;
- Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
- Evaluated the effectiveness of the FPI's disclosure controls and procedures and presented in the report their conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by the report based on such evaluation; and
- Disclosed in the report any change in the FPI's internal control over financial reporting that occurred during the FPI's most recent fiscal quarter (the FPI's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the FPI's internal control over financial reporting; and
- The FPI's certifying officer(s) and the signing officer have disclosed, based on their most recent evaluation of internal control over financial reporting, to the FPI's auditors and the audit committee of the FPI's board of directors (or persons performing the equivalent functions):
- All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting that are reasonably likely to adversely affect the FPI's ability to record, process, summarise and report financial information; and
- Any fraud, whether or not material, that involves management or other employees who have a significant role in the FPI's internal control over financial reporting.

Internal control certification

A FPI's obligation to comply with the internal control certification requirements does not begin until it is either required to file an annual report pursuant to Section 13(a) or 15(d) of the Exchange Act for the prior fiscal year or had filed an annual report with the SEC for the prior fiscal year. A FPI that is not required to comply with Items 15(b) and (c) of Form 20-F must include a statement in the first annual report that it files in substantially the following form:

“This annual report does not include a report of management's assessment regarding internal control over financial reporting or an attestation report of the company's registered public accounting firm due to a transition period established by rules of the Securities and Exchange Commission for newly public companies.”

The Exchange Act requires that each periodic report filed under the Exchange Act, including Form 20-F, must include the internal control certifications and must be signed by the registrant's chief executive officer and chief financial officer. Item 15 of Form 20-F contains the internal control certification requirements applicable to a FPI. Under Item 15(b), a FPI must disclose:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the FPI;
- A statement identifying the framework used by management to evaluate the effectiveness of the FPI's internal control over financial reporting;
- Management's assessment of the effectiveness of the FPI's internal control over financial reporting as of the end of its most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective; and
- A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the FPI's internal control over financial reporting.

Further, under Item 15(c), every registered public accounting firm that prepares or issues an audit report on a FPI's annual financial statements must attest to, and report on, the assessment made by management. Such attestation must be made in accordance with standards for attestation engagements issued or adopted by the Public Company Accounting Oversight Board, and cannot be the subject of a separate engagement of the registered public accounting firm. However, the universal practice is for the auditors to audit management's internal controls over financial reporting, and not actually attest to management's assessment. Furthermore, if a FPI qualifies as an EGC and elects to be treated as such, it would be exempt from the requirement to obtain an attestation report on internal control over financial reporting from its registered public accounting firm.

Corporate governance practices

The SEC and the United States national securities exchanges, separately, through statutes, rules and regulations, govern corporate governance practices in the United States. However, a FPI registered in the United States may continue to follow certain corporate governance practices in accordance with its home-country rules and regulations. The SEC and the US national securities exchanges acknowledge the disparities between domestic and foreign governance practices and the potential cost of conforming to US standards. Accordingly, a FPI is granted exemptions from certain corporate governance requirements in the event that it chooses to follow its home-country corporate governance practices (particularly with regard to audit committee and compensation committee requirements).

Audit committees.

The SEC provides exemptions to its independence requirement for audit committee members in order to accommodate the following global practices:

- *Employee representation:* If a non-management employee is elected or named to the board of directors or audit committee of a FPI pursuant to the FPI's governing law or documents, an employee collective bargaining or similar agreement, or other home-country legal or listing requirement, he or she may serve as a committee member.
- *Two-tiered board systems:* A two-tiered system consists of a management board and a supervisory/non-management board. The SEC treats the supervisory/non-management board as a "board of directors" for purposes of Rule 10A-3(b)(1) of the Exchange Act. As a result, a FPI's supervisory/non-management board can either form a separate audit committee or, if the supervisory/non-management board is independent, the entire supervisory/non-management board can be designated as the audit committee.
- *Controlling security holder representation:* The SEC permits one member of a FPI's audit committee to be a shareholder, or representative of a shareholder or shareholder group owning more than 50% of the FPI's voting securities, subject to certain conditions.
- *Foreign government representation:* In some instances, a foreign government may be a significant security holder or own special shares that entitle the government to exercise certain rights related to a FPI. The SEC permits a representative of a foreign government or foreign governmental entity to be an audit committee member, subject to certain conditions.
- *Listed issuers that are foreign governments:* The SEC grants an exemption to the audit committee independence requirements to listed issuers that are foreign governments.
- *Board of auditors:* The SEC permits auditor oversight

through a board of auditors, subject to certain conditions.

The US national securities exchanges, including the NYSE and Nasdaq, also impose rules and regulations governing audit committee composition and disclosures for companies that list on their exchanges. Like the SEC, each US national securities exchange provides exemptions for a FPI that prefers following its home-country practices in lieu of the exchange's rules. For example, under Nasdaq rules, a FPI opting to follow its home-country audit committee practices is required to submit a letter from home-country counsel certifying its practice is not prohibited by home-country law. A FPI is required to submit such a letter only once, either at the time of initial listing or prior to the time the FPI initiates a non-conforming audit committee practice. Similarly, under the NYSE Listed Companies Manual, a FPI may follow its home-country audit committee practice, provided it:

- Discloses how its corporate governance practices differ from those of domestically listed companies;
- Satisfies the independence requirements imposed by Section 10A-3 of the Exchange Act;
- Certifies to the NYSE that the FPI is not aware of any violation of the NYSE corporate governance listing standards; and
- Submits an executed written affirmation annually or an interim written affirmation each time a change occurs to the FPI's board or any of the committees of the board, and includes information, if applicable, indicating that a previously independent audit committee member is no longer independent, that a member has been added to the audit committee, or the FPI is no longer eligible to rely on, or has chosen not to continue to rely on, a previously applicable exemption to the audit committee independence rules.

The SEC, the NYSE and Nasdaq each require that a FPI disclose in its Annual Report on Form 20-F each US national securities exchange requirement that it does not follow and describe its alternative home-country practice.

Compensation committees.

Form 20-F requires a FPI to disclose information regarding its compensation committee, including the names of the committee members and a summary of the terms under which the committee operates. Similar to the audit committee requirements, both the NYSE and Nasdaq permit a FPI to follow home-country practices with regard to its compensation committee.

Beneficial ownership reporting obligations

Once a company becomes a public company under Section 12 of the Exchange Act, its shareholders become subject to the reporting obligations under Section 13(d) and 13(g) of the Exchange Act, relating to their ownership of the company's shares. These requirements apply to shareholders of all public companies with securities

registered under Section 12, including US and non-US shareholders of FPIs. The underlying premise of the reporting requirements is to give other shareholders and the securities markets notice of significant acquisitions or potential changes in control of public companies.

Section 13(d) and Section 13(g) of the Exchange Act require the reporting of beneficial ownership of a public company's equity securities by any shareholder (or group of shareholders acting together) owning more than 5% of the FPI's equity securities (whether held directly or indirectly). Each 5% or more shareholder (or group) must report its ownership, and any changes in its ownership, of the FPI's equity securities. This information is reported on either Schedule 13D or Schedule 13G, as applicable. These filings are the responsibility of each shareholder and are generally prepared and filed by the shareholder's counsel (or with FPI's counsel's assistance). These reports must be filed with the SEC through Edgar.

Initial reporting on Schedule 13G by exempt shareholders.

Each shareholder (including any director or officer) that beneficially owned 5% or more of a public FPI's equity securities before such securities were registered under the Exchange Act must file a Schedule 13G after the end of the calendar year in which the equity securities were first registered. These shareholders are called exempt shareholders because they were 5% shareholders before the equity securities were registered.

Reporting on Schedule 13D.

Once a FPI becomes public in the United States, any person that acquires 5% or more of its equity securities or any exempt shareholder that acquires more than 2% of its equity securities within a 12-month period is required to file a Schedule 13D if he or she is not a "passive investor." Schedule 13Ds are filed by those investors whose purpose is not passive, but rather are interested in influencing, or even changing, how the FPI is run. Directors and officers who are 5% shareholders cannot be considered passive investors because of their influence over the FPI, so they must file a Schedule 13D.

Schedule 13D is a longer, more extensive form than Schedule 13G. It requires the shareholder to disclose information including:

- The identity of the shareholder.
- How many shares of the company the shareholder owns and how the shares are owned.
- The source of the funds used to buy the shares.
- The shareholder's purpose for owning the shares.

A shareholder must amend its Schedule 13D promptly to report any material change to the information in the schedule and any increase or decrease of 1% or more in its beneficial ownership of the FPI's shares.

Reporting on Schedule 13G.

A Schedule 13G must be filed by a passive investor that owns less than 20% of the equity securities of a FPI (but more than 5%) and who did not acquire its shares for the purpose, or with the effect, of changing or influencing control of the FPI. Schedule 13G requires less disclosure about the shareholder than Schedule 13D. The primary information disclosed in a Schedule 13G consists of:

- The identity of the shareholder.
- How many shares of the FPI the shareholder owns and how the shares are owned.
- A certification that the shareholder is a passive investor.

Generally a shareholder must amend its Schedule 13G annually, after the end of each calendar year, to report any changes in its beneficial ownership of the FPI's equity securities. However, if a shareholder's ownership exceeds 10%, it must amend its Schedule 13G promptly after the date it exceeds 10% ownership. After exceeding 10% ownership, a shareholder must also promptly amend its Schedule 13G to report any increase or decrease of more than 5% in its beneficial ownership of the FPI's equity securities.

American Depositary Receipts

An American Depositary Receipt (ADR) is a negotiable instrument issued by a US depository bank that represents an ownership interest in a specified number of securities that have been deposited with a custodian, typically in the FPI's country of origin. ADRs can represent one or more shares, or a fraction of a share, of a FPI, and are offered as either unsponsored or sponsored programmes. Unsponsored ADR programmes are issued by a depository bank without a formal agreement with the FPI whose shares underlie the ADR. Consequently, an unsponsored ADR programme affords the FPI little to no control over the marketing or other terms of the offering. Unsponsored ADRs are only permitted to trade in over-the-counter markets.

In contrast, sponsored ADRs are depository receipts that are issued pursuant to a formal agreement, known as a depository agreement, between the depository bank and a FPI. The depository agreement between the FPI and the depository bank will, among other matters, cover fees (including fees paid by investors), communications with investors and monitoring the

The level of US trading activity will determine whether US registration will be required. There are three levels of sponsored ADR programmes:

- *Level I ADRs:* A sponsored Level I ADR programme is the simplest method for FPIs to access the US capital markets, and is similar to an unsponsored ADR programme. Unlike the other two levels of ADRs, Level I ADRs are traded in the US over-the-counter market with prices published in the Pink Sheets.⁷ In order to establish a Level I ADR, a FPI must: (1) qualify for an exemption under Rule 12g3-2(b) of the Exchange Act;

(2) execute a deposit agreement with the depository bank and the ADR holders, which details the rights and responsibilities of each party; and (3) furnish a Form F-6 with the SEC to register the ADRs under the Securities Act. Note that financial statements and a description of the FPI's business are not required to be included in a Form F-6 registration statement.

- *Level II ADRs*: Level II ADR programmes enable a FPI to list its depository receipts on a US national securities exchange, such as the NYSE or Nasdaq, but do not involve raising new capital. The requirements of a Level II ADR programme are significantly more burdensome than a Level I ADR. Under a Level II ADR, a FPI is obligated to file a registration statement on Form 20-F and comply with ongoing SEC reporting requirements, including filing Annual Reports on Form 20-F and Reports on Form 6-K, as needed. In addition, a FPI must also satisfy any listing requirements of the relevant US national securities exchange.
- *Level III ADRs*: A Level III ADR programme is used for capital raising by a FPI. Under a Level III ADR programme, the depository bank and the FPI must meet all of the Level II ADR programme requirements. In addition, the FPI must file a registration statement on Form F-1 under the Securities Act in order to register the securities underlying the ADRs. After the offering, the FPI will be subject to disclosure obligations under Section 15(d) of the Exchange Act and may have additional disclosure obligations under Section 13(a) of the Exchange Act if the ADRs are listed on a US national securities exchange.

For each of the three types of sponsored ADR programmes, the instructions on Form F-6 require that the depository bank, the FPI, its principal executive officer, financial officer, controller or principal accounting officer, at least a majority of the board of directors or persons performing similar functions and its authorised representative in the United States sign the registration statement on Form F-6.

ENDNOTES

1. See Rule 405 under the Securities Act and Rule 3b-4(b) under the Exchange Act.

2. See Rule 405 under the Securities Act and Rule 3b-4(c) under the Exchange Act.

3. Item 8.A.4 of Form 20-F.

4. An EGC is defined as an issuer with total gross revenues of under \$1 billion (subject to inflationary adjustment by the SEC every five years) during its most recently completed fiscal year. A company remains an EGC until the earlier of five years or:

- The last day of the fiscal year during which the issuer has total annual gross revenues in excess of \$1 billion (subject to inflationary indexing);
- The last day of the issuer's fiscal year following the fifth anniversary of the date of the first sale of common equity securities of the issuer pursuant to an effective registration statement under the Securities Act;
- The date on which such issuer has, during the prior three-year period, issued more than \$1 billion in nonconvertible debt; or
- The date on which the issuer is deemed a "large accelerated filer."

An issuer will not be able to qualify as an EGC if it first sold its common stock in an IPO prior to December 8, 2011.

On July 10, 2013, pursuant to Section 201(a) of the JOBS Act, the SEC issued final rules relaxing the prohibition on general solicitation and general advertising for certain private placements under Rule 506 under Regulation D and Rule 144A offerings. For more information, see Chapter 4 (Mechanics of a Section 4(a)(2) offering) and Chapter 5 (Mechanics of a Rule 144A/Regulation S offering).

5. However, a FPI that qualifies as an EGC may comply with the scaled-down disclosure requirements for EGCs, which include (1) two, rather than three, years of audited financial statements for initial registration statements, (2) for subsequent registration statements (or periodic reports), financial information within the selected financial data or MD&A disclosure for only those periods subsequent to those presented in the initial registration statements, and (3) the executive compensation disclosures for "smaller reporting companies" which are less detailed than for other types of issuers. A "smaller reporting company" is generally defined for the purposes of initial

testing as an issuer that has a public float of less than \$75 million or, in the case of an issuer that has no public float (eg, an IPO registrant), has annual revenues of less than \$50 million.

6. Regulation S-X sets forth the form, content of and requirements for financial statements required to be filed as part of: (a) registration statements under the Securities Act; (b) registration statements under Section 12 of the Exchange Act, annual or other reports under Sections 13 and 15(d) of the Exchange Act and proxy and information statements under Section 14 of the Exchange Act; and (c) registration statements and shareholder reports filed under the Investment Company Act, except as otherwise specifically provided in the forms.

7. The Pink Sheets are a daily publication compiled by the National Quotation Bureau with bid and ask prices of over-the-counter stocks, including the market makers who trade them.

CHAPTER 10

Foreign banks and the Investment Company Act

The Investment Company Act governs the registration and regulation of investment companies, which may be better known to foreign issuers as collective investment vehicles. Under the US regulatory scheme, every investment company is subject to registration and regulation pursuant to the Investment Company Act, unless it is exempt. Section 7(d) of the Investment Company Act generally prohibits any foreign entity that meets the definition of “investment company,” including a foreign bank, from making a public offering of its securities in the United States.

An investment company is defined broadly as an entity that holds itself out as being engaged primarily in “investing, reinvesting or trading in securities” and also includes entities engaged in the business of investing, reinvesting, owning, holding or trading in securities if securities represent 40% or more of the value of its assets.” As a result, foreign issuers that are banks, insurance companies or specialised finance companies may find that they inadvertently fall within the definition of an “investment company.” Similarly, certain operating companies that devote themselves principally to research and development activities and retain offering proceeds in cash, cash equivalents or securities also should take care to avoid being classified as “investment companies” within the meaning of the Investment Company Act.

Foreign banks may be exempt from the Investment Company Act. The most commonly used exemptions are: Rule 3a-6 for foreign banks; Rule 3a-5 for finance subsidiaries of foreign banks; and Rule 3a-1 for foreign bank holding companies. Each rule is discussed below. However, in certain cases, foreign banks may potentially qualify for other Investment Company Act exemptions. Non-bank affiliates of banks also could be “investment companies.” A foreign bank also may choose to limit its offering of securities solely to investors that are “qualified purchasers” and rely on the exemption provided by Section 3(c)(7) of the Investment Company Act. Finally, even if an issuer does not qualify for an Investment Company Act exemption, it may nevertheless seek an exemption under Section 6(c) of the Investment Company Act.

Rule 3a-6 exemption

Rule 3a-6 provides that “a foreign bank ... shall not be considered an investment company for purposes of the

Investment Company Act.” Thus, the exception is broader than merely exempting foreign banks from the registration requirements of the Investment Company Act.

Rule 3a-6(b)(1)(i) defines a “foreign bank” as a banking institution incorporated or organised under the laws of a country other than the United States, or a political subdivision of a country other than the United States, that is: (a) regulated as such by that country’s or subdivision’s government or any agency thereof; (b) engaged substantially in commercial banking activity; and (c) not operated for the purpose of evading the provisions of the Investment Company Act.

Rule 3a-6(b)(1)(ii) includes other entities within the definition of “foreign bank.” Under Rule 3a-6(b)(1)(ii)(A), a “foreign bank” also includes a trust company or loan company that is: (1) organised or incorporated under the laws of Canada or a political subdivision thereof; (2) regulated as a trust company or a loan company by that country’s or subdivision’s government or any agency thereof; and (3) not operated for the purpose of evading the provisions of the Investment Company Act. Under Rule 3a-6(b)(1)(ii)(B), a “foreign bank” includes a building society that is: (1) organised under the laws of the United Kingdom or a political subdivision thereof; (2) regulated as a building society by the country’s or subdivision’s government or any agency thereof; and (3) not operated for the purpose of evading the provisions of the Investment Company Act. Finally, Rule 3a-6(b)(1)(iii) states that “[n]othing in this section shall be construed to include within the definition of foreign bank a common or collective trust or other separate pool of assets organised in the form of a trust or otherwise in which interests are separately offered.” A special purpose vehicle (even if sponsored by a foreign bank) would have to find another exemption from the application of the Investment Company Act.

The term “engaged substantially in commercial banking activity,” used in the foreign bank definition discussed above, means “engaged regularly in, and deriving a substantial portion of its business from, extending commercial and other types of credit, and accepting demand and other types of deposits, that are customary for commercial banks in the country in which the head office of the banking institution is located.” Greater certainty regarding the meaning of the term was provided by a no-action letter, in which the SEC Staff explained:

“[T]he banking activities in which a foreign bank engages clearly must be more than nominal to satisfy the “substantial” standard in the rule. In addition, in order to meet this standard, [we] generally would expect a foreign bank: (1) to be authorised to accept demand and other types of deposits and to extend commercial and other types of credit; (2) to hold itself out as engaging in, and to engage in, each of those activities on a continuous basis, including actively soliciting depositors and borrowers; (3) to engage in both deposit taking and credit extension at a level sufficient to require separate identification of each in publicly disseminated reports and regulatory filings describing the bank’s activities; and (4) to engage in either deposit taking or credit extension as one of the bank’s principal activities.”¹

One commentator notes that Rule 3a-6 has four principal effects, which are as follows:

“First, it enables foreign banks ... to sell their securities in the United States without falling under the definition of an investment company, regardless of whether those securities are debt securities, preferred stock, common stock, or any other types of securities. Second, it allows finance subsidiaries of foreign banks ... to rely upon Rule 3a-5 under the 1940 Act when issuing debt securities or nonvoting preferred stock in the United States. Third, it allows holding companies of foreign banks ... to rely upon Rule 3a-1 under the 1940 Act. Fourth, it enables investment companies to acquire the securities of foreign banks ... without regard to the limitations imposed by Section 12(d)(1) of the 1940 Act upon an investment company’s acquisition of securities of another investment company.”²

US branches and agencies of foreign banks

Neither the exemption for banks in Section 3(c)(3) of the Investment Company Act nor the exemption for foreign banks in Rule 3a-6 expressly applies to US agencies or branches of foreign banks. Nonetheless, the SEC has issued an interpretive release in which it stated that solely:

“[F]or purposes of determining whether the issuance of securities by a United States branch or agency of a foreign bank would require the foreign bank or agency to register under the [1940] Act, the Commission will deem such a branch or agency to be a “bank” within the meaning of Section 2(a)(5)(C) of the [1940] Act, provided that the nature and extent of Federal and/or State regulation and supervision of the particular branch or agency are substantially equivalent to those applicable to banks chartered under Federal or State law in the same jurisdiction.”³

This interpretative position was adopted for the limited purpose of US branches and agencies of foreign banks issuing securities in the United States, and is not intended to address the status of US branches and agencies of foreign banks under the Investment Company Act for any

other purposes, for example, as eligible custodians or trustees under the Investment Company Act. In promulgating the interpretive release, the SEC Staff did not state whether a US agency or branch of a foreign bank falling within the interpretive position would additionally have to satisfy the criteria of Section 3(c)(3).

Rule 3a-5 exemption

Rule 3a-5(a) provides that a “finance subsidiary will not be considered an investment company under Section 3(a) of the Investment Company Act and securities of a finance subsidiary held by the parent company or a company controlled by the parent company will not be considered “investment securities” under Section 3(a)(1)(C) of the Investment Company Act” if certain conditions are met.

The definition of finance subsidiaries. A “finance subsidiary” is “any corporation: (i) all of whose securities other than debt securities or non-voting preferred stock meeting the applicable requirements of paragraphs (a)(1) through (a)(3) or directors’ qualifying shares are owned by its parent company or a company controlled by its parent company; and (ii) the primary purpose of which is to finance the business operations of its parent company or companies controlled by its parent company.” Generally, for purposes of Rule 3a-5, a finance subsidiary’s primary purpose of financing the business operations of its parent company will be evidenced if the finance subsidiary devotes at least 55% of its assets to such financing activities and derives at least 55% of its income from those activities.”

The definition of a parent company. Rule 3a-5(b)(2) defines a “parent company” as “any corporation, partnership or joint venture: (i) that is not considered an investment company under Section 3(a) [of the Investment Company Act] or that is excepted or exempted by order from the definition of investment company by Section 3(b) [of the Investment Company Act] or by the rules or regulations under Section 3(a) [of the Investment Company Act]; (ii) that is organised or formed under the laws of the United States or of a state or that is a [FPI], or that is a foreign bank or foreign insurance company as those terms are used in rule 3a-6; and (iii) in the case of a partnership or joint venture, each partner or participant in the joint venture meets the requirements of paragraphs (b)(2)(i) and (ii).”

The definition of a company controlled by the parent company. Rule 3a-5(b)(3) defines a “company controlled by the parent company” as “any corporation, partnership or joint venture: (i) that is not considered an investment company under Section 3(a) or that is excepted or exempted by order from the definition of investment company by Section 3(b) or by the rules or regulations under Section 3(a) [of the Investment Company Act]; (ii) that is either organised or formed under the laws of the United States or of a state or that is a [FPI], or that is a foreign bank or foreign insurance company as those terms

are used in Rule 3a-6; and (iii) in the case of a corporation, more than 25% of whose outstanding voting securities are beneficially owned directly or indirectly by the parent company; or (iv) in the case of a partnership or joint venture, each partner or participant in the joint venture meets the requirements of paragraphs (b)(3)(i) and (ii), and the parent company has the power to exercise a controlled influence over the management or policies of the partnership or joint venture.”

The conditions for finance subsidiaries. In order to qualify under Rule 3a-5, finance subsidiaries must meet certain conditions, which are as follows:

(1) Any debt securities of the finance subsidiary issued to or held by the public are unconditionally guaranteed by the parent company as to the payment of principal, interest and premium, if any (except that the guarantee may be subordinated in right of payment to other debt of the parent company);

(2) Any non-voting preferred stock of the finance subsidiary issued to or held by the public is unconditionally guaranteed by the parent company as to payment of dividends, payment of the liquidation preference in the event of liquidation, and payments to be made under a sinking fund, if a sinking fund is to be provided (except that the guarantee may be subordinated in right of payment to other debt of the parent company);

(3) The parent company’s guarantee provides that in the event of a default in payment of principal, interest, premium, dividends, liquidation preference or payments made under a sinking fund on any debt securities or non-voting preferred stock issued by the finance subsidiary, the holders of those securities may institute legal proceedings directly against the parent company (or, in the case of a partnership or joint venture, against the partners or participants in the joint venture) to enforce the guarantee without first proceeding against the finance subsidiary;

(4) Any securities issued by the finance subsidiary which are convertible or exchangeable are convertible or exchangeable only for securities issued by the parent company (and, in the case of a partnership or joint venture, for securities issued by the parent company or participants in the joint venture) or for debt securities or non-voting preferred stock issued by the finance subsidiary meeting the applicable requirements of paragraphs (1) through (3) above;

(5) The finance subsidiary invests in or loans to its parent company or a company controlled by its parent company at least 85% of any cash or cash equivalents raised by the finance subsidiary through an offering of its debt securities or non-voting preferred stock or through other borrowings as soon as practicable, but in no event later than six months after the finance subsidiary’s receipt of such cash or cash equivalents;

(6) The finance subsidiary does not invest in, reinvest in, own, hold or trade in securities other than government securities, securities of its parent company or a company

controlled by its parent company (or, in the case of a partnership or joint venture, the securities of the partners or participants in the joint venture) or debt securities (including repurchase agreements) which are exempted from the provisions of the Securities Act by Section 3(a)(3) of the Investment Company Act; and

(7) Where the parent company is a foreign bank as the term is used in Rule 3a-6, the parent company may, in lieu of the guaranty required by paragraphs (1) or (2) above, issue, in favour of the holders of the finance subsidiary’s debt securities or non-voting preferred stock, as the case may be, an irrevocable letter of credit in an amount sufficient to fund all of the amounts required to be guaranteed by paragraphs (1) and (2) above; *provided*, that: (i) payment on such letter of credit shall be conditional only upon the presentation of customary documentation; and (ii) the beneficiary of such letter of credit is not required by either the letter of credit or applicable law to institute proceedings against the finance subsidiary before enforcing its remedies under the letter of credit.

Notwithstanding Rules 3a-5(a)(1) and (2), the SEC Staff has taken the view that a finance subsidiary may issue debt securities and non-voting preferred stock that are not guaranteed by its parent company in a private placement in the United States under Section 4(a)(2) or under Rule 506 under Regulation D or in a public offering outside the United States in reliance upon Regulation S. The SEC Staff also has taken the position that securities issued by a finance subsidiary in a private placement, which are not guaranteed by the parent company, may be resold to qualified institutional buyers pursuant to Rule 144A and to institutional accredited investors. Furthermore, under appropriate circumstances, the SEC has granted exemptive orders when a finance subsidiary’s securities were not unconditionally guaranteed by the parent company.⁴

Rule 3a-1 exemption

Foreign bank holding companies may qualify for an exception under Rule 3a-1. Rule 3a-1 provides that notwithstanding Section 3(a)(1)(C) of the Investment Company Act, an issuer will be deemed not be an investment company under the Investment Company Act if:

(a) No more than 45% of the value (as defined in Section 2(a)(41) of the Investment Company Act) of such issuer’s total assets (exclusive of government securities and cash items) consists of, and no more than 45% of such issuer’s net income after taxes (for the last four fiscal quarters combined) is derived from, securities other than: (1) government securities; (2) securities issued by employees’ securities companies; (3) securities issued by the majority-owned subsidiaries of the issuer (other than subsidiaries relying on the exclusion from the definition of investment company in Sections 3(b)(3) or (c)(1) of the Investment Company Act) which are not investment companies; and (4) securities issued by companies: (i)

which are controlled primarily by such issuer; (ii) through which such issuer engages in a business other than that of investing, reinvesting, owning, holding or trading in securities; and (iii) which are not investment companies;

(b) The issuer is not an investment company as defined in Sections 3(a)(1)(A) or (B) of the Investment Company Act and is not a special situation investment company; and

(c) The percentages described in paragraph (a) are determined on an unconsolidated basis, except that the issuer shall consolidate its financial statements with the financial statements of any wholly-owned subsidiaries.

As discussed above, foreign banks qualifying for an exemption under Rule 3a-6 would not be considered “investment companies,” and, as a result, their holding companies could potentially rely upon Rule 3a-1. The SEC has stated: “With the adoption of Rule 3a-6, foreign banks ... are no longer regarded as “investment companies” under the [Investment Company] Act. Therefore, foreign bank ... holding companies qualify for the exception from the definition of investment company in Section [3(a)(1)(C) under the Investment Company Act] or Rule 3a-1 on the same basis as United States banks... ”⁵

Section 3(c)(7)

A foreign bank, a finance subsidiary, or a special purpose trust or issuance vehicle sponsored by a foreign bank or finance subsidiary also may qualify for an exemption under Section 3(c)(7) of the Investment Company Act. Section 3(c)(7) provides an exemption to “[a]ny issuer, the outstanding securities of which are owned exclusively by purchasers who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities.” Note that these types of entities need to rely on Section 4(a)(2) and Rule 506 promulgated thereunder for a Securities Act exemption, since Section 3(c)(7) requires an actual private placement. The definition of “qualified purchaser” is set forth in Section 2(a)(51)(A) of the Securities Act, and generally includes a natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under Section 3(c)(7) with that person’s qualified purchaser spouse) who owns not less than \$5 million in investments, and an entity acting for its own account or the account of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than \$25 million in investments. Generally, special purpose issuance vehicles will rely on this Section 3(c)(7) exemption and structure their offerings as private placements of Rule 144A eligible securities with the transfer restrictions expressly limiting transfers or resales to QIBs that are also qualified purchasers.

ENDNOTES

1. Seward & Kissel, SEC No-Action Letter, 2005 SEC No-Act. LEXIS 751 (October 12, 2005).
2. Robert H. Rosenblum, Investment Company Determination under the 1940 Act: Exemptions and Exceptions (2003), §29.1.
3. Status under the Investment Company Act of United States Branches or Agencies of Foreign Banks Issuing Securities, 1940 Act Release No. 17681 (August 17, 1990).
4. *See* Robert H. Rosenblum, Investment Company Determination under the 1940 Act: Exemptions and Exceptions (2003), §28.5.
5. Rule 3a-6 Adopting Release, 1940 Act Rel. No. 18381 (October 29, 1991).

CHAPTER 11

Blue sky laws

Every US state has its own blue sky or securities law that is designed to protect investors against fraudulent sales practices and activities, independent of the US federal securities laws. Blue sky laws may require registration of, or at least notice filings with respect to, securities exempt from registration under US federal securities laws. While these laws vary from state to state, most state laws require issuers to register their offerings before the issuers can sell their securities to residents of the particular state, unless the securities offerings are exempt from registration. These laws also address the licensing of brokerage firms, and their brokers and certain investment advisers and their representatives.

Covered securities

In October 1996, Congress enacted the National Securities Markets Improvement Act (NSMIA), which pre-empted the application of blue sky laws regarding a substantial number of securities offerings and/or transactions, and which substantially changed the scope of blue sky regulation. NSMIA amended Section 18 of the Securities Act to exempt “covered securities” from the registration requirements of the blue sky laws. Any offering document with respect to a covered security is similarly exempt from state regulation if the document is prepared by or on behalf of the issuer.

Covered securities include the following:

- Securities listed or authorised for listing on the NYSE or Nasdaq, and securities of the same issuer that are equal or senior in rank to such listed securities (collectively, “listed covered securities”);
- Securities registered under the Investment Company Act;
- Securities offered under to Rule 506 under Regulation D; and
- Securities exempt under Section 3(a) of the Securities Act (with certain exceptions).

No state filings or fees may be required in offerings of listed covered securities, but states still may require certain notice filings to be made and may charge filing fees for offerings of other covered securities.¹ NSMIA also permits states to continue to enforce their own anti-fraud laws.²

Bank notes

As we have discussed, Section 3(a)(2) exempts from registration under such act any security issued or guaranteed by a bank. This exemption is premised on the notion that, whether state or federal, banks are highly and relatively

uniformly regulated, and as a result will provide adequate disclosure to investors about their finances in the absence of federal securities registration requirements. In addition, banks are also subject to various capital requirements that may increase the likelihood that holders of their debt securities will receive timely payments of principal and interest. Bank notes qualify as covered securities because they are exempt from registration under the Securities Act under to Section 3(a)(2). However, bank notes typically are not listed or authorised for listing on the NYSE or Nasdaq, which means that states may still require certain notice filings and charge filing fees for bank note offerings.

Most states provide exemptions from registration for bank notes. For example, the State of Texas provides an exemption from registration for securities issued by domestic banks and certain thrifts:

“The sale by the issuer itself, or by a registered dealer, of any security issued or guaranteed by any bank organised and subject to regulation under the laws of the United States or under the laws of any State or territory of the United States, or any insular possession thereof, or by any savings and loan association organised and subject to regulation under the laws of this State, or the sale by the issuer itself of any security issued by any federal savings and loan association.”³

In addition, most states do not require registration for bank notes offered by a foreign bank through its US branch or agency under the principles of comity, on the theory that the domestic branch or agency is subject to oversight and regulation by US banking authorities. However, it is understood that there are a few states, including Texas, that do not extend the exemption to US branches or agencies.

Nevertheless, in 1998 the Texas State Securities Board (the Board) issued no-action letter relief and did not require registration for bonds issued by the State of Bank of India in minimum denominations of \$1,000 and marketed to US residents of Indian origin (NRIs) through US branches.⁴ The Board emphasised that the bonds would be treated as bank deposits subject to the banking regulations administered by the Reserve Bank of India and the Indian Government, that reserve requirements had been extended to NRI deposits, and that the bonds were subject to the same reserve requirements applicable to similar deposits.

The Board also pointed out that the bonds would be marketed in the United States through the issuer’s New York and Chicago branches, which were regulated by New York

and Illinois, respectively, and by the FDIC, and that the issuer represented that the nature and extent of state and federal regulation of the branches was substantially equivalent to that applicable to Texas state-chartered banks. This would suggest that bank notes offered by US branches or agencies of foreign banks should also be accorded similar relief in Texas, as such branches or agencies would be subject to the same regulation and oversight as US banks.⁵

As a reminder, where certain covered securities, including bank notes, are offered, a state may still reserve the right to require a notice filing and the payment of a filing fee if the security is not otherwise exempt from registration under that state's laws.⁶ In addition, some states may require filing fees for each series of bank notes offered (rather than a single one-time fee) and may not place a cap on aggregate fees paid.

Section 3(a)(3) securities

Short-term securities issued pursuant to Section 3(a)(3) of the Securities Act (such as commercial paper) are covered securities under NSMIA, and therefore exempt from registration under state blue sky laws.

Rule 144A securities

Rule 144A is a safe harbour exemption from the registration requirements of the Securities Act for certain resales of qualifying securities by certain persons other than the issuer of the securities. The exemption applies to resales of securities to QIBs (or purchasers that the sellers and any persons acting on the sellers' behalf reasonably believe to be QIBs). The securities eligible for resale under Rule 144A are securities of US and foreign issuers that are not listed on a US securities exchange or quoted on a US automated inter-dealer quotation system.

The securities laws of each state provide for an exemption from state securities registration for both sales and resales of securities to specified types of institutional investors. The institutional investor exemption in most states is self-executing, which means that no compliance measures, such as filings or fee payments, are needed to qualify for the exemption. Thus, if the investor to which the foreign issuer is making an offer or sale qualifies as an "institutional investor," as defined in that state's blue sky statute, the foreign issuer is not required to pay any fees to, nor make filings with, the state securities regulators except for (where required) the filing of a Form U-2 (the Uniform Consent to Service of Process designating a state's Secretary of State or securities commissioner as the issuer's agent for service of process in that state).

The breadth of the institutional investor exemption, however, varies from state to state. Most states have adopted provisions similar to those in the Uniform Securities Act, which exempts offers and sales to specified types of institutional investors such as banks, savings institutions, trust companies, insurance companies, registered investment companies or to a broker-dealer, whether the

purchaser is acting for itself or in some fiduciary capacity. Despite certain similarities between these institutions and "accredited investors" as defined in Regulation D, it should be noted that individuals, regardless of financial sophistication or assets held, are not covered by the exemption.

Regulation D

Regulation D provides a limited safe harbour from registration for offers and sales by issuers. The safe harbour can be utilised under the provisions of Rules 504, 505 or 506 under Regulation D. The first, Rule 504, provides an exemption pursuant to Section 3(b) of the Securities Act for offerings of up to \$1 million. The second, Rule 505, provides an exemption pursuant to Section 3(b) for offerings of up to \$5 million. The third, Rule 506, which is the most popular, provides an exemption pursuant to Section 4(a)(2) of the Securities Act for limited offerings and sales without regard to dollar amount, but only to 35 purchasers and an unlimited number of "accredited investors," who are typically institutional investors or high net-worth individuals. Under Rule 506, "non-accredited investors" must also have sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the proposed investment; and this "sophistication requirement" is the distinguishing feature of Rule 506. In order to avail itself of any of the safe harbours, the issuer must also take reasonable care to ensure that the purchasers of the securities are not "underwriters" and must file a Form D, including a sales report, with the SEC no later than 15 days after the first sale of securities under the offering.

Until recently, general solicitation was not permitted in private placements in accordance with Rule 506. However, in July 2013, pursuant to Section 201 of the JOBS Act, the SEC revised Rule 506 to permit general solicitation if: the issuer takes "reasonable steps to verify" that purchasers are accredited investors, all purchasers are accredited investors, or the issuer reasonably believes that they are, immediately prior to the sale, and certain other requirements are met. As part of the revised rule, the SEC established four optional methods for verifying accreditator investor status that would satisfy the accredited investor verification requirements. In addition, new disqualification provisions were added to Rule 506, prohibiting the use of the exemption by certain bad actors and felons, whether or not general solicitation is used. The amendments to Rule 506 took effect on September 23, 2013.

Securities offered pursuant to the Rule 506 safe harbour fall under NSMIA's definition of "covered securities," and are therefore exempt from blue sky filings as described above; however, securities issued in reliance on Rules 504 or 505 are not "covered securities." Because securities offered pursuant to Rule 506 are not listed covered securities, a state may require a notice filing and a fee in connection with a Rule 506 offering.

ENDNOTES

1. Sections 18(c)(2)(A) and (B) of the Securities Act.
2. Section 18(c)(1) of the Securities Act.
3. Tex. Rev. Civ. Stat. Ann. art. 581-5, § L.
4. *See* 3A Blue Sky L. Rep. (CCH) ¶ 55,828O.
5. Another helpful fact would be a minimum denomination significantly higher than \$1,000 per note, in order to help insure that the offering is more of an institutional offering than a retail offering.
6. *See, eg,* 7 Tex. Admin. Code §§ 114.1-.4, 3A Blue Sky L. Rep. (CCH) ¶¶ 55,590P – 55,590S.

CHAPTER 12

Regulation by the Financial Industry Regulatory Authority

The SEC has delegated part of the responsibility for enforcing securities laws to various self-regulatory organisations (SROs), as defined under the Exchange Act, including the various stock exchanges and Finra. Finra is the largest non-governmental regulator for all securities firms doing business in the United States. It was created in July 2007 through the consolidation of the National Association of Securities Dealers (NASD) and the member regulation, enforcement and arbitration functions of the NYSE. The Finra rulebook consists of:

- A growing set of Finra rules, which are based on the rules of the NASD (NASD Rules) and rules incorporated for the NYSE (the Incorporated NYSE Rules) but that may no longer be identical to the predecessor rules;
- NASD Rules that have not yet been converted into Finra rules; and
- Incorporated NYSE Rules that have not yet been converted into Finra rules.

While the NASD Rules generally apply to all Finra members (these are broker-dealers), the Incorporated NYSE Rules apply only to Finra members that are also members of the NYSE (again, broker-dealers).

Foreign bank issuers will be required to consider Finra rules in various contexts. First, almost any financing undertaken by a foreign bank issuer will entail the assistance of a financial intermediary. The financial intermediary will be a registered broker-dealer that is a Finra member.

Finra members

Foreign bank issuers should understand that the broker-dealer will be subject to supervision by Finra and required to comply with Finra rules. Finra rules impose a number of requirements on Finra members. For example, broker-dealers are subject to standards of conduct, including a duty of fair dealing, which includes a suitability obligation, and a duty of best execution. Broker-dealers owe various duties to their customers, such as the duty to recommend suitable investments, obtain best execution when effecting trades and charge fair commissions or mark-ups.

Also a general matter, NASD Rules and Finra rules require that firms ensure their communications with the public are based on principles of fair dealing and good faith, are fair and balanced and provide a sound basis for

evaluating the facts about any particular security, industry or service. Risk disclosures in offering documents (a prospectus or an offering circular or private placement memorandum) do not cure deficient disclosure in sales materials. Finra Rule 2090, the know-your-customer rule, requires that firms “use reasonable diligence, in regard to the opening of every account, to know (and retain) the essential facts concerning every customer... .” Finra Rule 2111 requires that firms have a reasonable basis for determining that a product is suitable for investors in general and that it is suitable for each specific customer prior to recommending the purchase or sale of a security.

Recent changes to the suitability rule also identify a quantitative suitability assessment that requires a broker-dealer to assess whether a transaction or series of transactions (if viewed together) are suitable for the client. The rule requires firms to make reasonable efforts to obtain information concerning: the customer’s financial status, tax status, investment objectives, time horizon, liquidity needs, risk tolerance and any other information considered reasonable by the member or registered representative in making recommendations to the customer. A firm’s registered representatives must familiarise themselves “with each customer’s financial situation, trading experience, and ability to meet the risks involved with such products.”¹

Apart from these Finra rules that impose certain duties on Finra members and prescribe compliance with certain requirements in connection with broker-dealer activity, the Finra rules also address the conduct of certain offerings of securities, whether public offerings or private placements.

Finra compensation review

Finra determines whether the terms of the “underwriting compensation” and arrangements relating to “public offerings” are “unfair and unreasonable.” The Finra rules address each of those concepts, particularly Finra Rule 5110. Finra Rule 5110 addresses commercial fairness in underwriting and other arrangements for the distribution of securities and provides for review by Finra of underwriting or other arrangements in connection with most public offerings in order to enable Finra to assess the fairness and reasonableness of proposed underwriting compensation. The rule is intended to prohibit the payment of underwriting compensation that is considered unfair or unreasonable. A determination regarding the

fairness or reasonableness of compensation will be highly fact specific and will depend on the type of offering. An offering that is required to be filed with Finra may not proceed until Finra has delivered a no-objection opinion relating to the underwriting compensation.

The Finra rules apply only to public offerings. A public offering includes any registered or non-registered primary or secondary distribution, and excludes any private placement made pursuant to certain provisions and rules of the Securities Act and any exempted security pursuant to the definition in the Exchange Act.

Finra Rule 5110(b)(1) states that “[n]o member or person associated with a member shall participate in any manner in any public offering of securities subject to this Rule, Rule 2310 or NASD Rule 2720 unless documents and information as specified herein relating to the offering have been filed with and reviewed by Finra.” Unless specifically exempt, as discussed below, Finra requires that certain documents and agreements be filed, including:

- The registration statement, offering circular or offering memorandum;
- Any proposed underwriting agreement, agreement among underwriters, agency agreement or similar agreement or any other document that describes the underwriting or other arrangements in connection with the distribution;
- Each pre- and post-effective amendment to the registration statement or other offering document;
- The final registration statement as declared effective by the SEC, or the equivalent final offering document, and a list of all members of the underwriting syndicate, if not indicated; and
- The executed form of the final underwriting documents

In addition, the Finra filing must include the following information:

- An estimate of the maximum public offering price;
- An estimate of the maximum underwriting discount or commission;
- An estimate of the maximum reimbursement for underwriter’s expenses and underwriter’s counsel’s fees; and
- A statement of the association or affiliation with any Finra member of any officer or director of the issuer, any beneficial owner of 5% or more of any class of the issuer’s securities, and of any beneficial owner of the issuer’s unregistered equity securities that were acquired during the 180-day period immediately preceding the required filing date of the public offering.

All documents and information are filed with Finra through its electronic filing system, Corporate Offerings Business Regulatory Analysis System, colloquially known as CobraDesk. Documents or information filed with Finra, unless already publicly available, will be treated as confidential. Finra uses these documents to determine compliance with applicable Finra rules and for other regulatory purposes it deems appropriate.

Exemptions

There are several types of offerings that are exempt from the Finra filing requirements. These include:

- Securities offered by an issuer that has unsecured nonconvertible debt with a term of at least four years, or unsecured non-convertible preferred securities, rated by a nationally recognised statistical rating organisation (NSRO) in one of its four highest generic rating categories, except that an initial public offering of the equity of an issuer is always required to be filed;
- Non-convertible debt securities and non-convertible preferred securities rated by an NSRO in one of its four highest generic rating categories;
- Offerings of securities pursuant to a shelf registration statement of an issuer that: (i) has been a reporting company for at least three years; and (ii) has an aggregate market value of the voting stock held by non-affiliates of at least \$150 million (or \$100 million aggregate market value and an annual trading volume of three million shares);
- Securities exempt from SEC registration pursuant to provisions of Sections 4(a)(1), 4(a)(2) or 4(a)(6) of the Securities Act, or pursuant to Rule 504 under the Securities Act, if the securities are “restricted securities” under Securities Act Rules 144(a)(3), 505 or 506. This means that private placements conducted in reliance on the exemption from registration provided by Section 4(a)(2) and/or Regulation D are exempt from the Finra compensation review.

The offering documents and distribution agreements for public securities offerings conducted by banks under Section 3(a)(2) of the Securities Act must be filed with Finra for review under Finra Rule 5110(b)(9), unless one of the exemptions above is available. For example, a foreign bank issuer that offers its securities pursuant to Section 3(a)(2) may nonetheless limit the public nature of the offering and conduct the offering in compliance with Regulation D. Such an offering would be exempt from the Finra compensation review.

Conflicts of interest

Finra Rule 5121 is intended to protect investors in the securities by providing for, under specified conditions, one or more of the following: (1) disclosure in the offering document of the nature of the conflict, including participation of the member in the offering; (2) disclosure of the participation of a “qualified independent underwriter” (QIU) in the offering; and (3) escrow of the proceeds of the offering. Finra Rule 5121 has particular importance when a broker-dealer seeks to sell securities of an affiliate. Finra Rule 5121 applies only to “public offerings” (as defined in the rule).

Finra Rule 5121 provides that a conflict of interest exists if, at the time of a member’s participation, any of the following four conditions applies:

- The securities are to be issued by the member;

- The issuer controls, is controlled by, or is under common control with the member or the member's associated persons;
- At least 5% of the net offering proceeds, net of underwriting compensation, is intended to be used either to reduce or retire the balance of a loan or credit facility extended by the member, its affiliates, and its associated persons (in the aggregate) or otherwise be directed to the member, its affiliates, and associated persons (in the aggregate); or
- As a result of the public offering and any transactions contemplated at the time of the public offering, the member will be an affiliate of the issuer, the member will become publicly owned, or the issuer will become a member or form a broker-dealer subsidiary.

If a conflict of interest exists, then the member must comply with the conditions of Finra Rule 5121, which require "prominent disclosure" in specified locations in the offering document of the nature of the conflict of interest (even if the lead underwriter does not have a conflict of interest) and under specified circumstances, could involve the services of a "qualified independent underwriter" (as defined in Finra Rule 5121). The QIU must satisfy certain requirements, must participate in the preparation of the registration statement and the offering document, and must exercise the usual standards of due diligence in respect of the offering. There must also be prominent disclosure of the name of the member acting as QIU and a brief general statement regarding the role and responsibilities of a QIU. A QIU is not required under certain limited circumstances. For example, a QIU is not required if the securities offered are investment grade rated or are securities in the same series that have equal rights and obligations as investment grade rated securities and other conditions are satisfied.

Finra's communications rules

In June 2012, Finra approved new rules relating to broker-dealers' communications with the public and impacting a wide variety of securities offerings. We discuss below some of the most significant rules.

Filing requirements. Finra Rule 2210(c)(3)(E) requires broker-dealers to file with Finra "retail communications" concerning any security that is registered under the Securities Act and that is derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance or a foreign currency." In addition, Finra Rule 2210(a)(4) provides that Finra members may not treat communications as institutional communications if they have "reason to believe" that the communication (or any excerpt) will be forwarded to any retail investors.³

Exemption from filing for certain materials. Finra Rule 2210(c)(7)(E) exempts from the filing requirement any prospectuses, preliminary prospectuses, offering circulars and similar documents that have been filed with the SEC. This exemption would remove a wide variety of

prospectuses and free-writing prospectuses from the filing requirements, since so many of them are in fact filed with the SEC under Securities Act Rules 424(b) or 433. However, this provision would not exempt from filing an investment company prospectus published pursuant to Securities Act Rule 482 and free writing prospectuses that have been filed with the SEC under Securities Act Rule 433(d)(1)(ii). Securities Act Rule 433(d)(1)(ii) is the provision that requires underwriters to file those free writing prospectuses that they distribute "in a manner reasonably designed to lead to its broad unrestricted dissemination."

Adequacy of communications. Old Finra Rule 2210(d)(1) had required a Finra member's communications to be fair, balanced and accurate and to provide a sound basis for evaluating the facts in regard to any particular security or service. Old Finra Rule 2210(d)(1) also prohibited a Finra member from omitting any material fact or qualification from a communication if the omission, in light of the context of the material presented, would cause the communication to be misleading, making any false, exaggerated, unwarranted, promissory or misleading statement or claim in any communication, and from publishing, circulating or distributing any communication that the Finra member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.

New Finra Rule 2210(d)(1) specifies that Finra members, in addition to the above, must:

- Ensure that statements are clear and not misleading within the context in which they are made, and that they provide balanced treatment of risks and potential benefits (communications must be consistent with the risks of fluctuating prices and the uncertainty of dividends, rates of return and yield inherent to investments);
- Consider the nature of the audience to which the communication will be directed, and must provide details and explanations appropriate to the audience; and
- Ensure that communications do not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast, except in certain limited circumstances.

Broadly disseminated underwriter FWP's are subject to the content standards of new Finra Rule 2210(d). In contrast, documents such as prospectuses and preliminary prospectuses are "issuer documents" that are exempt from these content standards. However, most broker-dealers currently prepare these documents in an effort to comply with both SEC rules and guidance (and potential liability for misstatements under the securities laws) and Finra's rules and guidance.

Principal approval requirements. Finra Rule 2210(b)(1)(A) requires an appropriately qualified registered principal of a Finra member to approve each

retail communication before the earlier of its first use or filing with Finra.

Research reports

Finra also imposes restrictions relating to analyst research reports, reflected in Finra Rule 2711. Finra Rule 2711 is designed to address conflicts of interest in connection with the preparation and publication of analyst research reports and public appearances relating to equity securities, and help increase analyst independence. Finra Rule 2711 prohibits, among other things, analyst participation in efforts to solicit investment banking business (with an exception for communications “the sole purpose of which is due diligence”), offering favourable research to induce issuers to award investment banking business, linking analyst compensation to a specific investment banking transaction, submitting a research report to the issuer prior to the report’s publication (with a narrow exception for verifying facts), having investment banking personnel supervising analysts or approving research reports, and personal trading by analysts in securities that are the subject of their research reports. Finra Rule 2711 also mandates “quiet periods” of 40 calendar days and 10 calendar days for managers and co-managers following IPOs and follow-on offerings, respectively, with exceptions for significant news or events and (in the case of follow-on offerings) for securities that meet the average daily trading volume (ADTV) test in Rule 101 of Regulation M under the Securities Act (Regulation M) and that also meet the requirements of Rule 139 under the Securities Act.⁴ Increased disclosures of conflicts of interest in research reports and public appearances by analysts and disclosure in research reports of data and price charts showing a firm’s ratings track record are also required.⁵

Regulation D offerings

In April 2010, Finra issued Regulatory Notice 10-22 reminding broker-dealers of their obligation, enforceable under US federal securities laws and Finra Rule 2310, to conduct a reasonable investigation of the issuer and the securities they recommend in offerings made pursuant to Regulation D. The notice also reinforces the obligations of broker-dealers that recommend securities offered under Regulation D to comply with the suitability requirements, the advertising and supervisory rules of Finra and SEC rules and regulations.

The notice details a broker-dealer’s duty, when recommending a security, under case law and SEC interpretations, to conduct a reasonable investigation of both the securities offered and the issuer’s representations about those securities. Broker-dealers acting as placement agents in connection with a private offering made in reliance on Regulation D will conduct a reasonable investigation concerning the issuer, its management, its business prospects, and the intended use of proceeds of the offering. The level of diligence undertaken by the

placement agent will vary depending upon the sophistication of the issuer, the broker-dealer’s familiarity with the issuer and its business, and the nature of the prospective offerees (whether investors are sophisticated institutions or individual investors). The notice reminds broker-dealers that if they are involved in the preparation of the offering materials, they will have heightened due diligence obligations.⁶

Finra Rule 5123

In June 2012, Finra Rule 5123 regarding private placements was adopted. Under Finra Rule 5123, a Finra member participating in a non-public offering must submit to Finra, or have submitted on its behalf by a designated member, a copy of any private placement memorandum, term sheet or other offering document, including any materially amended versions of those documents, used in connection with the offering within 15 calendar days of the date of first sale, or indicate to Finra that no such documents were used. Finra Rule 5123 applies to a “private placement” which refers to a non-public offering of securities conducted in reliance on an available exemption from registration under the Securities Act. The definition does not apply to securities offered pursuant to: Sections 4(a)(1), 4(a)(3) and 4(a)(4) of the Securities Act (which generally exempt secondary transactions); Sections 3(a)(2) (offerings by banks), 3(a)(9) (exchange transactions), 3(a)(10) (securities subject to a fairness hearing) or 3(a)(12) (securities issued by a bank or bank holding company pursuant to reorganization or similar transactions) of the Securities Act; and Section 1145 of the Bankruptcy Code (securities issued in a court-approved reorganisation plan that are not otherwise entitled to the exemption from registration afforded by Section 3(a)(10) of the Securities Act).⁷

To facilitate submission of the required information, Finra developed the Private Placement Form for the processing of specified private placement filings through Finra’s Firm Gateway. Finra members must complete and submit the Private Placement Form electronically through Finra’s Firm Gateway. The Private Placement Form requests the following information:

- Identifying and contact information for the Finra member and the issuer;
- Disclosure of any affiliate relationship between the Finra member and the issuer or sponsor; and
- Basic information about the nature of the offering (eg, type of security, offering size, offering period, underwriting discounts/commission, etc).

In addition, in September 2013, the SEC approved amendments to Finra Rule 6750 and Finra’s Trace (Trade Reporting and Compliance Engine) dissemination protocols that require the dissemination of transactions in Trace-eligible securities that are effected pursuant to Rule 144A. In addition, the SEC approved amendments to Finra Rule 7730 to establish real-time and historic data sets

for Rule 144A transactions. The effective date of the amendments is June 30, 2014.

Certificates of deposit

As we discuss in Chapter 7, CDs generally are considered bank deposits, and not securities. Traditional CDs bear a fixed interest rate over a fixed period and benefit from FDIC insurance up to the insurance limit. However, there may be non-traditional CD products, such as certain brokered CDs or market-linked CDs that may be more akin to securities than traditional bank deposits. Also, there may be bundled CDs with other features that again resemble securities rather than traditional bank deposits. Traditional CDs generally fall outside of Finra supervision. CDs that may be considered securities may be subject to Finra rules. As a result, it will be important to understand whether a CD is a bank deposit or a security.

ENDNOTES

1. For more information regarding Finra guidance regarding suitability with respect to structured products, *see* “Finra developments relating to the sales and marketing of structured products” in Chapter 13 (Special considerations related to structured products).
2. The term “retail communication” includes any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period. *See* Finra Rule 2210(a)(5). The term “retail investor” includes any person other than an institutional investor, regardless of whether the person has an account with the member. *See* Finra Rule 2210(a)(6). The term “institutional investor” includes registered investment companies, insurance companies, banks, registered broker-dealers, registered investment advisers, certain retirement plans, governmental entities, and individual investors and other entities with at least \$50 million in assets. *See* Finra Rule 2210(a)(4).
3. The term “institutional communication” includes any written (including electronic) communication that is distributed or made available only to institutional investors, but does not include a Finra member’s internal communications. *See* Finra Rule 2210(a)(3).
4. A 25-day IPO quiet period applies to all participating underwriters and dealers other than managers or co-managers. The quiet periods also apply to views expressed by analysts in public appearances. In addition, a 15-day quiet period is imposed prior to or following the expiration, waiver or termination of a lock-up agreement (with exceptions for significant news or events and for research reports or public appearances regarding securities that meet the ADTV test in Rule 101 of Regulation M and that also meet the requirements of Rule 139 under the Securities Act).
5. In October 2012, the SEC approved amendments to Finra Rule 2711 to conform the rule to changes effected by the JOBS Act for offerings by EGCs, including the elimination of post-IPO or follow-on offering quiet periods for EGCs and the permission of research analysts to attend a pitch meeting in connection with an IPO for an EGC that is also attended by investment banking personnel (provided that the research analyst may not engage in otherwise prohibited conduct in such meetings including efforts to solicit investment banking business). For more information regarding EGCs, *see* “FPI accommodations under US securities laws” in Chapter 9 (Exchange Act registration).
6. In January 2013, Finra announced that the policing of private placements, including offerings made pursuant to Regulation D, would be its regulatory priority for 2013. However, Finra enforcement actions relating to private placements have been dramatically increasing since 2010. With the adoption of Finra Rule 5123 regarding private placements (which we discuss below), this trend of increased enforcement seems likely to continue.
7. Finra Rule 5123 also exempts other types of private placements from the notice filing requirement, including: (1) offerings sold by a Finra member solely to (a) institutional accounts, as defined in Finra Rule 4512(c), (b) qualified purchasers, as defined in Section 2(a)(51)(A) of the Investment Company Act, (c) QIBs, as defined in Rule 144A, or (d) accredited investors as defined in Rules 501(a)(1), (2), (3) or (7) under the Securities Act; (2) offerings of exempted securities, as defined in Section 3(a)(12) of the Exchange Act; (3) offerings made pursuant to Rule 144A or Regulation S; and (4) offerings of exempt securities with short-term maturities under Section 3(a)(3) of the Securities Act and debt securities sold by members pursuant to Section 4(a)(2) of the Securities Act so long as the maturity does not exceed 397 days and the securities are issued in minimum denominations of \$150,000 (or the equivalent thereof in another currency).

CHAPTER 13

Special considerations related to structured products

In the aftermath of the financial crisis of 2008, financial engineering has engendered suspicion and financial products perceived to be complex have attracted regulatory attention. Structured products are among the financial products that have come under increasing regulatory scrutiny. Some of this attention may be unwarranted and may be the result of a case of mistaken identity. That is, financial products bearing very different characteristics are often grouped together and referred to as “structured products” if the products entail any structuring. For example, news articles may discuss structured finance products, or structured credit products, like collateralized debt obligations (CDOs) or collateralized loan obligations (CLOs), in the same breath as market-linked debt securities. This undifferentiated approach has led to a fair bit of confusion. Structured products or market-linked investments, are debt securities with cash flow characteristics that depend on the performance of one or more reference assets. The prototypical structured product may be a senior note with a return based on a popular commodity index, such as the S&P 500 Index or the DJIA.

The market for these products has proven resilient and has grown in recent years, with reported US sales reaching \$65 billion in 2012. These products are designed to meet the risk/reward needs of investors and offer distinct benefits that cannot typically be obtained from other types of investments. However, the US regulatory framework applicable to these products is difficult to navigate, and the purpose of this chapter is to discuss recent regulatory and enforcement developments and highlight disclosure and compliance concerns for market participants, as a wide variety of non-US banks, particularly European and Canadian banks, are frequent issuers of structured products in the United States.

Types of structured products

Structured products include equity-linked, index-linked, interest rate-linked, commodity-linked and currency-linked instruments. From a cash flow perspective, a structured product may look like a combination of a traditional debt security and a derivatives contract, but structured products are not derivatives contracts. Structured products simply involve trading away a portion of the full potential upside associated with a direct investment in the reference asset (such as an investment in the S&P 500 Index or the DJIA) in exchange for a return

of principal at maturity (subject to the issuer’s credit risk), or in exchange for assuming some lesser risk to the reference asset. Structured products may be structured as senior debt securities offered by an issuer (usually a financial institution that is a “well-known seasoned issuer”) under a shelf registration statement (if the securities are registered) or a program offering circular or offering memorandum (if the securities are unregistered), or they may be structured as market-linked CDs offered by a bank.

Regulatory framework applicable to structured products

As a result of the various forms that structured products may take, there is no single regulation or body of regulation applicable to the issuance, sale and marketing of structured products. First, the applicable regulatory scheme may turn on whether the structured product is a security (and whether it is a registered security or an unregistered security offered in a private placement or as a bank note) or a bank product. Second, the nature of the reference asset may raise particular considerations, as we discuss below in the context of commodity-linked products. Third, many structured products have distinct tax benefits, so tax considerations often are central to the structuring process. Fourth, questions may arise concerning the Employee Retirement Income Security Act of 1974 (Erisa), the Investment Company Act and the Investment Advisers Act of 1940, which need to be vetted carefully. Fifth, the nature of the investor base may raise particular concerns. For example, structured products that are sold to retail investors may be subject to higher scrutiny and more stringent regulatory requirements than products sold to institutional investors. Sixth, the broker-dealers that market structured products are subject to regulation by self-regulatory organisations (SROs), including national securities exchanges (eg, the NYSE and Nasdaq) and Finra.¹

For issuers of structured products, there are still other considerations that arise that are not unique to structured products offerings, but rather arise in connection with securities offerings generally. These considerations include issuer blackout periods, corporate authorisation of the issuance and sale of the securities and the availability of an effective registration statement or an up-to-date offering circular or offering memorandum. Similarly, there are

Finra regulations applicable to all securities offerings, such as those relating to communications and underwriting compensation, which also must be considered in the context of a structured products offering.

Securities liability at the time of sale

Most causes of action relating to structured products that are securities would be brought by investors alleging insufficient or inaccurate disclosure. In December 2005, the SEC, as part of its securities offering reform (Securities Offering Reform), in new Rule 159 under the Securities Act, codified its interpretation regarding the time at which liability is measured under Section 12(a)(2) of the Securities Act. The information upon which liability is based for insufficient or inadequate disclosure is established at the time of sale, or the moment the investor becomes contractually obligated to purchase a security. Time of sale liability also has been applied by market participants to unregistered offerings, due to the concern that a court or securities regulator could apply the principles underlying Rule 159 to the context of unregistered offerings.

As a result, a seller must convey information to an investor before an investment decision is made, and may not correct material misstatements or omissions in the information conveyed to an investor after the investment decision is made at the time of sale. Thus, an issuer may not avoid liability for a material misstatement or omission in a preliminary prospectus or supplement by simply correcting the text of the final prospectus or supplement. Previously, a final prospectus or supplement may have been used to correct or supplement information that had been provided to investors, but information conveyed after the time of sale now may no longer be considered in assessing liability. As a result of the increasing complexity of many structured products subsequent to Securities Offering Reform, many issuers and underwriters have given additional thought to the disclosure documents for structured products and have implemented revised policies and procedures relating to the sales and marketing of structured products.

Securities Offering Reform also introduced the concept of a free writing prospectus, which is any written communication used during the offering process other than the SEC-filed statutory prospectus. Free writing prospectuses are generally not subject to any content requirements or restrictions, but are subject to liability under Section 12(a)(2) of the Securities Act (although not Section 11 of the Securities Act), as well as the antifraud provisions of the US securities laws. Finra's disclosure rules also regulate the content of free writing prospectuses. As a result, distribution agreements between issuers and underwriters of structured products, and selling group agreements between lead underwriters and selling group members, often contain detailed provisions as to the use, preparation and required approvals of offering documents and other marketing materials.

An issuer is responsible for any free writing prospectus that is prepared by or on behalf of, or used or referred to by, the issuer. Free writing prospectuses that include marketing information about particular types of structured products or a specific structured product and hypothetical examples or plain English discussions of product features, are frequently being used in conjunction with the prospectus or prospectus supplement for registered structured products. Free writing prospectuses are also frequently used in lieu of a full preliminary statutory prospectus because, in principle, the base offering documents that relate to all of the issuer's securities need not be attached to the free writing prospectus. In addition, since there may be many variables that are determined on the pricing or trade date for structured products, which may impact potential returns to an investor (eg, trigger or barrier prices, index levels or return caps), free writing prospectuses may be used (usually in the form of final term sheets) to convey this information at the time of sale prior to confirmation of sales. Market participants in unregistered offerings similarly use marketing materials and final term sheets that are analogous to free writing prospectuses to provide additional information regarding products and product features and convey pricing information.

Disclosure issues

Distributors of structured products generally will rely on disclosures provided by the issuer and the underwriter of the products. However, it is important that the disclosures present a fair and balanced picture of the risks and benefits of the structured product. The SEC's prospectus disclosure rules, particularly those of Item 202 of Regulation S-K (description of securities) and Item 503 (risk factors) contain very little specific guidance that is useful in the context of structured products. However, a general consensus among market participants does exist as to the principal disclosures that should be made (although practices and text differ among issuers). In addition, Finra and the SEC have in the past few years have provided helpful guidance on disclosures related to structured products.

In April 2012, the SEC's Division of Corporate Finance announced that it had sent a letter to certain financial institutions relating to their structured note offerings. The SEC letter consists of 14 comments and restates certain of the SEC Staff's views with respect to structured products. For example, the SEC letter requests that issuers evaluate the names or titles of their structured products (such as the use of "principal protected notes") to ensure that these names are not confusing or misleading to investors. The SEC Staff requests that issuers ensure that prospectuses include prominent disclosures alerting investors that they are exposed to issuer credit risk if they purchase structured notes. The SEC letter reminds issuers that disclaimers of responsibility for information regarding an underlying

reference asset is inconsistent with the issuer's obligations under the US securities laws, and that some disclaimers of this kind may need to be revised. The SEC letter also seeks additional information from issuers of structured products. For example, the SEC letter requests information as to the circumstances under which an issuer or its broker-dealer affiliate repurchases notes from investors prior to maturity, suggesting that issuers provide more information about this in their offering documents. As discussed above, information about registered structured products is conveyed through a layered disclosure approach, which includes term sheets, prospectus supplements and product supplements. The potential complexity of this format is an issue that has arisen in a number of different contexts, including in connection with the securities litigation relating to Lehman Brothers' principal-protected structured notes and the SEC's releases relating to asset-backed securities. In addition, different underwriters make different uses of short-form, free writing prospectuses and statutory prospectuses.

The SEC letter also requests additional disclosure as to the estimated value of structured notes on the pricing date. In February 2013, the SEC Staff provided additional guidance regarding the type of disclosure regarding pricing that would be required. The SEC Staff noted that issuers must disclose the "issuer's valuation" on the cover page of the offering document, and share this information with investors prior to the time of sale. This estimated value should be based on the value of the "bond" component and the "derivative" component of the offered structured note. Disclosure documents should include a description of the estimated value, and any models used to calculate this amount, such as the issuer's internal funding rate or secondary market spreads. In discussing the value of the derivative component that is factored into the estimated value, the issuer also should discuss any valuation models or assumptions, particularly if the issuer has used inputs other than mid-market prices. The value of the derivative component generally should exclude the issuer's hedging costs. The offering document also should include narrative disclosure explaining the fees, costs and other amounts that may be added to the issuer's valuation to calculate the original issue price of the structured notes and whether those amounts received from investors are used or retained by the issuer or an affiliate. Risk factor disclosure should alert potential investors that the estimated value will be lower than the issue price of the notes. The disclosures also should address any risks inherent in the valuation or pricing of the bond or derivative components, including the use of any assumptions or internal models. The risk factors also should alert investors that there will not be a liquid secondary market for the securities, and that secondary market prices may be lower than the issue price. The SEC's guidance regarding pricing disclosure has resulted in significant changes to the disclosures used by

market participants in connection with structured product offerings.

Type of structured product

The disclosures regarding the type of structured product and its structure must be written clearly so that the average investor is able to understand how the structured product works. The type of structured product will also determine the type of disclosure and amount of information that needs to be disclosed. More complex structured products, such as highly leveraged exchange traded notes (ETNs) with frequent rebalancing and long/short strategies, structured products linked to hypothetical bond/yield curves and commodity-linked structured products with reference assets consisting of hypothetical baskets of futures contracts, may require a significant amount of disclosure to explain how the reference assets or baskets are constructed or composed and returns are calculated. Depending on the structured product, there also may be restrictions related to the potential investors. Certain structured products may only be offered to accredited investors, or may be subject to minimum denomination requirements, and certain structured products may not be appropriate for Erisa accounts.

Structured product names

Distributors should ensure that structured product names are not confusing or misleading to investors. For example, both Finra and the SEC have expressed concerns regarding the use of the term "principal protection" without providing accompanying prominent disclosure concerning issuer credit risk. The concern stems from the fact that an unsecured obligation to make principal payments does not dispense with the risk that if the issuer goes into bankruptcy, it may not have sufficient funds to make such principal payments to investors.

Credit risk

All disclosure and marketing documents should emphasise that structured products are subject to issuer credit risk. In light of the current challenges facing financial institutions, market participants should monitor changes in the issuer's creditworthiness, reflected in the issuer's credit ratings. Distributors must have procedures in place for notifying potential investors of changes in issuer credit ratings, or of any emerging risks affecting an issuer.

Risk disclosures

Special attention should be paid to highlighting clearly the risks associated with the structured product, including the lack of a liquid secondary market, the special tax features of the structured product, actual or potential conflicts of interest, and risks specific to particular payout structures. Again, the more complex the structured product, the greater the level of risk disclosure that should be included in the relevant offering document. And needless to say, the

length of the risk factor section will not help ensure against US securities liability if the content of the risk factors does not adequately explain the specific risks inherent in the structured product.

Fees

Investors should understand the fees and commissions associated with the structured product. As a result, issuers and distributors should aim to provide transparency with respect to the disclosure on fees and commissions. The existence of embedded fees and costs will add to the perception that the structured product is complex and thus impact Finra suitability requirements (which we discuss below).

Broker-dealer standard of care

The distributors of structured products are predominantly broker-dealers, and broker-dealers generally are not subject to a fiduciary standard of care. However, broker-dealers still owe various duties to their customers, which include the duty to recommend so-called suitable investments, the duty to obtain best execution when effecting trades and the duty to charge fair commissions or mark-ups. Finra rules further require that member firms ensure that their communications with customers and the public are based on principles of fair dealing and good faith, are fair and balanced and provide a sound basis for evaluating any particular security, industry or service. Risk disclosures in a prospectus or supplement do not cure deficient disclosure in sales or marketing materials. Finra Rule 2090, commonly referred to as the know-your-customer rule, requires that member firms perform reasonable diligence, with respect to the opening of every account, to know (and retain) the essential facts concerning every customer.

Finra Rule 2111 requires that Finra members have a reasonable basis for determining that a structured product may be suitable for investors in general (commonly referred to as reasonable-basis suitability) and that it is suitable for each specific customer (commonly referred to as customer-specific suitability), prior to recommending the purchase or sale of a security. Customer-specific suitability is the more quantitative suitability assessment of the two types of suitability. Finra Rule 2111 further requires member firms to make reasonable efforts to obtain information concerning:

- The customer's financial status;
- The customer's tax status;
- The customer's investment objectives;
- The customer's time horizon;
- The customer's liquidity needs;
- The customer's risk tolerance; and
- Any other information considered reasonable by the Finra member or registered representative in making recommendations to the customer.

Registered representatives of the broker-dealer also must familiarise themselves with each customer's financial

situation, trading experience and ability to meet the risks involved with the relevant security.

Finra developments relating to the sales and marketing of structured products

Notice to Members 3-71, 5-26 and 5-59

Finra (and its predecessor, the NASD, referred to herein throughout as Finra) have issued various Notices to Members and alerts that relate directly to the sales and marketing of structured products. In November 2003, Finra issued Notice to Members 3-71 regarding non-conventional investments, which was followed in April 2005 by Notice to Members 5-26 regarding new products and in September 2005 by Notice to Members 5-59 regarding structured products.

The three notices raise similar issues. Finra notes that Finra members must develop and implement written procedures to identify and consider new products, as well as post-approval follow-up and review procedures. Finra reminds Finra members that, in order to discharge their suitability obligation in connection with marketing and selling new products or structured products, Finra members should conduct adequate diligence. Finra members should conduct the diligence necessary to permit them to understand product features. The nature of the diligence will vary by product, but should take into account distinct product features and should include an understanding of the liquidity of the product, the creditworthiness of the issuer, the principal, return and/or interest rate and the tax consequences.

In Notice to Members 5-59, Finra notes that Finra members should consider whether an investment meets the reasonable-basis suitability standard if it is priced such that the potential yield is not an appropriate rate of return in relation to the volatility of the reference asset based on comparable or similar investments. Given that structured products are varied, comparing the yield/volatility profile of similar investments may pose challenges. Finra members also must perform a customer-specific suitability analysis to ensure that an investment in the product is suitable on a customer-by-customer basis. This requires taking into account the customer's financial and tax status, investment objectives and other similar information, without placing undue reliance on net worth alone. Notice to Members 5-59 also suggests that Finra members consider whether an investor meets the suitability requirements for options trading.

Any offering or sales material should provide balanced disclosure of the risk and rewards associated with the particular product, especially when selling to retail investors. In particular, the notices emphasise that many unique features associated with structured products may not be readily understood by retail investors. Finra members should avoid potentially misleading characterisations of structured products in offering or sales materials (for example, referring to the products as

“income-producing,” “conservative” or “yield-enhancing”). Notice to Members 5-59 also notes that offering materials that omit a description of the derivative component of the product and instead present such products as ordinary debt securities would violate Finra Rule 2210.

Offering documents also should highlight and explain the risks associated with structured products, which generally include market risk, interest rate risk, a risk of embedded leverage, the risk of reduced liquidity, issuer credit risk, uncertain tax treatment or adverse tax consequences, and the possibility that there may not be any current income for the holder. Risks specific to each product or structure also should be explained.

Regulatory Notices 09-73, 10-09 and 10-51

Following the failure of Lehman Brothers in September 2008, holders of Lehman Brothers structured products, including principal-protected products, faced losses. In legal or regulatory actions, holders of Lehman Brothers principal-protected notes alleged that they believed “principal-protected” meant repayment of principal was guaranteed and did not understand that the notes were senior unsecured debt obligations of the issuer, subject to issuer credit risk. Regulators took note and issued new guidance. In December 2009, Finra released Regulatory Notice 09-73 regarding principal protected notes, which reminds Finra members that communications must be fair and balanced and provide appropriate disclosures, including disclosures regarding issuer credit risk. Finra cautions that Finra members should conduct reasonable suitability assessments prior to recommending principal-protected notes. Finally, Finra emphasises that Finra members must train their registered representatives regarding the terms, conditions, risks and rewards of these products.

In 2010, Finra issued Regulatory Notice 10-09 regarding reverse convertible securities, which had become quite popular. The notice focuses on sales and marketing communications relating to reverse convertibles and recommended that Finra members ensure investors understand that reverse convertibles do not provide for principal protection and as a result investors may experience losses on their investments.

As commodity-linked products became increasingly popular, Finra issued Regulatory Notice 10-51 regarding commodity futures-linked securities, reminding firms of their sales practice obligations for such products. The notice highlights certain of the risks that may result from the methodologies used in connection with commodity futures-linked securities, including possible deviation between the performance of the commodity futures-linked security and the performance of the referenced commodity.

Regulatory Notice 12-03

In January 2012, Finra issued Regulatory Notice 12-03 regarding complex products. The notice identifies the types of products that may be considered “complex” and provides guidance to Finra members regarding supervisory concerns associated with sales of complex products. The notice makes clear that in Finra’s view, member firms have heightened obligations in respect of the sale of complex products. The notice also highlights additional steps to be taken in connection with new product review, training, suitability assessments and post-sale review for complex products.

Enforcement actions

In addition to providing regulatory guidance, Finra also has pursued enforcement actions against member firms involved in structured product sales. Generally, these enforcement actions have involved the misselling of structured products, a lack of appropriate training and insufficient supervisory procedures.

Useful reminders

Issuers of structured products and the broker-dealers that distribute structured products should anticipate that regulators will remain focused on this area. Consistent with their objective of protecting investors, regulators will seek to reduce complexity for retail investors and seek greater transparency and clarity in structured product disclosures. Moreover, given economic uncertainty and the losses borne by investors in complex structured credit products, concerns are likely to continue to be raised as to whether market-linked products are too complex for retail investors. Many of these discussions are likely to gloss over the distinctions between complexity and riskiness and may fail to distinguish among different types of retail investors with differing levels of sophistication.

In light of the regulatory environment, broker-dealers should take care to:

- Review their new product approval process;
- Adopt detailed policies and procedures that address the distinct issues posed by structured products;
- Address know-your-customer and suitability obligations, recognising that special procedures will be required in respect of structured products;
- Implement approaches to monitor concentration of structured products, single issuer exposures and trades prior to maturity in client accounts;
- Document a process or policies and procedures regarding the pricing of structured products and secondary market activities;
- Design comprehensive mandatory training and education specific to structured products;
- Focus on disclosures in offering documents and other marketing materials; and
- Document arrangements with distributors of structured products and vet distributors carefully based on know-your-distributor procedures.

Special attention should also be paid to product names, descriptions of pay-out structures and product features, and clear discussions of the product's risks, including the lack of a secondary market, the special tax features, the buy-and-hold nature of the product, the fees and expenses associated with the product and the potential conflicts of interest presented by the investment.

As with offerings involving other types of products, broker-dealers should consider carefully their existing policies and procedures related to information walls in order to, among other things, help ensure that from a compliance perspective product marketers are walled off from research analysts. In addition, broker-dealers should “window-clean” in order to make sure that they have a policies and procedures for:

- Vetting underlying stocks that may be reference assets or constituents of a narrow-based index that is a reference index;
- Licensing indices for use in structured products;
- Generating accurate and descriptive account statements that properly describe the products that customers have purchased;
- Vetting any marketing materials with Finra and filing any such materials with Finra; and
- Complying with trade reporting rules.

There also are a number of changes on the horizon, including those that may arise as a result of ongoing rulemaking in connection with the Dodd-Frank Act. For example, the possible imposition of a fiduciary duty on broker-dealers is likely to affect the structured products market.

Bank regulatory issues arising from hedging

Banks or their branches should consider closely the regulatory issues that may arise in connection with the issuance of structured products. To the extent that a foreign bank or branch seeks to issue structured products from the bank in reliance on Section 3(a)(2), the foreign bank or branch should consult with counsel concerning the types of products it intends to issue. In addition, the foreign bank should consult with its principal regulator. The New York Banking Department has published several rulings regarding linked securities, although these, by and large, address notes linked to broad-based indices. A foreign bank also should consider the FDIC's guidance in respect of domestic retail deposits. An uninsured foreign bank branch will want to make certain that any structured notes are considered “securities” and not deposit products. Finally, a foreign bank will want to consider carefully how the exposures arising in respect of structured products it issues are hedged. Depending on the structure of the foreign bank, hedging the associated exposures may raise regulatory concerns.

ENDNOTE

1. For more information regarding Finra, *see* Chapter 12 (Regulation by the Financial Industry Regulatory Authority).

CHAPTER 14

Covered bond basics

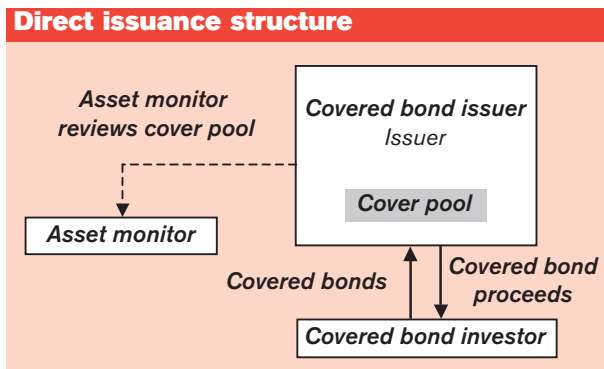
What are covered bonds?

Covered bonds are debt obligations that have recourse to the issuing bank, to an affiliated group to which the issuing entity belongs or both. Upon an issuer default, covered bond holders also have recourse to designated collateral known as a cover pool, which is separate and distinct from the issuer’s other assets. Cash from the cover pool continues to pay the covered bonds on scheduled payment dates and at maturity. The cover pool usually consists of high-quality assets, including residential mortgages, public debt or ship loans.

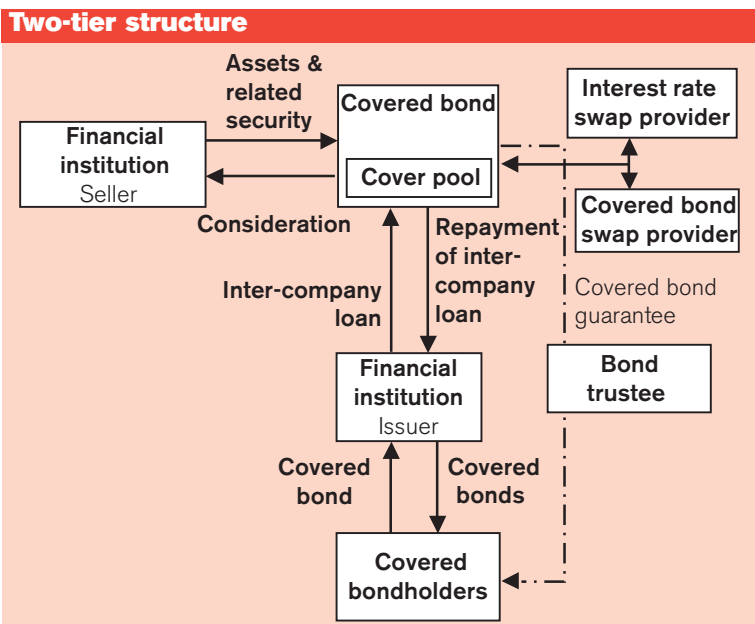
Used since the 18th century in Europe, covered bonds are relatively new to the United States. Most European countries have a statutory framework for the issuance of covered bonds. In the United States, a statutory framework to foster the issuance of covered bonds is emerging, while investor appetite for foreign-bank covered bonds is gaining strength.

How are covered bonds structured?

The structure of a covered bond transaction generally falls within one of two broad categories, determined by the jurisdiction of the covered bond issuer. As noted above, most European jurisdictions have adopted legislation providing statutory priority for covered bond holders over the cover pool upon the occurrence of an event of default. As a result, most European banks issue covered bonds directly, without the use of a special-purpose entity. This direct issuance structure generally is referred to as a legislative covered bond. As illustrated below, the institution originating the mortgage loans (or other cover pool assets) is usually the same entity that issues the covered bonds. In jurisdictions where covered bond legislation has not yet been enacted (for example, the United States or the United Kingdom or Canada prior to enactment of legislation) or jurisdiction-specific practice dictates (for example, the United Kingdom or Canada after enactment of legislation), issuers rely on contractual arrangements to ring-fence the cover pool from unsecured creditor claims. These covered bonds are often referred to as structured covered bonds.



Regardless of structure, there are five general principles underlying all covered bonds. First, the maturity date of covered bonds may not be accelerated for insolvency, ensuring the covered bond investor’s desired maturity profile. Second, the cover pool must be separate or otherwise segregated from the other assets of the issuer, affording the covered bond holders first priority to the assets in the cover pool upon an insolvency of the issuer. Third, the covered bonds must be secured by high-quality assets, usually determined by eligibility criteria in the related covered bond legislation. Fourth, the issuer must be



a regulated financial institution, ensuring a high level of transparency through disclosure, as well as comprehensive regulatory supervision. Finally, the cover pool must be dynamic, requiring the issuer to substitute assets which have become defective or otherwise unsuitable for inclusion in the cover pool.

Legislative covered bonds

As discussed above, covered bonds may be issued directly by institutions in countries with covered bond legislation. Above is a diagram of the direct issuance structure.

Structured covered bonds

Covered bonds issued in jurisdictions with no legislative framework, or which continue to use the previously adopted structure after enactment of legislation, rely on a two-tiered issuance structure. The two-tiered structure attempts to replicate the benefits conferred by legislation.

United Kingdom and Canada

In the United Kingdom and in Canada, for example, the depository institution establishes a special purpose vehicle to act as the guarantor of the covered bonds. The special purpose guarantor purchases from the depository institution the assets constituting the cover pool using the proceeds of a loan from the depository institution to the special purpose guarantor. The depository institution

issues the covered bonds which are guaranteed by the special purpose guarantor. The above diagram illustrates this approach.

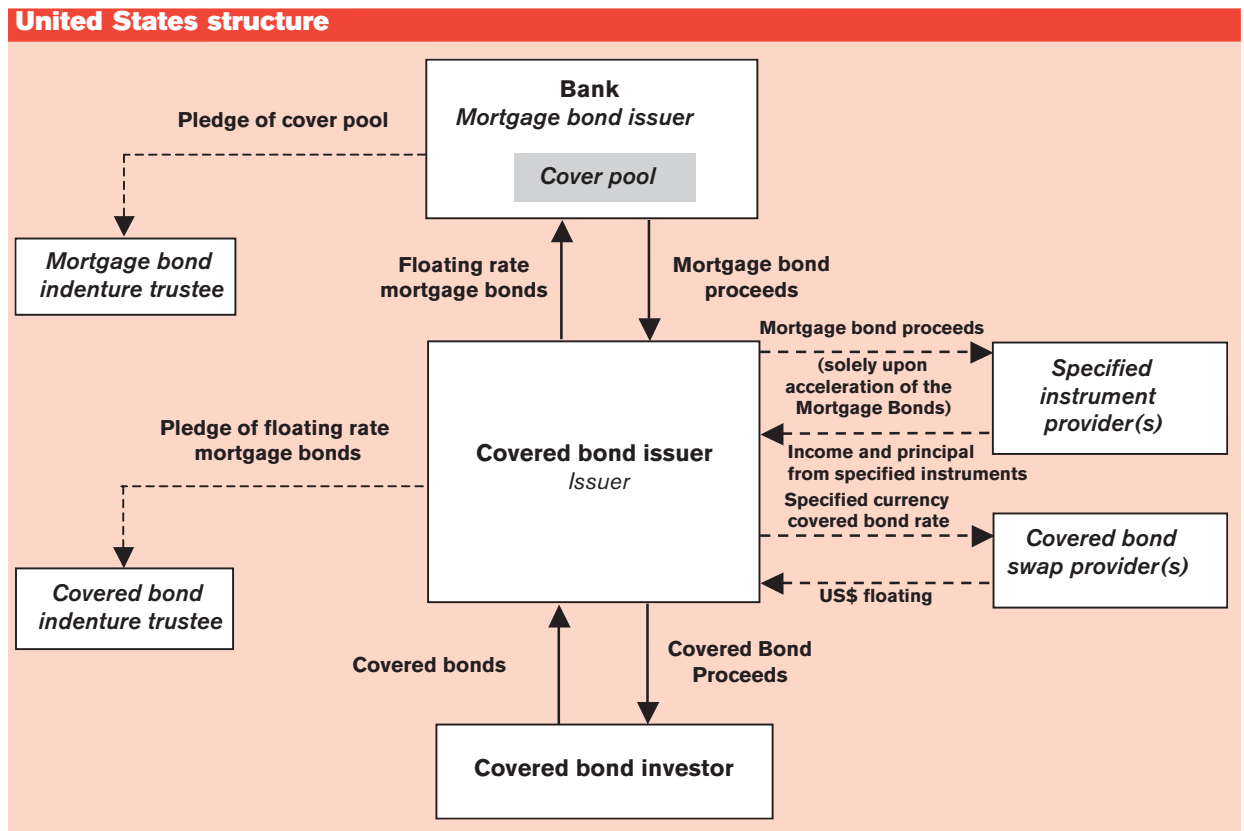
The United States

In the United States, the depository institution establishes a special purpose vehicle to act as issuer of the covered bonds. The special purpose vehicle issuer sells covered bonds to investors and uses the proceeds to purchase mortgage bonds from the bank (originator/aggregator), which acts as the mortgage bond issuer. The bank-issued mortgage bonds, which are direct and unconditional obligations of the bank, serve as collateral for the covered bonds. The cover pool, a specific, pledged pool of mortgage loans on the bank's balance sheet, secures the mortgage bonds, which back the covered bonds. The below diagram illustrates this approach.

The cover pool

The cover pool generally consists of high-quality assets, including residential mortgage loans, commercial mortgage loans, public debt or ship loans. The assets are subject to eligibility criteria. These criteria are specified either by legislation or by contract. Cover pool assets must be replaced if they fail to meet the specified eligibility criteria.

The issuer also must ensure that the cover pool meets



certain asset-coverage requirements, which will require the issuer to add assets to the cover pool to replace amortised, matured or defaulted assets. If loans in the cover pool prepay, the loans must be replenished. The bank is required to conduct a periodic asset-coverage test to ensure that the ratio of cover pool assets to the covered bonds exceeds the asset coverage threshold. Further, covered bonds are structured on a bullet-repayment basis so that covered bond holders are not exposed to prepayment risk.

Covered bonds are overcollateralised (that is, the collateral constituting the cover pool has a principal amount in excess of the face amount of the covered bonds). This helps to preserve the value of the covered bond holders' claims upon the occurrence of an insolvency of an issuer and to obtain the desired ratings for the covered bonds from rating agencies. In European jurisdictions with legislation, the statute may specify a minimum overcollateralisation level.

Covered bonds issued by foreign issuers into the United States

Despite the lack of an established market for US bank-issued covered bonds, approximately \$30 billion of covered bonds were issued into the United States by foreign banks in 2010, \$40 billion in 2011, and \$44 billion in 2012. Issuance into the United States in 2013 slowed to about \$25 billion due to Canadian and European developments, but issuance is expected to surge again in 2014. US investors have a healthy and growing appetite for covered bonds. Foreign banks have met investor demand by issuing covered bonds into the United States relying on their domestic covered bond frameworks. The cover pools supporting these foreign-issued covered bonds have been comprised exclusively of assets located outside the United States.

Compliance with US securities laws

When issuing covered bonds into the United States, foreign issuers must comply with US securities laws, including the Securities Act. The Securities Act requires that all securities issued and sold in the United States be either registered or exempt from registration. Until 2012, offerings of covered bonds by foreign banks had been structured as exempt offerings. However, in a major development, Royal Bank of Canada (RBC) registered the first-ever offering of covered bonds with the SEC in 2012 and other Canadian banks followed suit in 2013.

Rule 144A and Regulation S

As discussed in Chapter 5 (Mechanics of a Rule 144A/Regulation S offering), one approach for offering debt securities to US persons without pursuing a registered public offering is to rely on the exemption from registration provided by Rule 144A. Upon issuance, the covered bonds of foreign issuers are first offered in a private placement to the initial purchasers (the investment banks

that distribute the securities) in reliance on Section 4(2) of the Securities Act. The initial purchasers will immediately re-sell the covered bonds to QIBs in reliance on the Rule 144A safe harbor. Contemporaneously, the covered bonds also may be offered outside of the United States to non-US persons in reliance on Regulation S of the Securities Act.

Section 3(a)(2)

If a foreign bank has a branch or agency in the United States, it may be able to rely on Section 3(a)(2). To qualify for a Section 3(a)(2) offering, the covered bonds must be either issued or guaranteed by the US branch or agency. The SEC treats the US branch or agency of a foreign bank as a US branch or agency for purposes of Section 3(a)(2) if the foreign bank is a "national bank" or a "banking institution organised under the laws of any state" if the nature and extent of regulation and supervision of such foreign bank is "substantially equivalent to that of applicable federal or state chartered domestic banks doing business in the same jurisdiction." Additionally, if the covered bonds are guaranteed by such a branch or agency, the guaranty or assurance must cover the entire obligation. The guarantee or assurance cannot be for a partial repayment of the covered bonds.

Relying on the Section 3(a)(2) exemption has certain advantages. First, securities sold in reliance on Section 3(a)(2) are not restricted securities, while securities sold in a private placement and resold in reliance on the Rule 144A safe harbor are "restricted securities." Many institutional investors are subject to limitations on the amount of restricted securities that they may purchase. Second, resales of Rule 144A securities may only be made to QIBs (or to other purchasers that the initial purchasers and any persons acting on their behalf reasonably believe to be QIBs), whereas, Section 3(a)(2) securities generally may be sold to a broader universe of investors as discussed in Chapter 6 (Section 3(a)(2) and considerations for foreign banks financing in the United States). Finally, restricted securities are not eligible to be included in bond indices and are therefore viewed as less liquid.

SEC registration

In order to register its covered bonds, RBC obtained a no-action letter from the SEC in May 2012 that set forth prospectus disclosure requirements for the bonds. The no-action letter also requires monthly and annual filings with the SEC on the cover pool that are similar to the filings for an asset-backed security offering under Regulation AB. RBC is already an SEC-filer in connection with its senior debt program.

SEC registration significantly expanded the investor base in the United States for RBC's offerings, the securities are not "restricted securities," and the increased transparency and Trace eligibility significantly improved the secondary market. For issuers that have senior debt programs already registered with the SEC, this is likely to become the

avored avenue for issuance of covered bonds in the United States in 2014.

Documentation

Prospectus

Many European covered bonds are listed on securities exchanges. In connection with such listing, the prospectuses of such covered bonds are reviewed and cleared by entities including the UK Listing Authority (UKLA) and the Luxembourg Stock Exchange. The UKLA and the Luxembourg Stock Exchange require that the prospectuses include disclosure about the issuer or the issuer group and about the programme, including financial information. Generally, issuers also are required by statute to provide covered bond investors with periodic reports on the cover pool, including statistics on dwelling type, geographical location, loan amount, loan balance, remaining term, credit score, interest rate, occupancy, and loan-to-value ratio. These reports usually are not posted with the related listing authority, but often are posted on the issuer's website. There is a growing trend in both the US and European markets for investors to receive more information and obtain more transparency with respect to the cover pool.

A European covered bond issuer with a current prospectus (prepared in accordance with UKLA or Luxembourg Stock Exchange standards) can access the US Rule 144A market relatively easily. The prospectus can be supplemented with a few additional sections for the US market. The additional sections that would need to be added generally will include: disclosure regarding US tax implications, Erisa implications, settlement information for clearance of the covered bonds through DTC, the identity of the US paying agent, information regarding any selling restrictions and transfer restrictions in the case of a Rule 144A offering and information regarding the role of any US branch of a foreign bank in offerings and financial data regarding such branch in the case of a Section 3(a)(2) offering.

Existing programme agreements

Generally, few changes are required for an existing European covered bond programme to be amended in order to accommodate an offering in the United States. There is no requirement that the programme agreements be governed by US law, so the existing agreements remain largely unchanged. A few changes are necessary. First, a co-issuing agent must be appointed in the United States under the existing agency agreement (or other agreement providing for the issuance of securities) to provide for issuance of, and payment on, the bonds. This change is often accomplished by notice, without the amendment of the agency agreement.

Second, as required by DTC, the global bonds must be issued in the name of DTC's nominee, Cede & Co., and physically held by the US issuing agent. This may require

amendment of the agency agreement. Finally, the programme agreement (or other agreement governing the offering and distribution of the covered bonds) must be amended to include representations, warranties and covenants typical for an offering to US investors, selling restrictions, US-style indemnification provisions for false or misleading statements or omissions contained in the offering document, typical market-out provisions, and a requirement that the issuer's accountants deliver a comfort letter and perform certain agreed upon procedures.

Additional documents required for branch issuance or guarantee

In the case of an offering under Section 3(a)(2), steps must be taken to effect the issuance of the bonds through the US branch or agency of a foreign bank or for such branch or agency to guarantee the obligations evidenced by the covered bonds. In the case of an issuance of the covered bonds by the US branch or agency of a non-US bank, the final terms and subscription agreement or other documents to be executed for the issuance of a new series of bonds must be executed by the bank "acting through the branch [agency]" and the global bonds issued to DTC should show the bank "acting through the branch [agency]" as the obligor.

In the case of a guarantee by the branch, the bank "acting through the branch [agency]" would execute the final terms and the subscription agreement as guarantor. While it may initially appear strange that a branch office of a non-US bank would guarantee the obligations of the non-US bank, the structure is significant. The US branch or agency of a non-US bank is regulated by a US regulator and such branch or agency must often maintain separate capital in its local US jurisdiction. In the case of the branch or agency's failure, the US banking regulator will marshal the assets of the branch or agency in the jurisdiction and apply those assets to repayment of claims against the branch or agency before releasing assets to the home office of the branch or agency or to insolvency proceedings in the home jurisdiction of the bank.

10b-5 letters and due diligence

Several liability and diligence-related documents are commonly delivered at closing in connection with the issuance of debt securities into US markets. These documents include: (1) an auditor comfort letter, (2) a pool audit letter (agreed upon procedures letter) and (3) a 10b-5 letter.

In an SEC-registered offering, a Rule 144A offering and in a Section 3(a)(2) offering, an underwriter, initial purchaser or dealer is subject to US securities law liability in respect of losses if there are material misstatements or omissions contained in disclosure documents in a securities offering.¹ Generally, however, under applicable law, the underwriter, initial purchaser or dealer may limit its liability if it can establish that it did not know and, in

the exercise of reasonable care, could not have known of such misstatement or omission. This is often referred to as the due diligence defence.

The diligence process will entail discussions with the issuer's management, review of certain documents, including the issuer's board minutes and material contracts and other similar agreements and a review of the issuer's mortgage business policies and procedures. Some non-US issuers may find this inquiry intrusive. However, the diligence process can be handled with due consideration for the confidentiality of sensitive information. Furthermore, the review relating to a debt offering by a regulated financial institution with publicly available financial data should not be a lengthy process. For a regulated financial institution, a great deal of information about the institution is publicly available. Discussions with management should take hours, not days and the review of agreements, board minutes and other documents should be efficient.

As part of the diligence process, there also will be various business and regulatory diligence conference calls and discussions with the issuer's accountants, counsel and other advisors. Naturally, conducting diligence for the very first offering will be more time-consuming than for subsequent offerings. Subsequent offerings require only a review of new agreements and new board minutes. It should also be noted that diligence conducted, for example, for a covered bond programme can also serve as the basis for diligence for other securities offerings by the same issuer, such as offerings pursuant to an MTN programme or a Section 3(a)(2) banknote programme. Accordingly, once initial diligence is completed, the issuer may achieve future efficiencies if the issuer and the dealers work with the same counsel on other offerings.

The underwriter/initial purchaser/dealer also will request that the issuer's counsel and its own counsel deliver Rule 10b-5 letters at closing. In the letter, counsel will state that it is unaware of any untrue statement of material fact or omission to state a material fact necessary in order to make the statements made in the disclosure document and other related offering materials, in light of the circumstances under which they were made, not misleading.

Process

The process of preparing for and conducting a Rule 144A or Section 3(a)(2) offering should generally be familiar to a European issuer. After selecting the arranger/dealer for a US offering, the offering process would typically involve the following steps:

- Reviewing the existing programme agreements;
- Amending programme agreements, as needed;
- Drafting final terms and subscription agreement;
- In the case of a Section 3(a)(2) offering, discussing the offering with US banking regulators;
- Due diligence review;

- Obtaining a comfort letter;
- Preparing roadshow materials;
- Selecting the co-managers;
- Bring-down diligence;
- Launching the offering;
- Pricing; and
- Closing.

For a Section 3(a)(2) offering, the US bank regulator for the branch or agency should be consulted in advance. Covered bonds may not be familiar instruments to many state regulators and an effort should be made to explain to the regulator the role of the branch or agency and features of a covered bond.

For an SEC-registered offering, there will be several additional steps:

- Obtaining a no-action letter from the SEC, if necessary;
- Filing an SEC compliant prospectus for review by the SEC;
- Amending the trust deed or issuing agency agreement to comply with the Trust Indenture Act of 1939, as amended;
- Drafting an underwriting agreement for the offering;
- Obtaining an SEC order of effectiveness for the registration statement; and
- Drafting a prospectus supplement for the specific bonds to be offered.

ENDNOTE

1. Liability in a Rule 144A offering is different in certain respects from liability in a Section 3(a)(2) offering. For a discussion of liability in a Rule 144A offering, *see* “Due diligence” and “Liability concerns” in Chapter 5 (Mechanics of a Rule 144A/Regulation S offering). For a discussion of liability in a 3(a)(2) offering, *see* “Securities liability” in Chapter 6 (Section 3(a)(2) and considerations for foreign banks financing in the United States).

CHAPTER 15

Schedule B filers

Non-US sovereign governments and their political subdivisions frequently offer debt securities and guarantees of other debt securities in the United States by registering and issuing the debt securities and guarantees under Schedule B of the Securities Act. Schedule B is a schedule to the Securities Act that sets out the requirements to be included in the registration statements of sovereign foreign governments and their political subdivisions for guarantees and offerings of debt securities. Schedule B also offers a separate and generally more streamlined registration process for sovereign issuers compared with the process for domestic and foreign private issuers not entitled to use Schedule B.

The justification for the more streamlined process is the ability of sovereigns to satisfy interest and premium payments on debt securities by levying taxes. Sovereign issuers use Schedule B for issuing debt securities (sovereign issuers do not issue equity). References in this chapter to “sovereign issuer” include any foreign government, political subdivision, international organisation and instrumentality that is permitted to file under Schedule B.

There is no specific registration statement form for Schedule B sovereign issuers as there is for both domestic and foreign private issuers for other types of offerings (for example, Form S-1 and Form F-1). The registration statement for sovereign issuers must simply contain the information specified in Schedule B. Although the requirements for Schedule B registration statements are far shorter, the common practice is to disclose information analogous in scope to that required under Form S-1. Schedule B’s short length, which allows sovereign issuers far more latitude in drafting and the relative lack of statutory guidance has resulted in Schedule B practice evolving informally through SEC no-action letter guidance, the SEC review process itself and the self-policing mechanisms of sovereign issuers and underwriters and each of their counsel.

Who can use Schedule B?

Section 7 of the Securities Act provides that Schedule B applies to securities issued by a “foreign government, or political subdivision thereof.” Although this phrase is not specifically defined in the Securities Act, its meaning and by extension the types of issuers that may use Schedule B, have evolved over time along with the rest of Schedule B

practice. Schedule B is clearly available to any non-US sovereign nation and political subdivisions of such sovereign nation, which may include states, provinces, cities and municipalities. There are other classes of issuers where the application of Schedule B is unclear, especially with respect to nations where many corporations are partially nationalised. In situations where Schedule B applicability is unclear, the issuer and its US counsel should arrange a pre-filing conference with the SEC staff to obtain clearance to use Schedule B.

The SEC staff has permitted international organisations with sovereign nations as members to use Schedule B.¹ Some recent examples of organisations using Schedule B include the Council of Europe Development Bank and Corporación Andina de Fomento, both multilateral financial institutions with European and South American nations as their members, respectively. The international organisations permitted to use Schedule B typically serve governmental functions and have their financial obligations backed by the member nations in the event that the organisations cannot meet their obligations under their debt securities. Securities offerings of certain international organisations, including the African Development Bank, the Asian Development Bank, the European Bank for Reconstruction and Development, the Inter-American Development Bank and the International Bank for Reconstruction and Development, are governed by specific statutes and regulations that are even more favorable than Schedule B.²

The SEC staff also has permitted issuers that are part of, or owned by, sovereign nations to use Schedule B because investments in such issuers are secure from default to the same degree as sovereign credits.³ These decisions have typically focused on the guarantee of the issuer’s securities by a sovereign, the issuer serving a governmental purpose and the existence of sovereign ownership or control of the issuer.

Guarantee of the issuer’s securities by a sovereign

The most important factor for issuers that are part of, or owned by, sovereign nations is the existence of a sovereign guarantee or equivalent credit support of the issuer’s securities. The guarantee can be an express guarantee, a statutory guarantee or a legal requirement by operation of law requiring the sovereign to provide funding for the issuer to satisfy its obligations. A guarantee by a political

subdivision of a sovereign nation also is acceptable, assuming the political subdivision can levy taxes. Common examples of the latter are Canadian power and utility companies that regularly issue Schedule B securities guaranteed by the province they are located in. Where an express guarantee is provided, the guarantee is considered a separate security just as any other guarantee of a debt security, which means it must also be registered under Schedule B with the underlying debt securities and usually under the same registration statement. In such cases, both the issuer and the guarantor need to sign the registration statement. In such cases, both the issuer and the guarantor need to sign to registration statement. Even where an express guarantee is absent but the issuer is using Schedule B because of some other type of credit support from a sovereign, the SEC staff will typically require both the issuer and the sovereign to sign the registration statement.

Whatever the exact form of the sovereign guarantee or credit support, the SEC has generally taken the position that the sovereign guarantee or credit support must carry with it the “full faith and credit” of the sovereign. The SEC also has viewed the legal opinion of local counsel as authority for the sovereign’s guarantee or other necessary support. However, it seems unlikely that the SEC would grant Schedule B status where the sovereign’s support took the form of a mere contractual keep-well arrangement that fell short of a guarantee, even if the arrangement carried the full faith and credit of the sovereign. Nevertheless, a number of central banks have been permitted to register debt securities under Schedule B even though such obligations did not carry the full faith and credit of the sovereign or benefit from a formal sovereign guarantee or other keep-well arrangement.⁴

Issuer serves governmental purpose

Issuers that are formed by foreign governments to perform governmental functions are more likely to receive permission to use Schedule B. Examples of such issuers include foreign national development banks and foreign municipal school districts. In addition, issuers engaged in activities that bring them into excessive competition with private companies engaged in similar activities would not likely be able to use Schedule B.

Sovereign ownership or control of the issuer

Issuers that are owned or controlled by foreign governments also are more likely to receive permission to use Schedule B. The SEC staff typically looks for whole or substantially whole ownership of the issuer by the sovereign. With respect to control over the issuer, the SEC staff generally looks for governmental supervision, budgetary control and appointment of executives by the sovereign. In determining whether an issuer should be treated as part of a foreign government, the SEC has applied these criteria on the basis of all the relevant facts and circumstances.

Disclosure required under Schedule B

Schedule B requires a short list of disclosures for Schedule B registration statements compared with registration statements for other registered securities offerings. Schedule B specifically requires disclosure of the following items:

- The net amount and proposed use of proceeds of the offering;
- The amount and principal terms of the sovereign issuer’s “funded” (long-term) and “floating” (short-term) debt (both foreign and domestic);
- Any defaults by the sovereign issuer on external securities during the preceding 20 years;
- The sovereign issuer’s revenues and expenditures (including deficits) during the three most recent fiscal years;
- The name(s) of any authorised agent(s) in the United States;
- The name(s) of counsel will pass upon the legality of the securities being offered;
- The terms of the distribution, including the underwriting arrangements, if any, and the names of the underwriters;
- The price at which the securities are to be offered (or the method by which the price is to be determined);
- The commissions or other compensation to be paid to the underwriters; and
- Other expenses of the offering.

In practice, however, underwriters and investors have come to expect far more disclosure than what is specifically required under Schedule B because of the general liability provisions of US securities laws that require all information that would be considered important by investors in deciding whether to invest in the securities being offered or that is needed to ensure that the statement made in the prospectus are not misleading.

In addition, more robust disclosure often is necessary for marketing purposes from the underwriters’ perspective. Over the years, the disclosure format for sovereign issuers has become highly standardised and includes information regarding the home-country, its form of government and general political situation, the principal features of its economy, its natural resources and population, its balance of trade, its balance of payments, its aggregate external indebtedness, other factors affecting the availability of the currency in which the proposed registered offering is to be made, and the terms of the securities. In the case of securities that are guaranteed by a sovereign, essentially the same disclosure requirements apply to the sovereign.

A typical Schedule B registration statement contains a prospectus, certain undertakings (included in a Part II), the specific disclosures required by Items 3, 11 and 14 of Schedule B and various exhibits, usually comprising the form of underwriting agreement, the form of fiscal and paying agent agreement and the consents of government officials, auditors and law firms named in the prospectus.

Although Schedule B does not require audited financial statements, common practice is to include such financial statements (in English translation). However, the financial statements do not need to be presented in or reconciled with US generally accepted accounting practices. Nevertheless, sovereigns typically include some explanation of the financial statement presentation and methods to help US investors understand the financial statements.

Schedule B registration statements must be filed with the SEC and declared effective before an offering can proceed. Once Schedule B registration statements are filed they appear on Edgar under the designation S-B with a Securities Act file number just like any other Securities Act registration statement. The SEC staff assigned to the Office of International Corporate Finance, a subdivision of the Division of Corporation Finance, will review, comment on and ultimately declare the Schedule B registration statements effective.

Applicability of the Exchange Act and the Trust Indenture Act

Sovereign issuers are not required to file periodic reports under Sections 12(g) or 15(d) of the Exchange Act. Section 12(g) applies to issuers of equity securities and foreign governments issue only debt securities and Section 15(d) expressly exempts foreign governments and their political subdivisions. Only foreign governments and their political subdivisions that voluntarily list their debt securities on a US national securities exchange must file Exchange Act reports. Instead of filing the annual and periodic reports that are required of domestic and foreign private issuers, sovereign issuers first file a registration statement on Form 18 that includes its US national securities exchange listing application. Sovereign issuers then must file annual reports on Form 18-K and may keep such reports current with amendments on Form 18-K/A throughout the year. The disclosures required under Form 18 and Form 18-K though are similar to the disclosures required under Schedule B.

Section 304(a)(6) of the Trust Indenture Act, exempts debt securities issued or guaranteed by a foreign government or its subdivisions. As a result, Schedule B issuers enter into a fiscal and paying agent agreement, rather than an indenture, to specify the mechanics of issuing and paying principal and interest on the debt securities.

Shelf registrations under Schedule B

Rule 415 under the Securities Act, which permits delayed or continuous registered offerings (commonly referred to as shelf registrations), expressly prevents sovereign issuers from using shelf registrations. However, there is an uncodified but accepted practice allowing Schedule B issuers to use a delayed or continuous offering or shelf procedure similar to that under Rule 415 used by non-

sovereign issuers.⁵ Under this shelf procedure, a sovereign issuer can register an amount of debt securities it reasonably expects to offer over a two year period. A Schedule B shelf registration filing though is only available to seasoned sovereign issuers that have registered securities or guarantees of securities on Schedule B within the past five years and have not had any material defaults on their indebtedness for the past five years.⁶ Nevertheless, the SEC has permitted a non-seasoned sovereign issuer to file a Schedule B shelf registration statement, but in the limited case of the registration solely of its guarantees of registered debt securities issued by banking institutions.⁷ In addition, the registration statement cannot be used for other securities and the sovereign must file a prospectus supplement each time its guarantees are issued.⁸

Just as in a Rule 415 shelf registration statement, a base prospectus is filed with the registration statement to be updated by preliminary and final prospectus supplements as needed. The SEC reviews the registration statement with the base prospectus containing a full description of the issuer and its finances and must declare the registration statement effective before the offering can proceed. Prospectus supplements are then filed under Rule 424(b) under the Securities Act for each offering containing the material terms of the offered security and any material recent developments. Most exhibits to the registration statement can be filed before it is declared effective. Therefore, forms of documents that are not finalised, such as the underwriting agreement and in some cases the fiscal and paying agent agreement, can be filed as forms before effectiveness with the final versions filed as post-effective amendments to the registration statement. Similarly, a qualified legal opinion on the validity of the securities is typically filed before the registration statement is effective with a traditional validity opinion on the securities filed as an exhibit to a post-effective amendment.

Alternate shelf registration procedure on Form 18-K

Seasoned sovereign issuers also may take advantage of an alternative shelf registration procedure under Form 18-K permitted by a long line of SEC no-action letters.⁹ Sovereign issuers hoping to take advantage of the Form 18-K shelf registration procedure for the first time should request no-action letter relief from the SEC staff before proceeding. The Form 18-K shelf registration procedure also is available for political subdivisions and instrumentalities of seasoned sovereign issuers.

The seasoned sovereign issuer must first voluntarily file Form 18 and Form 18-K, unless it is already doing so because it has listed debt securities in the United States. The Form 18-K must include all of the information required by the form and by Schedule B, as well as any additional information that would be material to investors just as in any registered securities offering. Throughout the seasoned sovereign issuer's fiscal year, the Form 18-K is updated by filing amendments on Form 18-K/A, rather

than post-effective amendments to its Schedule B registration statement. Typical updates on Form 18-K/A include the inclusion of interim financial statements, revised budget estimates and material recent developments when considered necessary for disclosure purposes.

When seasoned sovereign issuers file Schedule B registration statements, they must incorporate by reference the previously filed Form 18-K and all subsequent amendments. The Schedule B registration statement should include the undertakings required by Item 512(a)(1),(2) and (3) and Item 512(i)(2) of Regulation S-K normally applicable to Rule 415 offerings that, among other things, include the obligation to include any prospectus required by Section 10(a)(3) of the Securities Act and reflect in the base prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment) that, individually or in the aggregate, represent a fundamental change in the information included in the registration statement. However, the seasoned sovereign issuer is not required to file a post-effective amendment otherwise required by the undertakings if the information required to be included in a post-effective amendment is contained in any report filed under the Exchange Act that is incorporated by reference in the registration statement.

At the time of any shelf takedown, the seasoned sovereign issuer must file a prospectus supplement under Rule 424(b) of the Securities Act that includes a complete description of the securities being offered and any material recent developments since the date of the base prospectus or the last Form 18-K that are not already filed on Form 18-K/A. The prospectus supplement should state that copies of any documents incorporated by reference and all exhibits will be furnished promptly upon request and free of charge. The information and documents required by Schedule B to be described or filed in or with the registration statement that would typically be filed by post-effective amendment at the time of an offering (for example, the underwriting amendment, the names and addresses of the underwriters and an itemised list of expenses and legal opinions) are instead included in (or as exhibits to) the Form 18-K or Form 18-K/A and incorporated by reference into the registration statement.

Limitations on sovereign liability

When issuing Schedule B debt securities, sovereign issuers typically appoint an agent in the United States for service of process and submit to a particular US jurisdiction for any lawsuits or actions related to the securities (typically New York state or federal courts). The consent to service of process and the submission to jurisdiction though expressly carve out actions arising out of or based on US federal or state securities laws. Sovereign issuers also typically waive their sovereign immunity, although the waiver does not apply to actions arising out of or based on US federal or state securities laws. However, whether a

sovereign can assert sovereign immunity from US federal securities laws remains an unsettled question.

The Foreign Sovereign Immunities Act of 1976 (FSIA) grants sovereign immunity to sovereigns and their agencies and instrumentalities subject to certain exceptions.¹⁰ One exception provides that sovereign immunity does not apply in actions based upon: (1) a “commercial activity” carried on in, or having substantial contact with, the United States; (2) an act performed in the United States in connection with a commercial activity of the sovereign elsewhere; or (3) an act outside the territory of the United States in connection with a commercial activity of the sovereign elsewhere that causes a direct effect in the United States.¹¹ Although not directly applicable to sovereign immunity under US federal securities laws actions, the US Supreme Court has held that a sovereign’s issuance of debt obligations was a commercial activity under the FSIA and accordingly, the sovereign was not immune to a breach of contract claim.¹²

Acts of state

A claim of sovereign immunity can be further complicated by the acts of state doctrine under which US courts defer to foreign courts and will not substitute their own judgments if an act by a sovereign issuer that injures securityholders is an act by that sovereign issuer within its own territory. Examples of such actions include changes in currency controls that result in restrictions on payments in foreign currencies, changes in economic policy and acts of war. This means that even if a US court were to ignore a claim of sovereign immunity in a securities action against a sovereign issuer, the sovereign issuer may still be able to avoid or limit liability if an act of state (as opposed to a commercial activity) caused the injury to securityholders.

Jurisdiction, immunity and enforcement disclosure

Schedule B registration statements typically include disclosure regarding the jurisdiction, immunity and enforcement issues discussed above. The disclosure usually is found in the prospectus towards the beginning, in the risk factors section or in the description of debt securities section. The disclosure needs to be tailored to the relevant jurisdiction and the particular laws governing the securities and the sovereign issuer. The most common points covered in the disclosure include the following:

- Because the issuer or guarantor is a foreign sovereign government, it may be difficult to obtain or enforce judgments against it in US courts or in the sovereign’s courts.
- The sovereign issuer has appointed its consulate in the United States or another agent for service of process.
- The sovereign issuer has submitted to the jurisdiction of US federal and state courts in New York and waived immunity from jurisdiction and any objection that it may have to the venue of such courts.

- The sovereign issuer reserves the right to plead sovereign immunity under the FSIA in actions brought against it under US federal securities laws or any state securities laws, and its submission to jurisdiction, appointment of the agent for service of process and waiver of immunity do not include such actions.
- In the absence of the sovereign issuer's waiver of immunity with respect to such actions, it would be impossible to obtain a US judgment in an action brought against the sovereign issuer under US federal or state securities laws unless a US court were to determine that the sovereign issuer is not entitled under the FSIA to sovereign immunity with respect to the action.
- Execution of a lien on the sovereign issuer's property in the United States to enforce a judgment in the United States may not be possible except under the limited circumstances specified in the FSIA, and even if securityholders are able to obtain a judgment against the sovereign issuer in the United States or in the sovereign issuer's courts, they might not be able to enforce it in the sovereign issuer's home country.

Regulation M

Regulation M governs the activities of underwriters, issuers, selling securityholders and other offering participants in connection with securities offerings and was adopted by the SEC to prevent manipulative conduct by persons with an interest in the outcomes of securities offerings. Rules 101 and 102 of Regulation M prohibit issuers, selling securityholders, distribution participants and any of their affiliated purchasers from directly or indirectly bidding for, purchasing, or attempting to induce another person to bid for or purchase a "covered security" until a restricted period has ended. Covered securities, for this purpose, mean the securities being distributed or any reference security, into which a subject security may be converted, exchanged or exercised, or under which the terms of the subject security may in whole or significant part determine its price.

Rules 101 and 102 apply to sovereign debt securities. Sovereign issuers cannot satisfy the requirements of one popular exemption from Regulation M for issuers whose common equity securities have a public float value of at least \$150 million because sovereign issuers do not issue equity securities. However, there is an exemption for sovereign debt securities that are rated investment grade, similar to domestic or foreign private non-convertible investment grade debt.¹³

In cases where the sovereign debt securities are not rated investment grade, the SEC staff has granted non-action letter relief from Rule 101 to permit the lead underwriters of sovereign issuances and their affiliates to conduct market-making activities during the restricted period imposed by Regulation M. In addition to being helpful for market making in sovereign debt, the SEC no-action letter relief also facilitates the reopening of previously issued series of

sovereign debt securities, a fairly common method of raising capital for sovereign issuers but one requiring an exemption from Regulation M because the distributed securities are identical to those already outstanding. This relief has been granted in a line of SEC no-action letters and is typically based on the following criteria, which are not exhaustive and not all of which need be satisfied in every situation:¹⁴

- The issuer is a sovereign government whose financial affairs are widely reported on.
- The issuer's public sector external debt is large in principal amount, typically well over US\$1 billion.
- The market for the debt securities is expected to be highly liquid and to have significant depth of trading.
- The underwriters estimate that a significant number of dealers (at least 10) are expected to regularly place bids and offers for the debt securities, of which a number (at least five) are expected to be continuous market makers.
- The underwriters estimate that daily purchases and sales of the debt securities by the underwriters and their affiliates will not account, on average, for more than a percentage of the average daily trading volume in the debt securities (this number is typically not higher than 20% to 25% but has been as high as 30% and 35%).
- The debt securities are expected to trade primarily on the basis of a spread to the US Treasury security with a corresponding maturity, in a manner similar to trading in investment grade debt securities.
- Bid and ask prices for the debt securities in the over-the-counter market is expected to be widely available.
- The debt securities are expected to be rated not far below investment grade (for example, BB by Standard & Poors and Ba2 by Moody's).
- The debt securities are offered under the sovereign's Schedule B registration statement.

However, even if the SEC is satisfied that enough criteria are satisfied, the relief will still be subject to two conditions. First, the prospectus supplement for the offering must disclose that the underwriters and certain affiliates have been exempted from the provisions of Regulation M. Such disclosure typically is included in the underwriting section of the prospectus supplement. Second, the underwriters and their affiliates must provide the SEC's Division of Trading and Markets, upon request, a daily time-sequenced schedule of all transactions in the debt securities made during the period that begins five business days prior to the pricing of the offering and ends when the distribution of the debt securities in the United States is completed or abandoned.

Requirements under Finra

Schedule B offerings are subject to Finra's corporate financing rule (Finra Rule 5110). Finra Rule 5110 regulates, among other things, the pricing and conduct of due diligence for registered offerings in which a Finra member or any of its associated persons or affiliates has a

conflict of interest. No Finra member that has a conflict of interest may participate in a registered offering unless the offering meets one of the specified exemptions or a “qualified independent underwriter” participates in the offering. Under Finra Rule 5121, a conflict of interest exists if:

- The securities are to be issued by the Finra member;
- The issuer controls, is controlled by or is under common control with the Finra member or the member’s associated persons;
- Where at least 5% of the net offering proceeds, not including underwriting compensation, are intended to be either used to reduce or retire the balance of a loan or credit facility extended by the Finra member, its affiliates and its associated persons (in the aggregate) or otherwise directed to the Finra member, its affiliates and associated persons (in the aggregate); or
- As a result of the registered offering and any transactions contemplated at the time of the registered offering, the Finra member will be an affiliate of the issuer, the Finra member will become publicly owned or the issuer will become a Finra member or form a broker-dealer subsidiary.

However, sovereign debt with a maturity of at least four years that is rated investment grade is exempt from the filing requirements under Finra Rule 5110. If sovereign debt does not qualify for this exemption, then the Schedule B registration statement must be filed with Finra, the sovereign issuer must pay a filing fee and certain disclosures regarding the conflict of interest must be included in the prospectus for the offering. For more information regarding Finra, *see* Chapter 12 (Regulation by the Financial Industry Regulatory Authority).

Documentation for a Schedule B offering

The documentation for Schedule B offerings is similar to the documentation for other registered securities offerings. However, the documentation needs to reflect the differences between each sovereign issuer and its structure and governing laws, and the underwriting agreement and the legal opinions will materially differ from other registered offerings. There are no comfort letters issued in Schedule B offerings as Schedule B does not require audited financial statements to be included in the registration statement. In addition, in place of board resolutions, sovereign issuers must obtain governmental approvals for the Schedule B offering. The Schedule B documentation typically includes the following:

- The Schedule B registration statement and prospectus (and for shelf issuers, prospectus supplements together with Forms 18-K and 18-K/A);
- A free writing prospectus filed with the SEC disclosing the material terms of the securities offered;
- A fiscal and paying agent agreement;
- All certificates, authorisations and receipts required under the fiscal and paying agent agreement, which are

similar to those required by standard indentures and typically executed by senior members of the sovereign issuer’s treasury department, finance ministry or similar financial subdivision;

- A DTC issuer blanket letter of representations;
- Any listing applications and confirmations if the securities are to be listed on a US national securities exchange.
- An underwriting agreement;
- Any applicable home-country governmental approvals; and
- Legal opinions required under the underwriting agreement.

Underwriting agreement

A copy of the underwriting agreement must be filed as an exhibit to a Schedule B registration statement. In the case of shelf registrations, a form of underwriting agreement typically is filed with the registration statement, and after an offering the sovereign issuer will update the form of underwriting agreement with the final underwriting agreement filed as an exhibit on Form 18-K/A. The underwriting agreement between the sovereign issuer and the underwriters will be very similar to underwriting agreements used for other registered offerings. The arrangements relating to service of process, jurisdiction and conditional waiver of sovereign immunity (as discussed above) will be set out in the underwriting agreement. Although certain of the representations and warranties given by the sovereign issuer will mirror those of non-sovereign issuers, there are a number that are unique to sovereign issuers:

- The obligations of the sovereign issuer under the debt securities are supported by the home-country’s full faith and credit.
- No documents or instruments need to be registered, recorded or filed with any court or other authority within the home-country (other than with respect to translations) to ensure the legality, validity, enforceability, priority or admissibility in evidence on the sovereign issuer of the underwriting agreement, the fiscal and paying agent agreement, the securities or any other document or instrument related to the offer and sale of the securities.
- There is no tax, levy, deduction, charge or withholding imposed by the sovereign issuer or any of its political subdivisions on any transaction or document execution contemplated in the underwriting agreement.
- The statements with respect to matters of the sovereign issuer’s governing law set forth in the prospectus are correct.
- The sovereign issuer has the power and authority to issue the securities.
- Any failure of the sovereign issuer to make the necessary or appropriate provisions in its budget for the timely payment of all amounts due under the securities will

not constitute a defense to enforcement of the obligations.

- All consents to service of process, submission to jurisdiction and waivers of immunity are binding on the sovereign issuer.

Governmental authority

Instead of board resolutions authorising the issuance of securities and the performance of the obligations under those securities, Schedule B issuances require governmental approvals. The action required and the method of documentation will vary with each sovereign issuer and will depend on how the home-country's government is structured. The authorisation can be as simple as an executive decree or may require multiple governmental bodies to issue letters, certificates and resolutions. For example, a home-country's legislature, central bank, and treasury and finance ministry may all need to authorise the securities and obligations. US securities counsel for the sovereign issuer and for the underwriters must work closely with local counsel in determining what is required under the home-country's laws, and the process and documentation required will need to be covered in the legal opinion to be provided by local counsel.

Legal opinions

Schedule B requires validity opinions to be filed as exhibits to the registration statement, along with English translations, if needed. The validity opinions must cover all of the applicable laws or other home-country acts authorising the securities. Sovereign issuers typically engage US counsel and sometimes local counsel (in the home-country) to provide legal opinions, while the underwriters engage both US counsel and local counsel (in the home-country). US counsel and local counsel (as well as in-house counsel for the sovereign issuer) provide legal opinions to the underwriters. In-house counsel for the sovereign issuer typically is a top-ranking attorney in the home-country's department of justice or finance.

The matters covered in the opinions from US counsel are similar to those covered in opinions for other registered offerings, including the validity of the securities and the adequacy of the disclosure in the Schedule B registration statement and the prospectus (often referred to as the 10b-5 paragraph). Similarly, the opinions from local and in-house counsel cover many of the same matters covered in local and in-house counsel opinions for other registered offerings. However, there will be certain opinion points included in the opinions from local and in-house counsel that are unique to sovereign issuers and that mirror the sovereign issuer's representations and warranties contained in the underwriting agreement, including the following:

- The sovereign issuer has full power and authority under its constitution or similar governing framework to perform its obligations under the debt securities, the

underwriting agreement and the fiscal and paying agent agreement, and all transactions contemplated by those agreements.

- There is no conflict with the general laws of the home-country and those laws specified in the opinion that cover the authorisation of the sovereign issuer to incur debt obligations.
- All necessary action, authorisations, approvals and consents, which are itemised in the opinion, from all governmental authorities within the home-country have been taken and obtained and are in full force and effect.
- The choice of law is valid and the sovereign issuer's consent to service of process, submission to US jurisdiction, waiver of objection to venue and waiver of sovereign immunity are legal and binding under the home-country's laws.
- It is unnecessary to file or register any transaction agreement, document or other document with any court or other authority in the home-country, or to pay any registration fee or stamp or similar tax to ensure the legality, validity, enforceability or admissibility in evidence of such agreement or document.
- The transaction agreements are in proper legal form under the laws of the home-country for enforcement against the sovereign issuer.

ENDNOTES

1. *See* SEC No-Action Letter, Nordiska Investeringsbanken (December 30, 1981).
2. *See, e.g.*, General Rules and Regulations Pursuant to § 9(A) of the European Bank for Reconstruction and Development Act, 17 C.F.R. §§ 290.1 *et seq.*
3. Certain foreign banks that are eligible to use Schedule B may also be able to take advantage of the exemption from registration under Section 3(a)(2) under the Securities Act if they issue securities through a US federal or state branch. For more information regarding Section 3(a)(2) offerings, *see* Chapter 6 (Section 3(a)(2) and considerations for foreign banks financing in the United States).
4. *See* SEC No-Action Letter, Bank of Greece (June 2, 1993).
5. *See* SEC Release No. 33-6240 (September 10, 1980); SEC Release No. 33-6424 (September 2, 1982).
6. *See* SEC No-Action Letter, Republic of Venezuela (November 24, 1980).
7. *See* SEC No-Action Letter, Commonwealth of Australia (February 26, 2009).
8. *See id.*
9. *See, e.g.*, SEC No-Action Letter, Canada and its Crown Corporations (April 16, 1991); SEC No-Action Letter, United Mexican States (February 25, 1994); SEC No-Action Letter, Republic of Hungary (September 27, 2007).
10. *See* 28 U.S.C. §§ 1602–1611.
11. *See* 28 U.S.C. § 1605(a)(2).
12. *See* Republic of Argentina v. Weltover, 504 US 607 (1992).
13. *See* Rules 101(c)(2) and 102(d)(2) under Regulation M.
14. *See, e.g.*, SEC No-Action Letter, Republic of Uruguay (June 24, 2008); SEC No-Action Letter, Republic of Panama (January 16, 2004); SEC No-Action Letter, Republic of Colombia (December 2, 2002); SEC No-Action Letter, Regulation M – Sovereign Bond Exemption (January 12, 2000).

