



# **Considerations for Foreign Banks Financing in the United States**

## 2019 Update

MORRISON | FOERSTER

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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 from, 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 US.

We also discuss continuous offering programmes, such as bank note and medium-term note programmes, since these are used by foreign banks that are frequent issuers. Finally, we address issuances of structured products into the US and the use of the US-Canadian Multijurisdictional Disclosure System (MJDS). We hope that this overview provides a helpful guide.

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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, which are considering accessing the US capital markets have a number of financing alternatives. As a preliminary matter, a foreign (non-US domiciled) issuer must choose between undertaking a public offering in the US, which would subject 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 US by registering the offer 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 public offerings of securities.

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 discussed further below, the Securities Act is a disclosure statute. Its purpose 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 Securities and Exchange Commission (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, or the steps

required in connection with the preparation of the document. Once filed, 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, it 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 Securities Act Rule 501(a). 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.

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?**

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.<sup>1</sup> 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 US, unless more than 50% of the issuer's outstanding voting securities are held directly or indirectly by US residents, 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 US; or (3) the issuer's business is principally administered in the US.<sup>2</sup> A foreign company that obtains FPI status can avail itself of the benefits of this status immediately. For more information regarding the determination of FPI status, see Chapter 9 (Exchange Act registration).

Current SEC rules ease the disclosure burdens imposed upon FPIs and reduce the ongoing costs of securities reporting obligations. 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 of the issuer's fiscal year-end.<sup>3</sup> 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.<sup>4</sup>
- *Quarterly financial reports.* An FPI has no legal obligation to file quarterly reports. By contrast, US domestic issuers

must file a quarterly report on Form 10-Q. An 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, an 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.<sup>5</sup>
- *Audit committee.* An 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.<sup>6</sup>
- *Internal control reporting.* An FPI only has to file annually regarding its financial reporting internal controls while a US domestic issuer must do so on a quarterly basis.<sup>7</sup>
- *Executive compensation.* An 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.<sup>8</sup>
- *Directors/officers, equity holdings.* Directors and officers of an 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).<sup>9</sup> 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.* An 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, an 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. An 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 sections 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 US 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 US has been no greater than five percent 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 US.

An 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 sections 13(a) or 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 US.
- *Exchange Act registration.* Rule 12g3-2(b) under the Exchange Act allows an 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 US. 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 an 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 US, and becoming subject to ongoing registration requirements is expensive. Foreign issuers considering whether to register their securities in the US 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.

For more information regarding Exchange Act registration and the reporting and disclosure obligations of FPIs, see Chapter 9 (Exchange Act registration).

## **Exemptions from registration**

Given the onerous registration requirements 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* 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 US, 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* 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* is an exemption from registration for transactions by an issuer not involving any public offering, or private placements. Issuers will often rely on the safe harbour 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 US. See Chapter 2 (Overview of financing through exempt offerings).

- *Rule 144A under the Securities Act* is a safe harbour available for the resale of certain securities to qualified institutional buyers, or 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* 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, 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 US 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 US, 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 US may choose to establish a continuous issuance programme, like a medium-term note (MTN) 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 favourable regulatory capital treatment, including contingent capital (CoCo) 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.

## **Tax considerations for foreign banks accessing the US capital markets**

As will be discussed in the following chapters, a non-US financial institution has many options in terms of how it may access the US capital markets. Depending on the range of entities at its disposal, it may choose to utilise a US affiliate, a US branch or entirely offshore sources. Regulatory considerations certainly will play a significant role in any choice of entity calculus (and may well predominate), but the tax consequences resulting from the identity of the issuer also will feature prominently in the decision matrix. These and other considerations will cause institutions to reach different conclusions on the question of whether it is more advantageous to employ a US branch or a US subsidiary to issue a particular instrument in the US capital markets. However, several aspects of the US tax analysis are common to virtually all issuers and are worthy of note, particularly in light of dramatic changes to US tax law since 2017.<sup>10</sup>

## **Withholding taxes**

It will be important to ensure that payments on the issued instruments can be made free of any applicable withholding taxes to protect yields, maintain competitiveness and avoid any need for possible gross-up payments. If the issuing entity is a US corporation and the holders will be exclusively US taxpayers, this typically will not be an issue. However, if the issuer is the US branch of an offshore entity, the question would be determined by the law of the home jurisdiction of the parent entity (or, where applicable, by the provisions of a tax treaty between that country and the US). Likewise, if the ultimate offshore parent issues the instruments into the US market, the question of withholding tax ordinarily will be determined by the laws of the country of its tax residence.

In any case, where non-US withholding tax is implicated, it generally will be important to ensure that a broad exemption from the tax is available for the instrument in question under the law of the relevant jurisdiction (as opposed to a treaty-based exemption that

looks to the residence of the holder of the instrument). This is necessary to ensure effective trading and free transferability of the instruments.

### Limits on the ability of US corporations to deduct interest

Prior to 2018, the deductibility of a US corporation's net interest expense payable to a related non-US party in any taxable year was generally limited only if (a) its debt:equity ratio exceeded 1.5:1 and (b) its net interest expense exceeded 50% of its adjusted taxable income (which was roughly equivalent to EBITDA) for the year.<sup>11</sup> Interest payable to unrelated persons was not subject to any type of formulaic limitation. After the 2017 Act, the deductibility of *all* interest expense of US corporations (whether paid to an unrelated party or to a related non-US or US person) is limited to an amount equal to 30% of adjusted taxable income each year.<sup>12</sup> After 2021, the definition of adjusted taxable income will change to approximate EBIT (earnings reduced by depreciation and amortisation), which will cause a greater number of taxpayers to run afoul of the interest limitation provision.

The changes made by the 2017 Act may cause existing multinational bank groups with US subsidiaries to consider rebalancing the overall leverage of the group. This is because multinationals traditionally tended to overweight their US entities with debt given the previously less-stringent deductibility rules in the US (as compared to other developed nations) and the higher US statutory tax rate. Given that both of these factors have changed with the passage of the 2017 Act, a reexamination of worldwide debt levels may now be appropriate.

### Base erosion and anti-abuse tax (BEAT)

The 2017 Act introduced a new US tax<sup>13</sup> designed to discourage corporate taxpayers from attempting to reduce their tax base by making deductible payments to related non-US persons. Although the most common of these payments probably are interest and royalties, the provision applies to any type of deductible payment made to a related non-US person, including payments for services and depreciation and amortization attributable to property purchased from a related non-US person. Only large corporate taxpayers earning at least \$500 million in gross receipts (determined on a group-wide basis) and with a base erosion percentage of at least three percent<sup>14</sup> are potentially subject to the tax. A taxpayer's base erosion percentage is generally equal to the percentage of its total deductions that represent base erosion payments (that is, payments of a type described above that are made to a related non-US person). The three percent threshold

required for a corporation to be potentially subject to the BEAT is reduced to two percent in the case of banks and registered securities dealers (including corporate groups that have a bank or a registered securities dealer as a member). However, recently proposed Treasury regulations<sup>15</sup> would clarify that for this purpose a bank includes only a US entity, so that a US branch of a non-US corporation would not be subject to the two percent base erosion percentage rule.<sup>16</sup>

The BEAT is basically an alternative minimum tax imposed at a 10% rate (five percent in 2018 and 12.5% in 2026 and thereafter) on the income of a subject taxpayer, computed without the benefit of any base erosion payments or the base erosion percentage of any net operating loss deduction. The rate of tax is one percent higher for any group that includes a bank.<sup>17</sup>

Several parties representing the banking industry submitted comments to Congress during the legislative process, and to the Treasury Department after the 2017 Act was passed into law, pointing out how the BEAT imposed an unfair burden on foreign banks doing business in the US. For example, it was noted that the funds borrowed by US subsidiaries and branches from foreign parent banks essentially represent the cost of goods sold for US lending operations that cannot be avoided and therefore should not be subject to the BEAT. It was also observed that the US Federal Reserve *requires* certain US affiliates to borrow from their foreign parent entities to minimise the risk of insolvency. In such cases it was thought to be inequitable to impose a tax law penalty for compliance with a US Federal Reserve requirement. Finally, comments demonstrated how the BEAT would result in amounts being taxed twice in many instances: Where the US branch of a foreign bank conducts business in the US, it is subject to full US tax on the same basis just as if it were a US corporation. However, the BEAT statute respects the branch's foreign status and payments to it are considered base erosion payments. As a result, any US affiliates of the US branch would be subject to the BEAT even though the US branch would be required to pay full US tax on the payments received from its US affiliates.

The Proposed Regulations would correct certain of these flaws. They contain a broad exception for banks making interest payments on their total loss-absorbing capital debt (TLAC) required by the US Federal Reserve.<sup>18</sup> The preamble to the Proposed Regulations states:

*'The Treasury Department and the IRS have determined that because of the special status of TLAC as part of a global system to address bank solvency and the precise limits that Board regulations place on the terms of TLAC securities and structure of intragroup funding, it is necessary and*

*appropriate to include an exception*' to the BEAT rules for TLAC payments. Thus the Treasury department considered both the fact that the payments are required by law and the apparently limited potential for their abuse in determining that an exception to the BEAT was appropriate. The preamble goes on to request comments on the question of whether 'a similar exception for foreign corporations that are required by law to issue a similar type of loss-absorbing instrument' should be written into the regulations.

The Proposed Regulations also address the double taxation problem described above, in which the related foreign person to whom a base-erosion payment is made is subject to US tax on the payment (for example, where a US branch of an offshore bank receives payments from its US affiliates). Under the Proposed Regulations, these payments would be excluded from the definition of base erosion payments where they are subject to US taxation in the hands of the recipient.<sup>19</sup> The preamble states:

*'The Treasury Department and the IRS have determined that it is appropriate in defining a base erosion payment to consider the US tax treatment of the foreign recipient [, and] that a payment to a foreign person should not be treated as a base erosion payment to the extent that payments to the foreign related party are effectively connected income [i.e., are subject to US income tax on a net income basis as opposed to a gross withholding tax basis].'*

The Proposed Regulations do not provide for the broad exemption from the BEAT for borrowings by US banks from foreign affiliates that had been requested by certain representatives of the international banking industry.<sup>20</sup> Some writers have suggested that in certain circumstances, the absence of appropriate exceptions could cause banks to turn to the capital markets to avoid the tax that could otherwise result from borrowing from their offshore parents. To the extent that the TLAC exception is not sufficient and the BEAT would otherwise impose a significant cost, unrelated public borrowings (as opposed to related foreign financing) could represent a solution in appropriate circumstances, assuming that incremental overall costs do not outweigh the savings realised by avoiding the BEAT.

Comments have been requested on the overall content of the Proposed Regulations, which are expected to be finalised during the course of 2019. Final publication on this timeline would enable any regulations to become retroactively effective for years after 2017.

## 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. Form 20-F, General Instruction A.(b)(2).
4. Form 10-K, General Instruction A.(2)(a)-(c).
5. Rule 3a12-3(b) under the Exchange Act.
6. Form 20-F Instruction to Item 6.C and SEC Release No. 33-8220 (April 9 2003).
7. SEC Release No. 33-8238 (June 5 2003).
8. Item 6.B of Form 20-F.
9. Rule 3a12-3(b) under the Exchange Act.
10. The Tax Cuts and Jobs Act of 2017 (2017 Act), which is generally effective for 2018 and later years, made sweeping changes to the US international taxation system (along with many other wide-ranging changes).
11. Section 163(j) of the Internal Revenue Code of 1986, as amended, prior to amendment by the 2017 Act. (All section references in this Chapter are to sections of the Code, unless otherwise indicated.)
12. Businesses with average annual gross receipts of \$25 million or less are exempt from this annual limitation.
13. Section 59A (this provision is referred to as the base erosion and anti-abuse tax or BEAT).
14. This threshold is reduced to two percent in certain cases, as discussed *infra*.
15. REG-104259-18 (IR-2018-250), December 13 2018 (Proposed Regulations).
16. Prop. Reg. § 1.59A-1(b)(4); Code § 581.
17. Similar to the base erosion percentage rules, the proposed regulations would treat only US banks as banks for purposes of the increased BEAT tax rate.
18. Prop. Reg. § 1.59A-3(b)(v).
19. Prop. Reg. § 1.59A-3(b)(3)(iii).
20. See Letter from Sarah A. Miller, (former) chief executive officer of the Institute of International Bankers, to Hon. Kevin Brady, Chairman, House Ways and Means Committee (December 7 2017).

## CHAPTER 2

# Overview of financing through exempt offerings

Foreign issuers often find that they would like to access investors in the US without subjecting themselves to the ongoing registration and reporting requirements applicable to public companies in the US. As a result, many foreign issuers consider offering securities to investors in the US 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 two 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 \$5 million.<sup>1</sup> The second, Rule 506, which is the most popular, provides an exemption pursuant to section 4(a)(2) for limited offerings and sales without regard to the 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(b). 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 by adding a new exemption, Rule 506(c), which permits 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 amendments, the SEC established four optional methods 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.

Section 4(a)(2) private placements are attractive to foreign issuers considering offering securities in the US 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 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 US;
- 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 US. 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, 4(a)(1) and 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 sections 2(a)(11) and 4(a)(1) of the Securities Act.
- 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 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 persons reasonably believed to be 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.
- 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. An 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.<sup>2</sup>

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.<sup>3</sup>

### **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, an 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, the section 4(a)(1½) exemption or the section 4(a)(7) 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.<sup>4</sup> 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 for 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.<sup>5</sup> 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.

### **The section 4(a)(7) exemption**

Section 4(a)(7) became effective immediately after the Fixing America's Surface Transportation Act was signed into law on December 4 2015. Section 4(a)(7) provides a resale exemption for certain transactions involving

unregistered resales and partially resembles the section 4(a)(1½) exemption for private resales of restricted securities, although it is more limited in scope. The section 4(a)(7) resale exemption requires, among other things, that (1) each purchaser is an accredited investor, (2) neither the seller nor any person acting on the seller's behalf engages in any form of general solicitation and (3) in the case of an issuer that is not a reporting company, exempt from the reporting requirements pursuant to Rule 12g3-2(b) under the Exchange Act, or a foreign government eligible to register securities on Schedule B, at the request of the seller, the seller and a prospective purchaser obtain from the issuer reasonably current information.

## **Regulation S**

Regulation S represents the SEC's position that securities offered and sold outside of the US 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). These provide that offers and sales made in compliance with certain requirements are deemed to have occurred outside the US and are, therefore, excluded from the application of Section 5. Regulation S is attractive for foreign issuers that may have operations in the US 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 US and Rule 144A offering inside the US, 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 MTN 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 US 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 US or an offering exempt from registration in the US, 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 US 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; or
  - 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 US 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.
  - 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:<sup>6</sup>
- No offer is made to a person in the US.

- 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 US if they (as opposed to the buyer's agent) are physically located outside the US. However, if the buyer is a corporation or investment company, the buyer is deemed to be outside the US when an authorised agent places the buy order while physically situated outside the US. In addition, offers and sales of securities made to persons excluded from the definition of US person, even if physically present in the US, 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.<sup>7</sup> 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 US. 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 US. Therefore, the only restrictions on such transactions are that they must be offshore transactions and that there be no directed selling efforts in the US.
- Categories 2 and 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 S<sup>8</sup> 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 to prevent the flow back of the offered securities into the US. 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, an 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 Categories 1, 2 and 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.<sup>9</sup>

### **Rule 144A/Regulation S**

An 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 US in reliance on Regulation S, even if the initial purchaser contemplates immediate resales to QIBs in the US.

### **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 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 their securities in a private placement to an initial purchaser that

will rely on Rule 144A for resales and contemporaneously offer their 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 US under Regulation S and resell them in the US to QIBs pursuant to Rule 144A during the distribution compliance period.<sup>10</sup> 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 144A<sup>11</sup> (i.e. 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 US 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.<sup>12</sup>

## **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.<sup>13</sup>

## **Section 3(a)(3)**

Most commercial paper is issued in reliance on section 3(a)(3), which 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.’<sup>14</sup> 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’.<sup>15</sup> 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.<sup>16</sup> 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.<sup>17</sup>

The SEC has established through several no-action letters<sup>18</sup> 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.<sup>19</sup> 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.<sup>20</sup>

## ENDNOTES

1. In October 2016, the SEC adopted final rules that, among other things, (1) amended Rule 504 to (a) increase the aggregate amount of securities that may be offered and sold in any 12-month period from \$1 million to \$5 million and (b) disqualify certain bad actors from participating in Rule 504 offerings, and (2) repealed Rule 505 of Regulation D, which had provided a safe harbour from registration for securities offered and sold in any twelve-month period from \$1 million to \$5 million. The repeal of Rule 505 took effect on May 20 2017.
2. Rule 144A(d)(4)(ii)(C) under the Securities Act. *See also* Rule 12g3-2(b) under the Exchange Act.
3. Securities Act Release No. 33-6862, 46 S.E.C. Docket 26 (April 23 1990).
4. 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.
5. 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).
6. Rule 902(h).
7. Rule 902(c).
8. Rule 902(f).
9. *Id.*
10. *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, 66 S.E.C. Docket 1069 (February 17 1998); Securities Act Release No. 33-6863, 46 S.E.C. Docket 52 (April 24 1990).
11. Securities Act Release No. 33-9415 at 57 (July 10 2013).
12. SEC Compliance and Disclosure Interpretation (C&DI) Rule 144A 138.04 (November 13 2013).
13. *See* Chapter 6 (Section 3(a)(2) and considerations for foreign banks financing in the United States).
14. Section 3(a)(3) of the Securities Act, 15 USC. § 77c(a)(3) (2009).
15. Securities Act Release No. 33-4412 (September 20 1961).
16. *Id.*
17. *Id.*
18. *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).
19. *Id.*; C&DI Securities Act Sections 219.02 (November 26 2008).
20. *See* Chapter 8 (Considerations relating to commercial paper).

## CHAPTER 3

# Overview of continuous issuance programmes

### **Overview**

A financial institution 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 reduced amount of documentation required for each issuance. Many foreign issuers may already be familiar with, or have established, global medium-term note (MTN) programmes, euro MTN 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 structured products or covered bonds. A foreign issuer may want to consider setting up a continuous issuance programme that permits it 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 five to seven years or more. Although MTNs typically have maturities of between two and five years, they are not required to have any particular tenor. An issuer may specify the overall amount of debt it will offer from its MTN programme. The issuer will typically work with its arranger to determine an appropriate size for the programme.

An MTN programme relies on 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 of notes. 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) of the Securities Act, 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 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. 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, if a national bank or a federal branch of a non-US bank; 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.<sup>1</sup>

## **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 or a similar 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, Clearstream and other international clearing agencies 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. Issuers frequently 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 as a whole. These procedures typically include a requirement that the new dealer delivers an accession letter or a similar agreement 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 or a similar agreement 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 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 Industry Guide 3 disclosure). Issuers and arrangers rely on the SEC disclosure rules in Regulations S-K 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 from other documents); 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 are typically 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 ranking, any bail-in or similar features that apply under relevant laws, 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 important 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. By doing so, the parties can attempt to ensure that all the relevant selling restrictions are provided for in advance.

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 a final term sheet 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 such as a broker-dealer affiliate of the issuer) 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, one or more opinions of counsel and a comfort letter.

### **Commercial paper**

Commercial paper generally consists of short-term unsecured promissory notes issued by 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 from 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 from 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

**S**ection 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 US. 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 US.

## Section 4(a)(2) private placements

There are a number of ways FPIs can raise capital in the US, including private placements under section 4(a)(2) and Rule 144A offerings. Foreign companies that have a class of their securities registered in the US may also raise capital through public offerings. Under section 4(a)(2), the registration and related prospectus delivery requirements under section 5 of the Securities Act are not applicable. However, the statute itself provides little guidance as to the types of transactions that fall within the scope of section 4(a)(2). 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.<sup>1</sup> 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 pre-existing 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.<sup>2</sup>
- *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. 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 availability of 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. It 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 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 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 is a non-exclusive safe harbour, 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 seven rules—Rules 501 through 504 and Rules 506 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 \$5 million. In October 2016, the SEC adopted final rules that, among other things, (1) amended Rule 504 to (a) increase the aggregate amount of securities that may be offered and sold in any 12-month period from \$1 million to \$5 million and (b) disqualify certain bad actors from participating in Rule 504 offerings, and (2) repealed Rule 505 of Regulation D, which had provided a safe harbour from registration for securities offered and sold in any 12-month period from \$1 million to \$5 million. The repeal of Rule 505 took effect on May 20 2017.
- 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.<sup>3</sup> Although the number of purchasers under Rule 506 is limited to 35, issuers may sell securities under Rule 506 to an unlimited number of AIs which are typically institutional investors or high net-worth individuals.<sup>4</sup> Rule 502(c) permits the use of general solicitation 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. Rule 506(b) does not permit the use of general solicitation, in which case the issuer may offer and sell securities to non-accredited and accredited investors. Rule 506(d) prohibits the use of the exemption by certain bad actors and felons.
- Rule 507 states that no exemption under Rules 504 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 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 or 506. A failure by an issuer to perform a factual inquiry and provide any disclosure regarding bad actor events required by Rules 504 or 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.<sup>5</sup>

The SEC used authority granted by section 3(b) of the Securities Act to establish Rule 504 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, Rule 504 exempts certain offerings with a total size of up to \$5 million. This exemption was created 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) of the Securities Act,

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) of the Securities Act.

### **Information requirements for non-accredited investors**

To use Rule 506, the issuer must provide each non-accredited investor with 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 non-accredited investors with 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 provide non-accredited investors with a brief written description of any material information about the offering that is given to AIs. While disclosure requirements are not applicable to offerings made to AIs, 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. More often than not, issuers will limit their offerings to AIs only and may not produce a disclosure document in connection with the financing.

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 two Regulation D exemptions have the following limitations:

	Rule 504	Rule 506(b)	Rule 506(c)
<b>Maximum size of offering</b>	\$5 million per year.	No limit on size of offering.	No limit on size of offering.
<b>Issuers permitted to rely on this exemption</b>	Non-reporting companies (including foreign private issuers that provide information under Rule 12g-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.	Any issuer. It is used by both reporting companies and nonreporting companies. Rule 506(d) prohibits the use of the exemption by certain bad actors and felons.	Any issuer. It is used by both reporting companies and nonreporting companies. Rule 506(d) prohibits the use of the exemption by certain bad actors and felons.
<b>Types of investors that can buy the securities</b>	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 (who alone or together with their purchaser representatives must be sophisticated investors).	Purchasers must be accredited investors. Issuer must take reasonable steps to verify accredited investor status.
<b>Issuer to furnish certain information?</b>	No.	Yes, to non-accredited investors.	N/A
<b>Prohibition on general solicitation or advertisement?</b>	Yes, subject to the two exceptions provided by Rule 504(b)(1).	Yes.	No.
<b>Bad actor prohibition?</b>	Yes.	Yes.	Yes.
<b>Limitations on resale of securities?</b>	Yes, subject to the two exceptions provided by Rule 504(b)(1).	Yes.	Yes.
<b>Subject to integration?</b>	Yes.	Yes.	Yes.
<b>Form D filing?</b>	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 US whose attendees have been invited by any general solicitation or advertisement.<sup>6</sup> SEC Staff has provided guidance regarding the types of communications that would be viewed as

constituting a general solicitation. Effective September 2013, Rule 502(c) was amended to allow general solicitation 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 still choose to 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 US 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. There also are a number of other specific integration safe harbours.

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 US 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.<sup>7</sup> 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.<sup>8</sup>

### **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 2013, Form D was amended to add a check box to Item 6 for specifying the use of Rule 506(c) (offerings to AIs 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 effort 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 section 4(a)(2) transactions may be structured so that the initial purchasers are all QIBs; in these so-called Rule 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 Rule 144A qualifying section 4(a)(2) private placement are QIBs, the securities will be eligible for settlement and transfer through The Depository Trust Company (DTC).

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.<sup>9</sup> 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) private placement 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) private placement 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. More often than not, the issuer will enter into an engagement letter with the placement agent, which will address the fees and expenses

to be paid by the issuer in connection with the transaction, as well as the term of the engagement. The engagement letter may contain certain basic representations and warranties from the issuer to the placement agent. The engagement letter generally also will provide that the placement agent will receive the benefit of and be entitled to rely on the representations and warranties of the issuer and of the investor made in the securities purchase agreement as well as on any legal opinion delivered by the issuer's counsel to the investors.

### **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 section 4(a)(2) offering to institutional investors.

In a section 4(a)(2) private placement, 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; SEC Release No. 33-4552; and SEC Release No. 33-5121.
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 Rule 504 was promulgated under section 3(b) of the Securities Act.
4. Rule 501 promulgated under Regulation D sets forth the definition of an accredited investor. In order for an individual to qualify as an accredited investor, they 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 their 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; File No. S7-21-11 (September 23 2013).
6. We discuss the SEC Staff's guidance regarding the types of communications that constitute a general solicitation in 'Practice Pointers on Navigating the Securities Act's Prohibition on General Solicitation and General Advertising,' available at <https://media2.mofo.com/documents/160600practicepointersgeneralsolicitation.pdf>
7. See SEC Release No. 33-8828 and the Black Box Incorporated (June 26 1990) and Squadron, Ellenoff, Pleasant & Lehrer (February 28 1992) SEC no-action letters.
8. *Id.*
9. 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 the US capital markets without becoming subject to US reporting requirements;
- offerings of common stock by private, non-reporting issuers (that is, Rule 144A equity 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 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 that is acting as 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 are registered under the Securities Act, any resale may be made only under 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). However 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 under Rule 144A as well as other available exemptions, including the hybrid section 4(a)(1½) exemption, Rule 144 or in a secondary private placement.

## Debt offerings

Both equity and debt can be issued under Rule 144A. However, 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;
- 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 special purpose vehicles (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 US securities 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 (or no) 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 US. 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 whether 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.

Rule 144A combined offerings are often focused on the US market. In such a 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 filings or review. A fully marketed Rule 144A transaction typically includes:

- preparation of the preliminary offering memorandum and performance of necessary due diligence by the initial purchasers;<sup>1</sup>
- 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 paying agency agreement, if debt securities are being offered (see the section below, Debt instrument documents) 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 after the initial settlement; 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 the purchase agreement 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 two to five business days after pricing; and
- at closing, execution, delivery and filing, as applicable, of any indenture or pay agency agreement, 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. 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 (or fiscal and paying agency agreement);
- 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, credit 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.<sup>2</sup> 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 defence against potential liabilities of the issuer and the initial purchasers for violations of the antifraud provisions of the US securities laws and assist in the marketing of the securities.<sup>3</sup>

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 and Form S-1 or S-3 set forth the specific matters that the SEC requires in a registered offering by domestic issuers, and Form F-1 or F-3 and Form 20-F set 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. 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 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.
- If the securities are debt securities or American depositary receipts (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, typically as to the relevant securities law requirements.

### **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. An indenture is frequently used; however, 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 these 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 stating 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 (or incorporated by reference) 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 that 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 jurisdictions 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 extent 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 anti-fraud provisions of the US securities laws apply to Rule 144A offerings,<sup>4</sup> 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.<sup>5</sup> 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.

### **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.<sup>6</sup> While this is an apparent advantage for them, they must still be mindful of the anti-fraud 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 (e.g. 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 to condition 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 became 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 harbour, such as Rule 135e under the Securities Act in respect of any offshore activities for a 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 US, conducting meetings with issuer or selling security holder representatives outside the US, or providing written press-related materials released (and received by the recipient)

outside the US. 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.

### **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 their 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 closing of 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 anti-fraud 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 sections 11 or 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 the 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 anti-fraud 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. In addition, section 17(a) of the Securities Act is a general antifraud provision that provides, among other things, that it is unlawful for any person in the offer and sale of securities to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of 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 defences. While the anti-fraud 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. For more information, *see* 'Liability concerns' below.
3. 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 anti-fraud or other provisions of the US federal securities laws.
4. For more information, *see* 'Liability concerns' below.
5. The definition of issuer for purposes of Regulation FD in Rule 101(b) excludes foreign governments and foreign private issuers, each as defined in Rule 405 under the Securities Act.
6. For more information, *see* 'Liability concerns' below.

## CHAPTER 6

# Section 3(a)(2) and considerations for foreign banks financing in the US

**S**ection 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, even in the absence of the federal securities registration requirements. 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 US under licences granted either by the Office of the Comptroller of the Currency (OCC) 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 Bankruptcy 964, 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 passbook 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 US were those licensed by states. Under the IBA, a foreign bank can establish a federal branch or agency licensed and supervised by the OCC. 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 their securities.

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.<sup>1</sup> 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 US 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 interpretative 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 considered to be 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.<sup>2</sup> 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 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 letter<sup>3</sup> 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.<sup>4</sup>

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.<sup>5</sup>

Section 3(a)(2) bank notes are not considered restricted securities, as would debt securities issued by a bank or its US branch under Rule 144A under the Securities Act. Accordingly, section 3(a)(2) bank notes are typically eligible for inclusion in indices that measure the performance of investment grade debt securities. This factor tends to increase their marketability.

## OCC registration

Notwithstanding the exemption from SEC 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. As a result, many banks seek to utilise an exemption from this registration process.

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 US.

Amendments to Rule 144A and Rule 506 of Regulation D allow 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.

Rule 506 now includes disqualification provisions, which prohibit the use of the exemption by certain bad actors and felons. These 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 OCC 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.
- The offering document and any amendments are filed with the OCC no later than the fifth business day after they are first used.

The definition of investment grade under Part 16.6 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).<sup>6</sup> 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).<sup>7</sup> 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, satisfies (i) 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 sections 11 and 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 complex 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.

For more information on blue sky laws, see Chapter 11.

### **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.

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.’<sup>8</sup> Some third party commentary also advocates the issuance of subordinated debt of banks only in large denominations.<sup>9</sup> The reasoning behind this position is that securities issued in increments in excess of, for example, \$250,000 (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 purchasers in minimum denominations of \$100,000.<sup>10</sup>

### **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 US 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 standalone 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, their respective counsels, 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 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 (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, certain 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).<sup>11</sup> 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. Needless to say, issuers and distributors of these types of securities exercise caution in terms of drafting the relevant disclosure documents, and ensuring the suitability of the relevant investors.
5. As new benchmark rates emerge in the international capital markets, these rates will likely find their way into bank note offerings as well.
6. See 61 Fed. Reg. 46808, September 5 1996. The policy was most recently revised in September 1996, and may be found at [www.fdic.gov/regulations/laws/rules/5000-500.html#fdic5000statementop](http://www.fdic.gov/regulations/laws/rules/5000-500.html#fdic5000statementop)
7. These requirements can be found at 12 C.F.R. 563g.
8. Federal Register, Vol. 73, No. 80, April 24 2008, at 22228.
9. See Statement of the Shadow Financial Regulatory Committee Meeting (Washington), March 2 2000.
10. N.Y. Banking Law § 202-a(1); N.Y. Comp. Codes R. & Regs. tit. 3, §§ 81.1-3.
11. 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

**F**oreign bank branches in the United States, federally or state-licensed, may exercise banking powers, such as accepting certain types of deposits.

Before December 19 1991, foreign bank branches could accept both retail and wholesale deposits. Starting on that date, however, although foreign bank branches may receive deposits of any size from foreigners, the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA) prohibited these branches from accepting or maintaining deposits of less than the standard maximum deposit insurance amount (\$250,000 as of 2018) 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 the standard maximum deposit insurance amount.<sup>1</sup>

Furthermore, after FBSEA, deposits in any foreign bank branch established after December 19 1991, are not covered by FDIC deposit insurance.

## When is a certificate of deposit a security?

A certificate of deposit (CD) is a type of deposit account with a bank that typically offers a higher rate of interest than a regular savings account. Under relevant federal judicial and regulatory guidance, a CD insured by the FDIC is generally not considered a security under the federal securities laws and 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 domestic banks.<sup>2</sup> However, there are limited circumstances in which courts have characterised certain CDs as securities.

In *Marine Bank v. Weaver*,<sup>3</sup> 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. It 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 banking laws. 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 instruments in question, the purposes intended to be served, and the factual setting as a whole'.<sup>4</sup>

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*.<sup>5</sup> 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) profit 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 purposes of the antifraud provisions of the Securities Act and the Exchange Act. Consequently, the additional protections of those antifraud 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**

Certificates of deposit 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 laws (also commonly referred to as 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-charted banks is insured by the FDIC but 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 (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.

An investment in structured CDs may give rise to 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 their 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 unfavourably, 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 realised 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 their 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 in many respects 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), a short-term, non-convertible debt typically issued by US and non-US banks, financial companies and other large, investment grade companies. Commercial paper issuers typically establish CP programmes to allow frequent, often daily, issuances on short notice. These programmes are similar to MTN programmes, where the main programme documentation, due diligence and deliverables are provided upon the CP programme's establishment. Commercial paper is not registered under the Securities Act and may be 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 using the resale exemption provided under Rule 144A of the Securities Act.

## What is commercial paper?

CP is a promissory note with a maturity of nine months or less, although typically with a maturity of 30 days or less. It is generally unsecured, issued in large denominations (\$100,000 or more) and sold in book-entry form at a discount from face value. Although CP typically is issued as a non-interest bearing security, it is sometimes offered in interest bearing form. As a result of its unregistered nature, CP is mainly purchased by institutional investors, including money market funds, insurance companies and banks. Purchasers are almost always either QIBs or institutional AIs (IAIs).

CP is an attractive funding instrument because it provides short-term liquidity and can be rolled over at maturity. 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 meet their payment obligations in the event of a disruption in the CP market, issuers maintain undrawn, revolving credit facilities or bank letters of credit in amounts equal to the maximum amounts of CP issuable

under their programmes. Issuers will not borrow under these credit facilities unless they are unable to repay maturing CP with new issuances or other available cash.

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 under the exemption provided by section 3(a)(2) for bank-issued securities. A letter of credit is an unconditional obligation of the issuing bank to pay out of its own funds maturing CP, in exchange for a fee which is a certain percentage of the amount of CP issued. Most letters of credit are direct-pay (i.e. the letter of credit bank pays the CP holders and the issuer or the issuer's parent reimburses the letter of credit bank pursuant to a reimbursement agreement). The other type of letter of credit is a stand-by letter of credit. Under a stand-by letter of credit, the letter of credit bank must pay only in the event that the issuer does not. Due to certain negative case law, the short-term nature of CP and the expectation of CP investors to quickly receive interest, if applicable, and principal payments, a stand-by letter of credit is not as popular with CP investors as a direct-pay letter of credit.

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.

Although the majority of CP issued by operating companies is unsecured, CP can also be asset-backed commercial paper (ABCP), in which case a bankruptcy-remote SPV or conduit is established to act as the issuer. The SPV uses the proceeds of an ABCP issuance primarily to purchase interests in various types of assets. Repayment of the ABCP issued by the conduit depends primarily on the cash collections received from the assets purchased and the conduit's ability to issue new ABCP. Typically, a bank or other financial institution will provide liquidity support to bridge the situation where maturing ABCP cannot be financed by the issuance of new ABCP due to 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**

Because of its short-term nature and frequent issuance, it is not practical to register CP under the Securities Act. Consequently, CP is issued pursuant to the exemption from registration under section 3(a)(3) or in a private placement pursuant to section 4(a)(2) using the resale exemption provided under Rule 144A. As such, a CP programme is usually structured as a section 3(a)(3) programme or a Rule 144A programme. In addition, CP can also benefit from the exemption provided by section 3(a)(2) of the Securities Act for securities that are either issued or guaranteed by a bank or supported by a letter of credit from a bank.

### **Section 3(a)(3) exemption requirements**

Section 3(a)(3) itself is brief and exempts from registration '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'. An SEC interpretive release and subsequent SEC no-action letters have established the following four criteria that must be satisfied:

The CP should:

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

The prime quality requirement has customarily been satisfied on the basis of ratings of the CP by nationally recognised rating services.<sup>1</sup> 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 issuer could obtain a committed 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)(3) 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 usually sold in much higher denominations. Purchasers of CP usually are required to be institutional investors or sophisticated individuals who would qualify as purchasers in a section 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 section 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, using CP to finance 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 no longer than one year will satisfy the current transaction requirement.

In those cases where it is not possible to trace the application of proceeds to particular uses, the SEC has accepted the use of limits on the amount of CP to be 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 use a balance sheet test for determining such CP capacity whereby the 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 section 3(a)(3) exemption is an exemption for the CP notes themselves. Therefore, if the conditions are met, there is no need for the issuer or secondary market resellers to ensure that each sale or presale of CP notes qualified as a private placement in accordance with the Securities Act. Consequently, section 3(a)(3) programmes are often preferred to section 4(a)(2) programmes. However, issuers often are unable to use the section 3(a)(3) exemption because they plan to use the proceeds for purposes that do not clearly meet the current transactions requirement or the CP will have a maturity longer than nine months. Some issuers maintain simultaneous section 3(a)(3) programmes and section 4(a)(2) programmes, and issue CP under a section 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 purposes are distinct the proceeds of the two programmes are segregated.

## **Section 4(a)(2) exemption requirements**

Section 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 from registration under section 4(a)(2) or the safe harbour provided by Rule 506 under Regulation D.

Under Rule 506(b) of Regulation D, an issuer can be assured it is within the section 4(a)(2) exemption by satisfying the following standards:

- The issuer cannot use general solicitation or advertising to market the securities.
- The issuer may sell its securities to an unlimited number of accredited investors and up to 35 other purchasers (all non-accredited investors, either alone or with a purchaser representative, must be sophisticated).
- The issuer must decide what information to give to accredited investors, so long as it does not violate the anti-fraud prohibitions of the federal securities laws (but the issuer must give non-accredited investors disclosure documents that are generally similar to, but briefer than, those used in registered offerings, which in some cases may need to be certified or audited by an accountant, and if the issuer provides information to accredited investors, it must make this information available to non-accredited investors as well).
- The issuer must be available to answer questions by prospective purchasers.

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 so-called section 4(a)(1½) exemption. In addition, resales of CP by dealers (including dealers no longer acting as underwriters with respect to such CP) to IAIs 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 section 4(a)(2) programme issuer (or a guarantor) of a section 4(a)(2) programme, must comply with the information requirements of Rule 144A(d)(4). Section 4(a)(2) programme issuers undertake to comply with these requirements by including such information in the private placement memorandum (PPM) for the programme. However, public companies will automatically comply if they continue to file reports under the Securities Exchange Act of 1934, as amended (Exchange Act). Section 4(a)(2) programme PPMs typically 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 and when sales are made to AIs under Regulation D such an offer is required in accordance with Rule 502(b)(2)(v) under Regulation D.

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

An issuer may decide to structure its CP programme as a section 4(a)(2) programme in order to avoid the current transactions test and the 270-day limitation on maturity under section 3(a)(3). An issuer of CP under a section 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). The CP notes issued under a section 4(a)(2) programme also are not subject to the 270-day maturity limitation, although their maturity will still be limited by marketability and by concerns under the Investment Company Act. Though a section 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. Any CP with a longer maturity is generally not marketed, 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, however, can provide the issuer with an exemption from registration under the Investment Company Act.

It is not uncommon for issuers to convert section 3(a)(3) CP programmes to section 4(a)(2) programmes, particularly if the issuer would like to use the CP programme to fund an acquisition. In such a case, there is a concern with avoiding integration of the resulting section 4(a)(2) programme with the issuer's other offerings and programmes. However, this concern is addressed by covenants in the dealer agreement whereby the CP issuer agrees for a six-month period to use CP proceeds for current transactions and to issue CP with maturities of nine months or less. Some issuers also simultaneously maintain a section 3(a)(3) programme and a section 4(a)(2) programme. In such a case, there has to be careful segregation of the proceeds of each programme and the use of proceeds of each programme needs to be distinct due to the current transactions requirement under section 3(a)(3).

#### **Disadvantages of a section 4(a)(2) programme**

The drawbacks to a section 4(a)(2) programme are mostly due to the fact that section 4(a)(2) CP notes, unlike section 3(a)(3) CP or section 3(a)(2) CP, are restricted securities. As a result, each resale must be exempt from registration because CP notes sold in a section 4(a)(2) programme are privately placed. Each resale of the CP, including each resale by a purchaser in the secondary market, must be made in a transaction exempt from the registration requirement. 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 section 4(a)(2) programmes, the PPM will specify that purchasers can resell their CP only to QIBs under Rule 144A or to the issuer or a programme dealer. The issuer or dealers can resell CP they reacquire using the same exemption used in the original sale, if desired. In addition, section 4(a)(2) CP is generally sold in larger minimum denominations than section 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 section 4(a)(2) programme also requires additional language regarding the section 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 deemed representations of the purchasers of the CP, 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 section 4(a)(2) programme, is subject to Regulation T, which imposes limitations on the use of proceeds. The form dealer agreement of the Securities Industry and Financial Markets Association (SIFMA) for section 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**

Often issuers have not relied on Rule 144A in order that privately placed CP could be sold to purchasers who are not QIBs. Instead, Regulation D was used to permit sales to AIs. However, if the CP is sold to QIBs, then CP issuers may structure their programmes so that dealers may use Rule 144A for sales of CP so long as the other requirements of Rule 144A are met, 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, nor a foreign issuer exempt from reporting pursuant to Rule 12g3-2(b) of the Exchange Act, nor 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 section 3(a)(3) programme (for example, offering memorandum, dealer agreement, issuing and payment agent agreement, master note and the like). This means that a section 3(a)(3) programme could be converted over to a Rule 144A programme with relative ease.<sup>2</sup>

#### **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 section 3(a)(3) CP. This explains why section 3(a)(3) 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.

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

In order to establish a CP programme, the issuer will need an issuing and paying agent (IPA), which is a third-party trust company or bank that serves a function somewhat like a trustee under an indenture. The IPA plays various roles under a CP programme, including coordinating settlement of CP notes with 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. More often, CP dealers instead rely on the opinion delivered to them by issuer's counsel, in contrast to other types of offerings (for example, term securities under Rule 144A/Regulation S offerings, section 4(a)(2) private placements and section 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 separate 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. Key documents are the PPM, the dealer agreement, the issuing and paying agent agreement, the master note, the guarantee, if any, 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 because, due to the short-term nature of CP, 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 short-term nature of CP and to the fact that CP must be highly rated to be marketable. 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.

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 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 section 4(a)(2) programme, the PPM also will include the deemed representation of the purchasers that they are AIs and the limitations on transfer of the notes. Similarly, in a Rule 144A programme, the offering memorandum also will include the deemed representation of the purchasers that they are QIBs. The actual terms of a CP note are disclosed in a confirmation of purchase.

CP programmes may have one or more dealers. If there is more than one dealer, the CP issuer is generally expected to provide each dealer 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 in a section 4(a)(2) or Rule 144A programme) governs the relationship between the CP issuer and the dealers for the duration of the CP programme and sets the manner of sale of CP to or

through the dealers. The dealers' role is to locate investors and to advise the CP issuer regarding potential investors and offering procedures. The dealers also coordinate with the ratings agencies as most CP is rated by rating agencies.

SIFMA has published model dealer agreements for section 3(a)(3) programmes and section 4(a)(2) programmes.<sup>3</sup> 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 signing, 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 related to the PPM. 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. 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 for acting as principal or agent by paying them a fee based on the amount of CP purchased by the dealers. 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.

Upon signing, the dealer agreement also requires the CP issuer to deliver 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, it 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, 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 standard and non-controversial.

### **Master note**

The CP issued under a 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 in book-entry form 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 settled in book-entry form through the facilities of DTC.

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 CP issuance are recorded in the IPA's records. 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 section 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.

### **Guarantee**

When an investment grade issuer establishes a CP programme through a subsidiary (as is often 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 some 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) the exemption from 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 and lend the proceeds to the parent. In such cases, it is likely that the CP issuer will fall within the definition of an investment company under the Investment Company Act. Therefore, the CP issuer will need to avail itself of an applicable exemption from registration under the Investment Company Act. Some common exemptions used for CP issuance include Rule 3a-5 (an exemption for certain finance subsidiaries) and Rule 3a-3 (available only if the CP issuer has only short-term securities with maturities of 270 days or less outstanding). Sections 3(c)(1) and 3(c)(7) of the Investment Company Act also provide exemptions for issuers that issue only short-term CP. However, use of sections 3(c)(1) or 3(c)(7) may raise considerations under the Volcker Rule. In addition, 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.

### Amendments to Rule 2a-7

Money market funds, which have traditionally been major purchasers of CP, had previously been subject to restrictions under Rule 2a-7 under the Investment Company Act that limited their ability to invest in securities that are not in the two highest rating categories. In March 2011, the SEC proposed amendments to Rule 2a-7 to remove references to credit ratings. The amendments were intended to implement the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), specifically section 939A, which is designed to reduce reliance on credit ratings in response to the financial crisis of 2008. The SEC re-proposed these amendments in July 2014 and adopted them in September 2015. Under the amendments, money market fund boards (or their delegates) must determine that portfolio securities have minimal credit risk and apply a four-pronged test instead of relying in part on objective standards, such as credit ratings. In addition, other money market reforms, including the requirement of a basis point floating net asset value (NAV) per share on institutional prime and tax-exempt money market funds and the imposition of liquidity fees and redemption gates, which were adopted in July 2014, have resulted in money market funds moving away from CP in order to improve liquidity. Since the effectiveness of these money market reforms in October 2016, approximately \$1 trillion of funds have moved away from CP, which is significant given that the size of the money market fund industry is approximately \$2.6 trillion according to Bloomberg Markets.

The amendments to Rule 2a-7 also included the removal from the rule's issuer diversification requirement the exclusion for securities that are guaranteed by a non-controlled person. Accordingly, a money market fund is required to limit its investments in securities of a non-governmental issuer to no more than five percent of the money market fund's total assets, regardless of whether or not the security is guaranteed by a non-controlled person.

**Comparison of section 3(a)(3) programmes and section 4(a)(2) programmes**

Offering Exemption	Requirements	Advantages	Disadvantages	Investors	Listing	Settlement
Section 3(a)(3)	<ul style="list-style-type: none"> <li>• CP must:</li> <li>• be of prime quality and negotiable;</li> <li>• be of a type not ordinarily purchased by the general public;</li> <li>• be of a type eligible for discounting by Federal Reserve banks;</li> <li>• have a maturity not exceeding nine months; and</li> <li>• be issued to facilitate current transactions.</li> </ul>	<ul style="list-style-type: none"> <li>• CP is not restricted.</li> <li>• No need for the issuer or secondary market resellers to ensure that each sale of CP is a private placement.</li> <li>• Can use general solicitation.</li> </ul>	<ul style="list-style-type: none"> <li>• Must satisfy the current transactions requirement.</li> <li>• Cannot have a maturity longer than nine months.</li> </ul>	Institutional money market investors	None	DTC
Section 4(a)(2)	<ul style="list-style-type: none"> <li>• Cannot use general solicitation.</li> <li>• Dealers must resell securities to QIBs.</li> <li>• Issuer must be available to answer questions by prospective purchasers.</li> <li>• Financial information must be furnished under Rule 144A(d)(4).</li> </ul>	<ul style="list-style-type: none"> <li>• No current transactions requirement.</li> <li>• Can have a maturity longer than nine months.</li> </ul>	<ul style="list-style-type: none"> <li>• CP is restricted (although resales permitted under Rule 144A).</li> <li>• Cannot use general solicitation.</li> <li>• Potential integration with other private placements.</li> </ul>	Institutional money market investors	None	DTC

## ENDNOTES

1. Standard & Poor's, Moody's and Fitch utilise three generic short-term ratings, which apply to CP, in order of credit quality from high to low: tier-1, tier-2, and tier-3. Standard & Poor's and Fitch have also used a plus (+) with respect to their tier-1 rating to denote overwhelming safety. Since the analytical approach in assigning a short-term rating is virtually identical to the one followed in assigning a term debt rating (i.e. medium-term note and/or long-term bond), a strong link or correlation between an issuer's short-term and term debt ratings has evolved for the rating agencies, as follows:

<b>Term rating</b>	<b>CP rating</b>
AAA to AA	Tier-1+
AA- to A	Tier-1
A- to BBB	Tier-2
BBB- and lower	Tier-3 and lower

2. For more information regarding Rule 144A, see Chapter 5 (Mechanics of a Rule 144A/Regulation S offering). A conversion of a section 3(a)(3) programme must be handled with care to avoid an integration problem.
3. These forms are available at [www.sifma.org/services/standard-forms-and-documentation/corporate-credit-and-money-markets/](http://www.sifma.org/services/standard-forms-and-documentation/corporate-credit-and-money-markets/).

## CHAPTER 9

# Exchange Act registration

**F**oreign companies realise a number of benefits by being a public company in the US. 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 US. 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 an FPI?

As discussed in Chapter 1, 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.<sup>1</sup> 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 US, unless more than 50% of the issuer's outstanding voting securities are held directly or indirectly by residents of the US, 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 US.<sup>2</sup>

## Methodology for calculating voting securities held by US residents

Securities held of record by a broker, dealer, bank, or nominee for the accounts of customers residing in the US are counted as held in the US by the number of separate

accounts for which the securities are held. In addition, a foreign issuer also must treat as owned of record by US residents any shares reported as beneficially owned by a US resident in a filing made under section 13(d) of the Exchange Act or any comparable reporting provision of another country. This method of calculating record ownership differs from the method a US domestic issuer is permitted to use in its determination of the number of record owners for purposes of section 12(g) of the Exchange Act, which counts only record owners and not beneficial owners holding securities in street name. Rule 12g3-2(a) under the Exchange Act. A foreign issuer that maintains multiple voting classes may use one of two methods to determine whether its voting stock is owned by more than 50% of US residents by assessing: (1) whether 50% of the voting power of those classes on a combined basis is directly or indirectly owned of record by residents of the US; or (2) the number of voting securities. While the SEC staff has not expressed a preference for either methodology, it has affirmed that a foreign issuer must apply a determination methodology on a consistent basis.<sup>3</sup>

While a person who has permanent resident status (i.e. a Green Card holder) is presumed to be a US resident, the SEC staff has explained that individuals without permanent resident status may also be deemed US residents (for purposes of Rule 405 and Rule 3b-4(c)) based on the following criteria:

- tax residency;
- nationality;
- mailing address;
- physical presence;
- the location of a significant portion of the person's financial and legal relationships; or
- immigration status.

While the SEC staff has not mandated the use of any one of these criteria, it has asserted that a foreign issuer must nevertheless decide what criteria it will use to determine residency and apply them consistently without changing them to achieve a desired result.<sup>4</sup>

## Determining US citizenship or residency of officers and directors

For purposes of determining whether a majority of a foreign issuer's executive officers or directors are US residents or citizens under Rule 405 and Rule 3b-4(c), the SEC staff has clarified that the calculation must be made separately for each of its directors and officers. Accordingly, a foreign issuer must make the following four determinations under Rule 405 and Rule 3b-4(c):

- the citizenship status of its executive officers;
- the residency status of its executive officers;
- the citizenship status of its directors; and
- the residency status of its directors.

In the case of a foreign issuer that maintains two boards of directors, the foreign issuer must make the majority analysis with respect to the board of directors that performs functions that closely resemble those undertaken by a US-style board of directors. If such functions are allocated to both boards, then the foreign issuer may aggregate the members of both boards for purposes of calculating the majority.<sup>5</sup>

## Determining the location of assets in the US

To determine whether more than 50% of a foreign issuer's assets are located in the US, the SEC staff has clarified that a foreign issuer may either:

- use the geographic segment information determined in the preparation of its financial statements; or
- apply on a consistent basis any other reasonable methodology in assessing the location and amount of its assets.<sup>6</sup>

## Determining whether the business is administered principally in the US

There is no particular factor that is determinative for evaluating whether a foreign issuer's business is administered principally in the US under Rule 405 and Rule 3b-4(c). Instead, a foreign issuer must assess on a consolidated basis the location from which its officers, partners or managers primarily direct, control and coordinate its activities. For example, absent any other factors, an issuer that holds an annual (or special) meeting of its shareholders or occasional meetings of its board of directors in the US would not be deemed to be administering its business principally in the US.<sup>7</sup>

## When is FPI status determined?

An FPI is only required to determine its status on the last business day of the most recently completed second fiscal quarter, rather than on a continuous basis. An 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).<sup>8</sup> However, a foreign company that obtains FPI status following an annual qualification test can avail itself of the benefits of FPI status immediately. Note that if an FPI loses its status as an 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.<sup>9</sup>

## How does an FPI become subject to US reporting requirements?

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

- Foreign private issuers 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.<sup>10</sup> 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 must also 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.
- An FPI may also 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 US. 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).

- An 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, an 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 an FPI once it becomes public**

Once an 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 burden on FPIs that become public companies. The 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 the 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.

An FPI may, pursuant to Rule 12b-23 under the Exchange Act, incorporate by reference information

previously filed with the SEC into any item of its annual report on Form 20-F, subject to certain limitations set forth under Rule 12b-23. A FPI that elects to incorporate such information by reference must, however, identify with specificity the information that is being incorporated by reference.<sup>11</sup> An FPI's wholly owned subsidiary may also omit certain information under General Instruction I(2) (to Form 10-K) from its annual report on Form 20-F, as long as the registrant includes a prominent statement on the Form 20-F's cover page that it satisfies the conditions set forth under General Instruction I(1)(a) and (b) to Form 10-K and is therefore filing the Form 20-F with a reduced disclosure format.<sup>12</sup>

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. An FPI may also be required to disclose specialised information. For example, the 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.

The FPI has four months after the end of its fiscal year to file an annual report on Form 20-F.<sup>13</sup> However, if the Form 20-F is incorporated by reference to an 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.<sup>14</sup> 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, an 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 an FPI, and may include press releases, security holder reports and other materials that an 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, an 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 an 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.

## Accommodations under US securities laws

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

- *Annual report filings:* Currently, an 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:* An FPI is not required under US federal securities laws to file or make publicly available quarterly financial information, subject to certain exceptions. An FPI with a class of securities listed on the NYSE must submit semi-annual unaudited financial information under cover of Form 6-K within six months following the end of the second fiscal quarter. In contrast, US domestic issuers are required to file unaudited financial information on quarterly reports on Form 10-Q.
- *Proxy solicitations:* An 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 an FPI's audit committee or permitted alternative.

• *Internal control reporting:* Both an 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 an 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:* An FPI is exempt from the detailed disclosure requirements regarding individual executive compensation and compensation plan analysis now required by the SEC. An 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, an 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 an 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:* An FPI may prepare its financial statements in accordance with IFRS as issued by the International Accounting Standards Board (IASB) without reconciliation to US GAAP. Non-US filers reporting under US GAAP are required to include in their Form 20-F their financial statements in an interactive data format based on eXtensible Business Reporting Language (XBRL). In March 2017, the SEC made available an XBRL taxonomy for IFRS financial statements. As a result of the availability of the taxonomy, FPIs that prepare their financial statements under IFRS as issued by the IASB must file their financial statements in XBRL for fiscal years ending on or after December 15 2017.

• *Confidential submissions:* Under SEC guidance issued in December 2011 and amended in May 2012 (the 2012 Guidance), an 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. Prior to July 10 2017, US domestic issuers were required to file all registration statements publicly on the electronic data gathering and retrieval system (EDGAR). If an FPI does not meet the requirements of the 2012 Guidance, 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 15 days prior to the FPI's commencement of the road show.<sup>15</sup> In June 2017, the SEC staff announced a new policy to make the confidential submission process for registration statements more broadly available. Since July 10 2017, all companies, including FPIs and Canadian issuers that rely on the Multijurisdictional Disclosure System, may submit draft IPO registration statements for confidential review.<sup>16</sup> Therefore, FPIs may elect to benefit from this new guidance, the procedures available to EGCs (if they so qualify) or the 2012 Guidance.

- ***Exemption from Exchange Act reporting:*** An FPI may be automatically exempt from Exchange Act reporting obligations if the FPI satisfies certain conditions.
- ***Easy termination of registration/de-registration:*** An 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**

An 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.<sup>17</sup> 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. An 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<sup>18</sup>.

Item 18(b) of Form 20-F grants a limited exemption to the aforementioned 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 an 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 an 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.

Where an FPI guarantees securities of its non-FPI subsidiary, the parent FPI (as guarantor) and non-FPI subsidiary (as issuer) may use an F-Series registration statement to register the offering of the securities under the Securities Act and use Form 20-F with respect to any reporting obligations, as long as certain requirements are satisfied.

Where the parent-guarantor and subsidiary-issuer are eligible to present condensed consolidated financial information in the parent-guarantor's filings, and the parent qualifies as an FPI, the parent-guarantor and its subsidiaries may use:

- an F-Series registration statement to register an offering of guarantees and guaranteed securities that are issued by a subsidiary (either domestic or foreign) that does not itself qualify as an FPI; and
- a Form 20-F with respect to any reporting obligations associated with the F-Series registration statement.

The subsidiary-issuer would not be required to submit separate financial statements if any of Rules 3-10(b) through 3-10(d) under Regulation S-X apply and all other applicable conditions of the rule(s) are satisfied by the parent FPI's filings (as guarantor). The SEC staff has further explained that the same would apply in the case of a parent-guarantor and subsidiary-issuer that were eligible to present narrative disclosures (as opposed to condensed consolidating financial information) under Rule 3-10 under Regulation S-X.<sup>19</sup>

Where a parent FPI issues securities that are guaranteed (or co-issued) by one or more of its non-FPI subsidiaries, the parent FPI and subsidiary guarantor(s) (or co-issuers) may still use an F-Series registration statement to register the offering under the Securities Act and use Form 20-F

with respect to reporting obligations. Separate financial statements will not be required to be filed for the parent's subsidiaries if:

- Rule 3-10(e) or 3-10(f) under Regulation S-X applies; and
- all applicable conditions of Rule 3-10 under Regulation S-X relied upon are satisfied in the parent's filings.<sup>20</sup>

### **Rule 12g3-2(b) exemption**

Rule 12g3-2(b) under the Exchange Act exempts certain FPIs that have sold securities in the US 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. An FPI can claim an exemption under Rule 12g3-2(b) if:

- it is not required to file or furnish reports under sections 13(a) or 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 US 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.

An 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 ADRs (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 an 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 an 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.
- 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

An 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. An 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 an FPI. Under Item 15(b), an 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 an 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 an 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 US national securities exchanges, separately, through statutes, rules and regulations, govern corporate governance practices in the US. However, an FPI registered in the US 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, an 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 an 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, an 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 an 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 an 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 an FPI that prefers following its home country practices in lieu of the exchange's rules. For example, under Nasdaq rules, an 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. An 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, an 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 an 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 an 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 an 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.

Sections 13(d) and 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 five percent of the FPI's equity securities (whether held directly or indirectly). Each five percent 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 the 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 five percent 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 five percent shareholders before the equity securities were registered.

### **Reporting on Schedule 13D**

Once an FPI becomes public in the US, any person that acquires five percent or more of its equity securities or any exempt shareholder that acquires more than two percent 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 five percent 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; and
- 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 one percent 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 an FPI (but more than five percent) 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; and
- 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 five percent in its beneficial ownership of the FPI's equity securities.

### American Depository Receipts

An 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. It can represent one or more shares, or a fraction of a share, of an FPI, and is 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 an 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, these are traded in the US over-the-counter market with prices published in the OTC Pink (formerly the Pink Sheets).<sup>21</sup> 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 an 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, an 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, an 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 an 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 US 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. Securities Act Rules C&DIIs, Question No. 203.17; Exchange Act Rules C&DIIs, Question No. 110.02.
4. Securities Act Rules C&DIIs, Question No. 203.18; Exchange Act Rules C&DIIs, Question No. 110.03.
5. Securities Act Rules C&DIIs, Question Nos. 203.19 and 203.20; Exchange Act Rules C&DIIs, Question Nos. 110.04 and 110.05.
6. Securities Act Rules C&DIIs, Question No. 203.21; Exchange Act Rules C&DIIs, Question No. 110.06.
7. Securities Act Rules C&DIIs, Question Nos. 203.22 and 203.23; Exchange Act Rules C&DIIs, Question Nos. 110.07 and 110.08.
8. SEC Release No. 33-8959 (September 23 2008).
9. *Financial Reporting Manual*, Division of Corporate Finance, Topic 6120.2, available at [www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml](http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml).
10. A listing without a capital raise is commonly referred to as a direct listing. Given the new SEC policy permitting issuers, including FPIs, to submit for confidential review a Form 20-F, which is discussed below, it is now easier to undertake a direct listing.
11. Exchange Act Forms C&Ds, Question No. 110.07.
12. Exchange Act Forms C&Ds, Question No. 110.06.
13. In the case of a FPI whose last day of its fiscal year is the last day of the month (e.g. February 28), the Annual Report on Form 20-F will be due four complete months after that day. Exchange Act Forms C&DIIs, Question No. 110.05.
14. Item 8.A.4 of Form 20-F.
15. An EGC is defined as an issuer with total gross revenues of under \$1.07 billion (adjusted from \$1 billion in March 2017, and 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 \$1.07 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.
16. 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).
17. An FPI that relies on the accommodations available to EGCs or on this new policy will have to comply with the requirement to file publicly at least 15 days prior to commencement of its roadshow, which would not apply under the 2012 Guidance. The SEC did not extend any of the other JOBS Act benefits (i.e. the ability to test the waters or reduced disclosure requirements) to non-EGC IPO issuers. However, the new policy does permit an IPO issuer to omit financial information that the issuer reasonably believes will not be required at the time that the registration statement is publicly filed. The SEC also extended the ability to make confidential submissions for EGCs and other issuers in connection with offerings undertaken within the first 12 months after the issuer has become an SEC-reporting company. In the case of a follow-on offering within the first 12 months following the effective date of the IPO or an Exchange Act section 12(b) registration statement, the issuer must file publicly at least 48 hours prior to any requested effective time and date. An issuer relying on the confidential submission process for follow-on offerings cannot file amendments on a confidential basis, it can only make the first submission of the follow-on registration statement on a confidential basis. In addition, the SEC also will permit an issuer to submit for confidential review a registration statement filed to register a class of securities under the Exchange Act, such as a registration statement on Form 20-F for an FPI. An issuer must publicly file an Exchange Act registration statement at least 15 days prior to seeking its effectiveness.
18. However, an 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 \$250 million (adjusted from \$75 million in September 2018) or, in the case of an issuer that has no public float (e.g. an IPO registrant) or a public float that is less than \$700 million, has annual revenues of less than \$100 million (adjusted from \$50 million in September 2018).
18. 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.
  19. Securities Act Forms C&DIs, Question No. 102.03; Exchange Act Forms C&DIs, Question No. 110.03.
  20. Securities Act Forms C&DIs, Question No. 102.04; Exchange Act Forms C&DIs, Question No. 110.04.
  21. OTC Pink is an electronic quotation system run by OTC Markets Group 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 of 1940

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, collective investment vehicles are subject to registration and regulation pursuant to the Investment Company Act, unless they can take advantage of statutory or regulatory exemptions. section 7(d) of the Investment Company Act generally prohibits any foreign entity that meets the definition of investment company, which may include a foreign bank, from making a public offering of its securities in the US in the absence of complying with the Investment Company Act.<sup>1</sup>

Section 3(a) of the Investment Company Act broadly defines an “investment company” to include an entity that holds itself out as being engaged primarily in “investing, reinvesting or trading in securities” or an entity engaged in the business of “investing, reinvesting, owning, holding or trading in securities” if investment securities<sup>2</sup> represent 40% or more of the value of its total 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.<sup>3</sup> Non-bank affiliates of banks also could meet the definition of investment companies.

Notwithstanding the breadth of the definition, foreign banks may be able to rely on an exemption from the definition or from the registration obligations of the Investment Company Act. The most commonly used exemptions are: section 3(c)(3) for certain branches of foreign banks, Rule 3a-6 for foreign banks; Rule 3a-5 for finance subsidiaries of foreign banks; Rule 3a-1 for foreign bank holding companies; and section 3(c)(7) for a special purpose vehicle (SPV) sponsored by a foreign bank or its finance subsidiary. These potential exemptions are discussed below.<sup>4</sup>

## US branches and agencies of foreign banks

Section 3(c)(3) exempts any bank from the definition of investment company. Section 2(a)(5) of the Investment Company Act defines a bank to include any “branch or

agency of a foreign bank” as those terms are defined in section 1(b) of the International Bank Act of 1978 (IBA). section 1(b) of the IBA defines a “branch or agency of a foreign bank” to include any office or place of business of a foreign bank located within the US at which deposits are received, credit balances are maintained, checks are paid, or money is lent. Accordingly, many branches of foreign banks can rely on the exemption from the definition of investment company included in section 3(c)(3).

## Rule 3a-6 exemption

Rule 3a-6 provides that a foreign bank will not be considered an investment company for the purposes 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 US, 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) expands the definition of a foreign bank to specifically include certain trust companies or loan companies organised or incorporated under the laws of Canada or a political subdivision thereof and building societies that are organised under the laws of the UK or a political subdivision thereof.<sup>5</sup>

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 organized in the form of a trust or otherwise in which interests are separately offered.’ Thus, an SPV (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, as used in the definition of foreign bank, 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.'*<sup>6</sup>

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 [Investment Company] 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 [Investment Company] 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.'*<sup>7</sup>

### Rule 3a-5 exemption

Rule 3a-5(a) provides an exemption from the investment company definition to certain finance subsidiaries of US and non-US companies. In addition, the Rule provides that 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

In general, a finance subsidiary is a subsidiary whose primary purpose is to finance the business operations of its parent company or companies controlled by its parent

company. Rule 3a-5(b)(1) defines a "finance subsidiary" as 'any corporation: (i) all of whose securities other than debt securities or non-voting preferred stock meeting the applicable requirements of [the Rule] 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'.<sup>8</sup> For purposes of Rule 3a-5, a finance subsidiary's "primary purpose" will be evidenced if the finance subsidiary devotes at least 55% of its assets to 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" in part, 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 exempted 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]'. Importantly, under this definition, entities that are exempted from the definition of investment company under section 3(c) of the Investment Company Act or by order of the SEC under section 6(c) of the Investment Company Act, will not be considered parent companies. Accordingly, a finance subsidiary of such an entity would need to seek exemptive relief from the provisions of the Investment Company Act.

### The definition of a company controlled by the parent company

Rule 3a-5(b)(3) defines a "company controlled by the parent company" to include 'any corporation...more than 25% of whose outstanding voting securities are beneficially owned directly or indirectly by the parent company; or [any partnership or joint venture with respect to which] the parent company has the power to exercise a controlling influence over the management or policies of the partnership or joint venture'. Similar to the definition of parent company above, such an entity must either not meet the definition of investment company or must be exempted from such definition by SEC order under section 3(b) or by rules and regulations adopted under section 3(a). A controlled company must be organised under the laws of the US or a state thereof, be an FPI, or be a foreign bank or insurance company.

### The conditions for finance subsidiaries

In order to qualify under Rule 3a-5, any securities of a

finance subsidiary issued to or held by the public in the US must be debt securities or nonvoting preferred stock.<sup>9</sup> Any such debt securities must be unconditionally guaranteed by the parent company as to the payment of principal, interest and premium, if any, and any such nonvoting preferred stock must be unconditionally guaranteed by the parent company with respect to dividends, payment of any liquidation preference, and any payments under a sinking fund. The parent company's guarantee must provide that in the event of a default by a finance subsidiary, the holders of the securities issued by the finance subsidiary may institute legal proceedings directly against the parent company to enforce the guarantee without first proceeding against the finance subsidiary. The parent company guarantee may be subordinated in right of payment to other debt of the parent company.<sup>10</sup>

Where the parent company is a foreign bank, it may, in lieu of a guarantee, issue an irrevocable letter of credit in favour of the holders of the finance subsidiary's debt securities or nonvoting preferred stock, as the case may be. This letter of credit must be in an amount sufficient to fund all of the amounts required to be guaranteed, provided that: (i) payment on such letter of credit can be conditional only upon the presentation of customary documentation; and (ii) the beneficiary of such letter of credit cannot be required by either the letter of credit or applicable law to institute proceedings against the finance subsidiary before enforcing its remedies against the parent company under the letter of credit.

Any convertible or exchangeable securities issued by a finance subsidiary must be 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 that meet the requirements of the Rule.

Finally, in order to rely on Rule 3a-5, a finance subsidiary must invest in or loan to its parent company or a company controlled by its parent company at least 85% of any cash or cash equivalents raised 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 proceeds. In addition, a finance subsidiary relying on Rule 3a-5 may 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 exempt from registration under the Securities Act pursuant to section 3(a)(3).

### **Rule 3a-1 exemption**

Foreign bank holding companies may also be able to take advantage of Rule 3a-1, which provides an exclusion from the definition of investment company contained in section 3(a)(1)(C). Rule 3a-1 provides that, notwithstanding section 3(a)(1)(C), an issuer will be deemed not be an investment company under the Investment Company Act if:

(a) No more than 45% of the value<sup>11</sup> 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: (i) government securities; (ii) securities issued by employees' securities companies; (iii) 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 3(c)(1) which are not investment companies; and (4) securities issued by companies which are controlled primarily by such issuer, through which such issuer engages in a business other than that of investing, reinvesting, owning, holding or trading in securities, and which are not investment companies.

(b) The issuer is not an investment company as defined in sections 3(a)(1)(A) or (B) and is not a special situation investment company;<sup>12</sup> and

(c) The percentages described in paragraph (a) above are determined on an unconsolidated basis, except that an 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.<sup>13</sup>*

### **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). 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'. Thus, in order to rely on this exemption, an entity must offer its securities in a private placement exempt from registration under the Securities Act pursuant to section 4(a)(2) or Regulation D.

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, SPVs will rely on the 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. Although section 7(d) explicitly prohibits only public offerings by foreign investment companies, the SEC staff has interpreted the provision to also prohibit private offerings by foreign investment companies unless such companies can comply with either section 3(c)(1) or section 3(c)(7). *See Touche Remnant, SEC no-action letter (August 23 1984).*
2. Section 3(a)(2) of the Investment Company Act defines “investment securities” to include all securities except (A) government securities, (B) securities issued by employees’ securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which (i) are not investment companies, and (ii) are not relying on the exception from the definition of investment company contained in either section 3(c)(1) or section 3(c)(7).
3. Certain operating companies, such as those that devote themselves principally to research and development activities and that 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.
4. This chapter does not contain a comprehensive summary of all of the potential exemptions from registration under the Investment Company Act. In addition, even if an issuer does not qualify for an exemption from the Investment Company Act, it may seek an exemption from the SEC under section 6(c).
5. In each case, such an entity must be regulated by that country’s or subdivision’s government or any agency thereof and cannot be operated for the purpose of evading the provisions of the Investment Company Act.
6. Seward & Kissel, SEC no-action letter (October 12 2005).
7. Robert H. Rosenblum, Investment Company Determination under the 1940 Act: Exemptions and Exceptions (2003), §29.1.
8. Rule 3a-5 does not define the term corporation. The SEC staff has, however, taken the position that, for purposes of the Rule, the term includes not only entities formed as corporations, but also certain partnerships, limited liability companies and business trusts.
9. A finance subsidiary may also issue debt securities and nonvoting preferred stock that is not guaranteed by its parent company in a private placement in the US under section 4(a)(2) or Regulation D or in a public offering outside the US under Regulation S. Such private securities may be resold to QIBs pursuant to Rule 144A and to IAIs.
10. Under appropriate circumstances, the SEC has granted exemptive orders when a finance subsidiary’s securities were not unconditionally guaranteed by the parent company. *See, eg, BellSouth Capital Funding Corp, Investment Company Act Rel. No. 16054 (October 14 1987).*
11. Section 2(a)(41) of the Investment Company Act defines “value” to mean: (i) with respect to securities owned at the end of the last preceding fiscal quarter for which market quotations are readily available, the market value at the end of such quarter; (ii) with respect to other securities and assets owned at the end of the last preceding fiscal quarter, fair value at the end of such quarter, as determined in good faith by an entity’s board of directors; and (iii) with respect to securities and other assets acquired after the end of the last preceding fiscal quarter, the cost thereof.
12. “Special situation investment company” is not defined in the Investment Company Act. According to the SEC, however, ‘[s]pecial situation investment companies are companies which secure control of other companies primarily for the purpose of making a profit in the sale of the controlled company’s securities’. *See Rule 3a-1 Proposing Release, Investment Company Act Release No. 10937 (November 13 1979).*
13. Rule 3a-6 Adopting Release, Investment Company 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.<sup>1</sup> 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 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 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 covered securities, but states still may require certain notice filings to be made and may charge filing fees for offerings of other covered securities.<sup>2</sup> NSMIA also permits states to continue to enforce their own antifraud laws.<sup>3</sup>

NSMIA does not pre-empt secondary market transactions in securities from blue sky laws. Only transactions under sections 4(a)(1) or 4(a)(3) of the Securities Act are pre-empted if the issuer is a reporting company. State securities statutes include different types of non-issuer exemptions that may apply to secondary market transactions, including exemptions for isolated transactions, the manual exemption (where the issuer of the securities publishes certain continuous disclosure information on an ongoing basis in a recognised manual) and unsolicited transactions conducted through a registered broker-dealer. These exemptions, however, may vary significantly from state to state.

## Bank notes

As we have discussed, section 3(a)(2) of the Securities Act exempts from registration under the Securities 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.<sup>4</sup>*

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 (TSSB) issued no-action letter relief and did not require registration for bonds issued by the State Bank of India in minimum denominations of \$1,000 and marketed to US residents of Indian origin (NRIs) through US branches.<sup>5</sup> The TSSB 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 TSSB also pointed out that the bonds would be marketed in the US 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.<sup>6</sup>

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.<sup>7</sup> 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 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 \$5 million.<sup>8</sup> The second, 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 AIs, who are typically institutional investors or high net-worth individuals. Under Rule 506, NIAs 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 September 2013, general solicitation was not permitted in private placements in accordance with Rule 506(b). However, in July 2013, pursuant to section 201 of the JOBS Act, the SEC revised Rule 506 by adding a new exemption, Rule 506(c), which permits general solicitation if the issuer takes reasonable steps to verify that purchasers are AIs, all purchasers are AIs, or the issuer reasonably believes that they are, immediately prior to the sale, and certain other requirements are met. The SEC also revised Rule 506 to disqualify certain bad actors from participating in such offerings.

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 Rule 504 are not covered securities.

## ENDNOTES

1. Most states have an exemption from securities registration requirements for securities issued by a foreign government. Generally, the language of the exemption tracks section 201(2) of the Uniform Securities Act (2002), which provides that an exempt security is ‘a security issued, insured or guaranteed by a foreign government with which the United States maintains diplomatic relations, or any of its political subdivisions, if the security is recognized as a valid obligation by the issuer, insurer or guarantor’.
2. Sections 18(c)(2)(A) and (B) of the Securities Act.
3. Section 18(c)(1) of the Securities Act.
4. Tex. Rev. Civ. Stat. Ann. art. 581-5, § L.
5. See 3A Blue Sky L. Rep. (CCH) ¶ 55,828O.
6. Another helpful fact would be a minimum denomination significantly higher than \$1,000 per note, to help insure that the offering is more of an institutional offering than a retail offering.
7. See, e.g. 7 Tex. Admin. Code §§ 114.1-.4, 3A Blue Sky L. Rep. (CCH) ¶¶ 55,590P – 55,590S.
8. In October 2016, the SEC adopted final rules that, among other things, (1) amended Rule 504 to (a) increase the aggregate amount of securities that may be offered and sold in any twelve-month period from \$1 million to \$5 million and (b) disqualify certain bad actors from participating in Rule 504 offerings, and (2) repealed Rule 505 of Regulation D, which had provided a safe harbour from registration for securities offered and sold in any 12-month period from \$1 million to \$5 million. The repeal of Rule 505 took effect on May 20 2017.

## CHAPTER 12

# Regulation by the Financial Industry Regulatory Authority

The SEC has delegated part of the responsibility for administering securities laws to various self-regulatory organisations (SROs), as defined under the Exchange Act, including the various stock exchanges and the Financial Industry Regulatory Authority (Finra). Finra is the principal SRO for broker-dealers doing business in the US. Virtually all registered broker-dealers in the US are required to be members of Finra, which 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. Over the past decade, Finra has been adopting a set of Finra rules, many of which are based upon and supersede prior NASD and NYSE rules. However, as of January 1 2019, there are a number of pre-2007 NASD rules which continue in effect for all broker-dealers, and NYSE rules that remain in effect for NYSE member firms.

Foreign bank issuers will be required to consider Finra rules in various contexts. Any person in the US engaged in the business of effecting securities transactions is required to register with the SEC as a broker-dealer.<sup>1</sup> Therefore, it is likely that any financial intermediary engaged to assist with a financing in the US will be an SEC-registered broker-dealer that is a member of Finra.

## Basic Finra requirements

Finra rules impose a number of general requirements on member firms, including a duty of fair dealing, a duty to recommend suitable investments, a duty to obtain best execution when effecting trades and a duty to charge fair commissions and mark-ups. Finra also requires member firms to ensure their communications with the public are fair and balanced and provide a sound basis for evaluating the facts about any particular security or investment strategy. 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 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 a specific customer prior to recommending the purchase or sale of a

security to that customer. In this regard, Finra Rule 2090 requires broker-dealers to know the customer by using 'reasonable diligence, in regard to the opening of every account, to know (and retain) the essential facts concerning every customer'. Broker-dealers should 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 tolerate risk.

The suitability rules also include a quantitative element, whereby the broker-dealer must determine if a specific transaction, when viewed in the context of other transactions for that customer, is suitable for the customer.<sup>2</sup>

The suitability requirements set forth in the Finra rules are likely to be supplemented and/or superseded by a new best interest standard to be adopted by the SEC. The SEC introduced this new standard in the proposed Regulation BI in April 2018. It is currently expected that Regulation BI will be finalised and adopted in the second quarter of 2019. However, the significant issues and debate about this rule may require more time to resolve.

Although the final form of Regulation BI cannot be determined at this time, it is expected to include the following elements:

- a requirement that broker-dealers act in the best interest of their retail customers and not place the broker-dealer's interest ahead of the customer;
- a requirement that broker-dealers implement compensation practices and supervisory procedures intended to ensure that their associated persons act in the best interest of customers;
- a requirement to identify material conflicts of interest and to eliminate or mitigate such conflicts; and
- a requirement to provide retail customers with certain basic disclosures about the broker-dealer's services, standard of care, fees and charges and material conflicts of interest.

## **Finra compensation review**

Finra determines whether the terms of the underwriting compensation and arrangements relating to public offerings are unfair and unreasonable. 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. A determination regarding the fairness or reasonableness of compensation will be highly fact-specific and will depend on the type of offering. An offering required to be filed with Finra may not proceed until Finra has delivered a no objection opinion relating to the underwriting compensation.

The Finra compensation rules generally apply only to public offerings. Private placements are generally exempt from Rule 5110, as are offerings of exempted securities and municipal securities as defined in the Exchange Act and offerings made in connection with mergers and similar corporate reorganisations.

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, [Finra] Rule 2310 or [Finra] Rule 5121 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 five percent 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 are filed with Finra through its electronic filing system for public offerings. Unless already publicly available, documents or information filed with Finra will be treated as confidential. Finra uses these documents to determine compliance with applicable rules and for other regulatory purposes it deems appropriate.

Certain offerings, although subject to the rule's substantive requirements, are exempt from the filing requirements. These include, among others:

- securities offered by an issuer that has unsecured non-convertible debt with a term of at least four years, or unsecured non-convertible preferred securities, is rated by a nationally recognised statistical rating organisation (NSRO) in one of its four highest generic rating categories, except that an IPO 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; and
- 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).

Public offerings by banks, although exempt from SEC registration under section 3(a)(2), are subject to Finra Rule 5110. 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, unless an exemption is available.

## **Offerings involving a conflict of interest**

Finra Rule 5121 imposes additional requirements on public offerings that involve certain conflicts of interest. Such conflicts include situations where a broker-dealer is offering securities issued by itself or by an affiliate such as a related bank or bank holding company. A conflict of interest could also arise from the intended use of offering proceeds to pay indebtedness due to a bank or other affiliate of the broker-dealer. In such situations, it is generally required that a qualified independent underwriter (QIU) participate in and price the offering. In

addition, there must be adequate disclosure of the conflict of interest, as well as the role of the QIU in the underwriting.

In order for a broker-dealer to be deemed a QIU, it must be unaffiliated with the issuer and its affiliates, and have sufficient experience in offerings of a similar nature. The specific requirements are set forth in Rule 5121(f)(12).

Public offerings that are subject to Rule 5121 are also subject to Rule 5110, even if the offering would otherwise have been exempt from the requirements of Rule 5110.

A QIU is not required if the securities offered are investment grade-rated; or if they are part of the same series - with equal rights and obligations - as other investment grade-rated securities, and other conditions are satisfied. Offerings by foreign banks often qualify for this exemption.

### **Finra communications rules**

Finra has adopted a series of rules relating to communications with customers as set forth in Rules 2210 *et. seq.* Rule 2210 sets forth general requirements for communications, while the other rules address specific communications related to variable annuities, investment companies, bond mutual funds, investment analysis tools, securities futures, collateralised mortgage obligations (CMOs) and options.

Finra Rule 2210 divides communications into three categories: (i) institutional communications that are sent only to institutional investors (generally, investors with at least \$50 million in assets); (ii) correspondence, which consists of communications sent to not more than 25 retail investors in any 30-day period; and (iii) retail communications, which includes all other communications.

Institutional communications and correspondence must be reviewed internally at the member firm by an appropriate supervisor. However, retail communications may need to be filed with Finra and in certain cases may require pre-approval by Finra. Retail communications that must be filed include communications relating to CMOs and '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'. 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.

Rule 2210 also imposes certain content standards on all customer communications. Under Rule 2210(d), all communications must be fair and balanced and must

provide a sound basis for evaluating the facts in regard to any particular investment. Material omissions are proscribed, as are any false, exaggerated, unwarranted, promissory or misleading statements or claims. The discussion of risks and potential benefits must be balanced and the firm should not predict or project performance or imply that past performance will recur. Member firms should ensure that statements are clear and not misleading within the context in which they are made. They should also consider the nature of the audience to which the communication will be directed, and must provide details and explanations appropriate to the audience. If the communication includes an investment recommendation, the member firm must disclose potential conflicts, such as the fact that it makes a market in the recommended security or that it has managed or co-managed a public offering for the issuer within the past 12 months.

### **Research reports**

Finra Rules 2241 governs research reports on equity securities, while Finra Rule 2242 governs research reports on debt securities.<sup>3</sup> These rules reflect a principles-based approach and incorporate many of the Finra interpretations that have developed over the last decade. Finra Rule 2241 also seeks to establish a level playing field between investment banks subject to the global research analyst settlement and those that are not, as well as for issuers that are "emerging growth companies" (EGCs).<sup>4</sup>

Finra Rules 2241 and 2242 both require member firms to establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest related to (a) the preparation, content and distribution of research reports, (b) public appearances by research analysts, and (c) the interaction between research analysts and persons outside of the research department, including investment banking and sales and trading personnel, the subject companies and customers. The rules each require that a firm's policies and procedures establish information barriers or other institutional safeguards that ensure that the research department is insulated from the review, pressure or oversight by persons engaged in investment banking services, sales and trading (or, in the case of debt research, principal trading or sales and trading activities) and other persons who may be biased in their judgment or supervision.

Written policies must also be reasonably designed to:

- promote objective and reliable research that provides only the truly held opinions of research personnel;<sup>5</sup>
- prevent the manipulation of research personnel (or their research reports) in an attempt to favour the interests of

- the firm or a current or prospective customer or class of customers;
- provide for separate reporting lines for both research and investment banking personnel;
  - provide for a dedicated legal and compliance staff for the research department;
  - prohibit retaliation against research personnel for an unfavourable report;
  - prohibit investment banking personnel, and other firm employees engaged in investment banking services activities, from directing research personnel to engage in sales or marketing efforts related to any investment banking transactions;
  - prohibit three-way meetings with research personnel, investors and investment banking personnel (with the exception of certain meetings with EGCs); and
  - ensure the independent review of the research department.

The head of the research department may report to or through a person or persons to whom the head of investment banking also reports, provided that such person(s) have no direct responsibility for investment banking activities or decisions.

In accordance with Finra Rules 2241 and 2242, firms must implement written policies and procedures that at a minimum prohibit investment banking personnel (or, in the case of debt research, personnel engaged in investment banking services transactions, principal trading activities or sales and trading), from supervising or controlling research analysts, including exerting any influence or control over research analyst compensation and determinations.

Rules 2241 and 2242 also require the member firm to make a variety of disclosures in the report intended to identify potential conflicts of interest that could affect the objectivity of the report. Such disclosures include, among other things, past or future investment banking engagements for the subject company, acting as a market maker in the subject company's securities, ownership by the member firm and its affiliates of an aggregate one percent or greater interest in the subject company's equity securities, and any compensation received by the member firm or the analyst from the subject company during the past 12 months. Additional disclosures are mandated with respect to any ratings system or price targets included in the research report.

There are certain restrictions on the dissemination of research reports by broker-dealers that are acting as underwriters for the company that is the subject of the report. Generally, underwriters will refrain from disseminating research about a company that they are in

the process of preparing a registered offering on behalf of. Rule 2241 imposes a post-offering quiet period of a minimum of ten days in the case of an IPO and a minimum of three days in the case of a secondary offering. Finra interprets the date of the offering to be the later of the effective date of the registration statement or the first date on which the securities were bona fide offered to the public. Notwithstanding the limitations of Rule 2241, many broker-dealers voluntarily elect not to disseminate research reports about a company for whom they underwrote an IPO until 25 days after the offering.

The quiet period restrictions generally do not apply to EGCs.<sup>6</sup>

### **Exempt offerings**

Finra member firms acting as placement agents in private placements under Regulation D or in other exempt offerings are obligated to conduct a reasonable investigation of the issuer and the securities that are being offered for sale. The analysis should include, at a minimum, a reasonable investigation concerning the issuer, its management, its business prospects, and the intended use of proceeds of the offering.

Pursuant to Finra Rule 5123, a member firm 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. There is no requirement that Finra approve the offering or the compensation payable to the broker-dealers.

Finra Rule 5123 applies to many exempt offerings, including private placements. However, it does not apply to, among others, (i) exempt offerings sold solely to institutional investors, (ii) Rule 144A offerings, (iii) Regulation S offerings, (iv) exempt offerings of non-convertible debt or preferred securities that meet the transaction eligibility criteria for registering primary offerings of non-convertible securities on Forms S-3 and F-3, and (v) private placements of commercial paper.

### **Payments to third parties**

Finra member firms are generally prohibited from paying to, or sharing commissions or other transaction-based compensation with, any person who is not a Finra member firm or an associated person of a Finra member firm. One exception to this rule is set forth in Finra Rule 2040, which permits the payment of referral fees to foreign persons who

refer foreign clients to the Finra member firm. The exception is only available for payments to foreign nationals and foreign entities domiciled outside the US, and the member firm must satisfy itself that the foreign person has not conducted any activity in the US that would subject it to US broker-dealer registration requirements. Disclosure of the referral fee must be made to the foreign customer, who must acknowledge receipt of such disclosure.

### **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. There may also be bundled CDs with other features that again resemble securities rather than traditional bank deposits. Traditional CDs generally fall outside of Finra supervision. Broker-dealers selling 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. There are exemptions for banks to conduct certain types of securities business without registering as a broker-dealer.
2. For more information regarding Finra guidance on 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).
3. For more information regarding Finra Rules 2241 and 2242, see our Client Alert, 'Finra's Final Equity Research Rules Go Effective; Final Debt Research Rules' Effective Date Quickly Approaching' (January 25 2016), available at:  
<https://media2.mofo.com/documents/160125finrafinalequitydebtresearchrules.pdf>
4. The global research analyst settlement is an enforcement agreement first announced in December 2002 and approved by the United States District Court for the Southern District of New York on October 31 2003, among the SEC, the NASD, the NYSE, the New York State attorney general and 10 of the then-largest investment banking firms in the US. The Global Settlement addressed issues related to conflicts of interest between the research and investment banking departments of these firms that became apparent during the dotcom boom and then bust of the late 1990s and early 2000s.
5. This conforms with the requirements of SEC Regulation AC, which provides that research analysts must affirm their reports reflect their personal views.
6. The JOBS Act prohibits a national securities association or the SEC from maintaining rules restricting research analysts from participating in meetings with investment banking personnel and an EGC in connection with an EGC's IPO. Prior to the enactment of the JOBS Act, research personnel were prohibited from attending meetings with an issuer's management that were also attended by investment banking personnel in connection with an IPO, including pitch meetings. Section 105(b) of the JOBS Act permits research personnel to participate in any communication with the management of an EGC concerning an IPO that is also attended by any other associated person of a broker, dealer, or member of a national securities association whose functional role is not analyst, including investment banking personnel. For more information regarding EGCs, see 'FPI accommodations under US securities laws' in Chapter 9 (Exchange Act registration).

## CHAPTER 13

# Special considerations related to structured products

In the aftermath of the financial crisis of 2008, financial engineering engendered suspicion, and financial products perceived to be complex have attracted regulatory attention. Structured products are among the financial products that have been 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, such as collateralised debt obligations (CDOs) or collateralised 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, CDs or other instruments 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 equity index, such as the S&P 500 Index or the Dow Jones Industrial Average (DJIA).

The market for these products has proven resilient, and has grown in recent years. 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. Accordingly, 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 US.

## 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; however, structured

products are not derivatives contracts. Structured products may simply involve, for example, 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 (often a financial institution that is a well-known seasoned issuer) under a shelf registration statement (if the securities are registered) or a programme 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 are typically subject to higher scrutiny and more stringent regulatory requirements than products sold to institutional investors. Finally, the broker-dealers that market structured products are subject to regulation by SROs, including national securities exchanges (e.g. NYSE and Nasdaq) and Finra.<sup>1</sup>

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, 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 under the Securities Act 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 the 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.

The 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 anti-fraud 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 (e.g. 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 to 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 consisted of 14 comments, and restated certain of the SEC staff's views with respect to structured products. For example, the SEC letter requested 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 requested 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 reminded 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. It also sought additional information from issuers of structured products. For example, the SEC letter requested 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 requested 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. It 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 should also discuss any valuation models or assumptions, particularly if the issuer has used inputs other than mid-market prices. The value of the derivative component should generally exclude the issuer's hedging costs. The offering document should also 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 price of the notes. The disclosures should also 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 should also 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 proprietary indices or 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 only to options-eligible accounts, 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 eliminate 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 potential 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 will impact Finra suitability requirements (which we discuss below).

### Broker-dealer standard of care

The distributors of structured products are predominantly broker-dealers who 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 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, and 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 often 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 incur the risks involved with the relevant security.

### **Finra developments relating to the sales and marketing of structured products**

#### **Notices 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 members must develop and implement written procedures to identify and consider new products, as well as post-approval follow-up and review procedures. It reminds

members that, in order to discharge their suitability obligation in connection with marketing and selling new products or structured products, they 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 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 should also highlight and explain the risks associated with structured products, which generally include market risk and the potential loss of principal, 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 that the term 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 its 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; 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. It also highlights the 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, the 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 in the past, 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 (KYD) procedures.

Special attention should also be paid to product names, descriptions of payout 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 the section 3(a)(2) exception, 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 department of financial services 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

# The US-Canadian multijurisdictional disclosure system

**T**he US-Canadian multijurisdictional disclosure system (MJDS) was adopted in July 1991 by the SEC and the Canadian Securities Administrators. It is designed to facilitate cross-border public offerings of securities between the US and Canada. The MJDS allows eligible Canadian issuers to make registered public offerings in the US using a prospectus prepared and reviewed in Canada that is mainly, although not exclusively, in accordance with Canadian disclosure requirements. The MJDS also allows eligible issuers to comply with US continuous reporting requirements by filing their Canadian disclosure documents with the SEC (subject to certain additional US disclosure and corporate governance requirements). MJDS offerings can be made on a US-only basis or in connection with a concurrent offering in Canada.

Although less frequently used, there is also a reciprocal MJDS which allows eligible US issuers to make public offerings in Canada using a prospectus prepared predominantly in accordance with the requirements of, and reviewed by, the SEC.<sup>1</sup>

## Advantages of using the MJDS

The MJDS registration process avoids duplicative regulatory review and reduces the costs, time and other burdens of complying with two disclosure regimes, allowing eligible Canadian issuers to more easily access the US capital markets.

The principal advantages of using the MJDS are summarised below:

- *Streamlined registration statement.* The MJDS registration statement filed with the SEC consists of a prospectus prepared mainly, although not exclusively, in accordance with Canadian disclosure requirements. It is generally wrapped around a Canadian prospectus. The prospectus, which is filed as part of the MJDS registration statement, includes a list of all of the documents filed as part of the registration statement and certain legends to notify US investors that the registration statement was prepared in accordance with Canadian disclosure requirements. The prospectus filed with the SEC may omit information that is applicable

exclusively to Canadian investors and not material to US investors. The required exhibits that must be filed as part of an MJDS registration statement include copies of all documents incorporated by reference in the prospectus, and all documents required to be filed or made public in Canada such as experts' written consents and certain material agreements.

- *Limited SEC review and automatic effectiveness.* While the SEC reserves the right to review filings on MJDS registration forms, they generally do not. Instead, the SEC typically defers to home jurisdiction review in Canada, unless there is reason to believe there is a problem with the filing. If an offering of securities is being made contemporaneously in the US and Canada, an MJDS registration statement will generally become effective automatically upon filing with the SEC, unless a Canadian preliminary prospectus is being filed initially as part of the MJDS registration statement in order to permit offers in the US prior to effectiveness. If an MJDS registration statement relates to a US-only offering, the issuer will file the preliminary prospectus with one Canadian provincial securities regulator, typically in the issuer's home province. The MJDS registration statement will be declared effective after the SEC receives a copy of a receipt or notification of clearance from the principal provincial securities regulator.
- *Simplified continuous reporting.* Similar to any US public offering, the filing of an MJDS registration statement will generally create a continuous reporting obligation under sections 13 or 15(d) of the Exchange Act. However, under the MJDS, Canadian issuers can generally satisfy these continuous reporting obligations by filing their Canadian continuous disclosure documents with the SEC. Annex A to this document includes a summary comparison of the MJDS forms as compared to other SEC registration forms.

## Issuers eligible for the MJDS

Generally, to be eligible to use the MJDS, an issuer must:

- be incorporated or organised under the laws of Canada or any Canadian province or territory;

- be an FPI;
- have been subject to the continuous disclosure reporting requirements for the preceding 12 calendar months with a Canadian securities regulatory authority (36 months for Forms F-7, F-8 and F-80), and in compliance with those reporting requirements;
- have a public float of outstanding equity securities held by persons other than its affiliates of \$75 million or more; and
- not be an investment company registered or required to be registered under the Investment Company Act.

The \$75 million public float requirement can serve as a barrier to use of the MJDS, particularly for:

- companies that are not yet public and are planning a simultaneous US and Canadian initial public offering;
- smaller Canadian public companies; and
- Canadian public companies that have a significant percentage of their shares held by members of the management team or other affiliates. These types of companies will often need to commence any US registration using the more detailed US forms, such as Form F-1.

Eligible MJDS issuers are not required to use the MJDS. All Canadian issuers that qualify as FPIs are eligible to use the SEC's foreign issuer forms (Forms F-1, F-3 and F-4) for registration of public offerings under the Securities Act, and for continuous reporting under the Exchange Act (Forms 20-F and 6-K). US domestic offering forms (Forms S-1, S-3 and S-4) and continuous reporting forms (Forms 10-K, 10-Q and 8-K) are generally available to Canadian issuers that voluntarily choose to use them.

However, Canadian issuers are not required to use them unless they no longer qualify as FPIs.

### **WKSIs**

Generally, a well-known seasoned issuer (Wksi) is an issuer that is required to file reports with the SEC under section 13(a) or section 15(d) of the Exchange Act and as of a date within 60 days of filing its shelf registration statement, either (1) has a worldwide market value of its outstanding voting and non-voting common stock held by non-affiliates of \$700 million or more or (2) has issued in the last three years at least \$1 billion aggregate principal amount of non-convertible securities in registered primary offerings for cash.

A Wksi benefits from a more flexible registration process and is able to register unspecified amounts of securities in the US under a shelf registration statement that can be used for most offerings and becomes effective automatically upon filing with the SEC.

Only issuers that file annual reports on Form 10-K or

Form 20-F with the SEC are eligible to be a Wksi. The SEC has confirmed that Canadian issuers filing annual reports on Form 40-F under the MDJS will not qualify for Wksi status. Canadian issuers are not required to use the MJDS and may file their annual reports with the SEC on Forms 20-F or 10-K in order to become a Wksi. Utilising either of these two approaches, however, will subject a Canadian issuer to the burden of complying with an additional set of different, ongoing and more stringent disclosure requirements, which they are not subject to under the MJDS.<sup>2</sup>

### **Securities eligible for the MJDS**

All securities are eligible for the MJDS, except for certain types of derivative securities, as discussed below. While rights offerings are eligible for the MJDS, only the securities issuable upon exercise of those rights are freely transferable in the US.

### **Registered offerings under the Securities Act**

MJDS issuers effect public offerings in the US on Forms F-7, F-8, F-10 and F-80.

- Form F-7 – rights offerings. Form F-7 is used for the registration of securities offered for cash upon the exercise of rights to purchase or subscribe for such securities that are granted proportionately to existing security holders. To be eligible for Form F-7, an issuer must have a class of its securities listed on the Toronto Stock Exchange or the Senior Board of the Toronto Venture Exchange for the 12 calendar months immediately preceding the filing of Form F-7, and meet the conditions described in 'Issuers eligible for the MJDS' above. However, the public float requirement is not applicable.
- Form F-10 – general. Form F-10 is the most frequently used MJDS form and may be used to register any kind of security by an eligible issuer meeting the conditions described in 'Issuers eligible for the MJDS' above. Form F-10 can only be used for derivative securities when they are warrants, options, rights and convertible securities that are issued by the registrant, and are convertible only into securities of the registrant or one of its affiliates. Registration on Form F-10 requires that financial statements included in or incorporated by reference be reconciled to US GAAP or prepared in accordance with IFRS as issued by the IASB.
- Forms F-8 and F-80 – acquisitions and other transactions. Forms F-8 and F-80 may be used for the registration of any security, except a derivative security (other than certain warrants, options, rights and convertible securities), to be issued in connection with

an exchange offer or in connection with a statutory amalgamation, merger, arrangement or other reorganisation requiring a shareholder vote (a business combination). Each of these forms can facilitate merger transactions involving Canadian companies in which a portion of the target's shareholders reside in the US. To be eligible for Forms F-8 and F-80, an issuer must have a class of its securities listed on the Toronto Stock Exchange or the Senior Board of the Toronto Venture Exchange for the 12 calendar months immediately preceding the filing of Forms F-8 and F-80 and meet the conditions described in 'Issuers eligible for the MJDS' above. However, the public float requirement, which is stated in Canadian dollars, need not be satisfied if the issuer of the securities to be exchanged is also the registrant on the applicable Form F-8 or F-80. Generally, Form F-8 may be used where US holders own less than 25% of the target securities, and Form F-80 may be used where US holders own less than 40% of the target securities. In the event that Forms F-8 and F-80 are unavailable, certain exchange offers and business combinations may be registered on Form F-10, subject to eligibility requirements.

- *Recession of Form F-9.* On December 31 2012, as part of its rule revisions relating to the reduction of its reliance on credit ratings, the SEC rescinded Form F-9. This form was previously used to register investment grade debt and preferred securities under the MJDS. MJDS companies who would have been eligible to use Form F-9 must now use Form F-10. However, there is an eligibility gap between Form F-10 and F-9 where F-9 filers were not required to have a public float of \$75 million or have the registered securities guaranteed by a parent that meets the \$75 million public float requirement. This eligibility gap between Forms F-10 and F-9 prevents companies who would have been MJDS-eligible on Form F-9 from accessing the MJDS. Moreover, removal of Form F-9 references from Form 40-F caused MDJS companies who were eligible to use Form 40-F based on their registration on Form F-9 to be no longer eligible to use Form 40-F and required them to file on Form 20-F, which requires disclosure in accordance with SEC standards rather than Canadian disclosure rules.

In order to address this eligibility gap, the SEC adopted a temporary grandfathering provision that permitted registrants who would have been eligible to use Form F-9 as of December 31 2012 to file on Form F-10 without satisfying the public float or parent guarantee requirement until December 31 2015. The SEC also adopted a permanent grandfathering clause allowing

filers who have filed and sold securities under a Form F-9 before December 31 2012 to continue to be eligible to use Form 40-F to satisfy their Exchange Act reporting requirements.

Securities linked to currencies, commodities, stocks or indexes (also referred to as structured notes) were previously eligible for registration on Form F-9. However, they are no longer eligible for the MJDS and must be registered using the foreign forms (F-1, F-3 and F-4) or the US domestic forms (S-1, S-3 and S-4), as applicable. Canadian financial institutions that issue structured notes typically register these offerings on Form F-3.<sup>3</sup>

### **Contents of an MJDS registration statement**

The MJDS registration statement filed with the SEC consists of a cover page, prospectus, exhibits, undertakings and consent to service of process as described below.

The cover page contains basic information relating to the issuer, calculation of the registration fee and a check box which must be selected if the securities are to be offered on a delayed or continuous basis under the home jurisdiction's shelf prospectus offering procedures. Issuers registering on Form F-10 must set forth the approximate date of commencement of the proposed sale of the securities to the public.

The prospectus is governed largely, although not exclusively, by Canadian disclosure requirements with a few modifications, such as the addition of certain legends and a list of all documents filed as part of the registration statement. Information relating solely to Canadian investors and not material to US investors may be omitted from the prospectus. The exhibits that must be filed as part of an MJDS registration statement include copies of all documents incorporated by reference in the prospectus, and all documents required to be filed or made public in Canada such as experts' written consents and certain material agreements.

With the exception of Form F-7, an issuer must undertake to make available to the SEC, upon request, information relating to the securities registered. In the case of an exchange offer, an issuer using Forms F-8 or F-80 must undertake to disclose in the US, on the same basis as it is required to make such disclosure in Canada under any applicable Canadian law, regulation or policy, information regarding purchases of the issuer's securities.

The issuer and any non-US person acting as trustee must file a written irrevocable consent and power of attorney on Form F-X.

## **Information from a Canadian prospectus that can be omitted from a US registration statement filed under the MJDS**

A US registration statement filed under the MJDS may omit disclosure that is applicable only to Canadian investors and not material to US investors, including:<sup>4</sup>

- any Canadian red herring legend;
- any discussion of Canadian tax considerations not material to US investors;
- the names of any Canadian underwriters not acting as underwriters in the United States;
- any description of the Canadian plan of distribution (except to the extent necessary to describe the material facts of the US plan of distribution);
- any description of investors' statutory rights under applicable Canadian securities law; and
- certificates of the issuer or any underwriter that are required under Canadian securities law.

## **US GAAP reconciliation requirements that are applicable to MJDS registration statements**

Form F-10 requires reconciliation of all financial statements to US GAAP as required by Item 18 of Form 20-F. Reconciliation to US GAAP is not required if the financial statements are prepared in accordance with IFRS as issued by the IASB. US GAAP reconciliation is not required for the registration of securities on Forms F-7, F-8 or F-80.

Financial statements included in MJDS registration statements must satisfy SEC rules regarding auditor independence, with the exception of registration statements on Form F-7.

Canadian issuers with financial statements prepared in accordance with IFRS as issued by the IASB must also provide their financial statements included on Forms 40-F or 6-K and on their corporate websites in interactive data format using XBRL (eXtensible Business Reporting Language).

## **Canadian and US jurisdictions where MJDS registration statements will be filed**

A Canadian issuer conducting a public offering of securities in the United States under the MJDS must file a prospectus with the securities regulators in all of the Canadian territories and provinces where the securities will be offered. Regardless of the number of jurisdictions in which the prospectus is filed, only the principal provincial securities regulator and, if applicable, the Ontario Securities Commission, will review the prospectus. Generally, the determinations of the principal regulator will bind all of the other provincial securities regulators

where the prospectus is filed, absent unusual circumstances. For US-only offerings, a Canadian issuer must file the prospectus with the provincial securities regulator in the jurisdiction where the issuer's head office is located.

Subject to the limitations imposed by the National Securities Markets Improvement Act and absent an applicable exemption, a state filing requirement may be triggered in each US state where offers and sales will be made.

## **How SEC filing fees are calculated for MJDS offerings**

All MJDS offerings require the payment of an SEC filing fee in US dollars. The fee is based on the aggregate dollar amount of securities registered. Only securities offered in the US need to be registered; however, the possibility of flow back into the US if the securities are concurrently offered in Canada and the US should be considered. The filing fee is calculated according to section 6(b) of the Securities Act and can vary from year to year. The SEC filing fee for MJDS offerings is the same as for other SEC-registered offerings.

## **SEC review of MJDS registration statements**

While the SEC reserves the right to review MJDS registration statements, it generally does not. Instead, the SEC typically defers to home jurisdiction review in Canada unless there is reason to believe there is a problem with the filing. However, as required under section 408 of the Sarbanes-Oxley Act, the SEC will review, at least every three years, the periodic filings of MJDS filers whose securities are listed on a US national securities exchange. Accordingly, the issuer may receive written comments as to these filings.

## **Non-MJDS forms and registering securities**

An MJDS issuer can use non-MJDS forms to register securities in the US. An MJDS issuer can register its securities in the US using the foreign forms (F-1, F-3 and F-4) or the US domestic forms (S-1, S-3 and S-4). Unlike the MJDS forms, the foreign forms and US domestic forms are subject to substantive review by the SEC and require presentation of information in accordance with US disclosure standards.

## **Finra rules and regulations**

MJDS offerings are subject to review by Finra. Unless an exemption is available, a filing consisting of the registration statement and draft underwriting agreement must be made with Finra and a filing fee paid within one

business day of filing with the SEC. The SEC will not declare a registration statement effective until it has received a no-objection letter from Finra with respect to the terms of the underwriting arrangement and the plan of distribution.

Certain offerings are exempt from Finra review. These include, among others, offerings of:<sup>5</sup>

- securities of an MJDS issuer registered with the SEC on Form F-10 and offered under the Canadian shelf prospectus offering procedures;
- securities offered in a redemption standby firm commitment underwriting arrangement registered with the SEC on Form F-10;
- securities of a corporate, foreign government or foreign government agency issuer that has unsecured non-convertible debt with a term of issue of at least four years, or unsecured non-convertible preferred securities;
- non-convertible debt securities and non-convertible preferred securities rated by a nationally-recognised statistical rating organisation in one of its four highest generic rating categories; and
- exchange offers of securities where the issuer qualifies to register securities with the SEC on registration statement Forms S-3, F-3 or F-10.

### **MJDS offerings of debt securities and the Trust Indenture Act of 1939**

Public offerings of debt securities are generally subject to the Trust Indenture Act of 1939, as amended (Trust Indenture Act). The Trust Indenture Act requires, among other things, the appointment of an independent and qualified trustee to act for the benefit of the holders of debt securities, and specifies a variety of substantive provisions that must be included in the trust indenture. The Trust Indenture Act requires the trustee to be a corporation subject to supervision or examination by a regulatory authority in the United States.

The SEC adopted exemptive rules under the Trust Indenture Act intended to facilitate MJDS offerings. Rule 10a-5 under the Trust Indenture Act permits Canadian trust companies subject to supervision or examination under the Canadian Trust Companies Act or the Canada Deposit Insurance Corporation Act to act as the trustee for MJDS debt offerings. In addition, Rule 4d-9 under the Trust Indenture Act exempts Canadian trust indentures used to issue debt securities under the MJDS from nearly all of the substantive requirements of the Trust Indenture Act, provided the trust indentures are subject to the Canada Business Corporations Act, the Bank Act (Canada), the Business Corporations Act (Ontario) or the Business Corporations Act (British Columbia). The

Canadian trustee is also required to file a consent to service of process on Form F-X as part of each MJDS registration statement.

### **Shelf offerings**

MJDS issuers are able to effect shelf offerings in both the United States and Canada by establishing a Canadian shelf prospectus in accordance with Canadian shelf rules and concurrently filing a Form F-10 with the SEC. The Canadian shelf rules are similar to the SEC rules for continuous or delayed offerings of securities under Rule 415 of the Securities Act. Once a Canadian shelf prospectus has been filed with the issuer's principal provincial securities regulator in Canada, a receipt or notification of clearance will be issued.

The SEC must receive this receipt in order for the Form F-10 to become effective. The shelf prospectus may be used for a period of 25 months before a new shelf prospectus must be filed in Canada. For 25 months after the date the receipt or notification of clearance is issued, an issuer may then issue any combination of debt or equity securities off the shelf (depending on the types of securities contemplated by the shelf prospectus) in the US, Canada, or both, by filing and delivering a prospectus supplement for each shelf offering. The prospectus supplement setting forth the terms of the specific takedown will be filed with the issuer's principal securities regulator in Canada in accordance with Canadian shelf prospectus rules on or before the date it is first delivered or, if earlier, two business days after pricing. A corresponding prospectus supplement to the shelf prospectus must be filed with the SEC in electronic format on the Edgar system within one business day of being filed in Canada. Each SEC filing will set forth the applicable registration fee and include the following legend in the upper right-hand corner of the cover page:

*'Filed pursuant to General Instruction II.L. of Form F-10;  
File No. 333-[insert number of the registration statement].'*

The Canadian shelf rules allow a final receipt to be issued before the offering price is determined, and are similar to Rules 430A and 424(b) under the Securities Act. Although the MJDS forms do not allow Rules 415, 424(b) or 430A under the Securities Act to be relied upon in an MJDS offering, they permit the use of the corresponding Canadian rules in accordance with General Instruction II.L. to Form F-10.<sup>6</sup>

### **US state securities laws**

#### **MJDS offerings exempt from state securities laws**

Securities offerings in the US, including offerings by MJDS companies, are exempt from state registration in the US if the security being offered is a covered security as

defined under section 18 of the Securities Act.

A covered security is:

- a security that is listed or authorised for listing on the NYSE, Nasdaq or a US national securities exchange with substantially similar listing standards as the NYSE or Nasdaq;
- a security that is equal in seniority or that is senior to a security listed or authorised for listing on the NYSE, Nasdaq or a US national securities exchange with substantially similar listing standards as the NYSE or Nasdaq;
- a security offered and sold only to qualified purchasers; or
- a security issued under section 4 of the Securities Act, subject to certain restrictions.

However, US state antifraud laws still apply to these transactions and registrants must comply with US state fee requirements and filing requirements that are solely for notice purposes.

### **Registration by coordination**

If the offered securities are not covered securities, the issuer must comply with applicable US state securities laws. Some US states will provide an exemption for securities registered with the SEC, but may require filing of a notice of intention to sell. Most US states have adopted the Uniform Securities Act's registration by coordination provisions, which allow a registration statement to become effective in such US states upon, among other requirements, notice to US state administrators of an effective registration statement with the SEC and filing of the registration statement seven days prior to the effective date with US state administrators. US states that have not adopted the Uniform Securities Act's registration by coordination provisions have accommodated MJDS registrants by providing automatic effectiveness of the registration statement when it is declared effective by the SEC, providing an exemption from registration upon payment of a fee and the filing of a disclosure document seven days before the offering is made or expediting the review process.

### **Exchange Act reporting**

MJDS companies will be subject to the reporting requirements under the Exchange Act upon registering an offering on the MJDS forms. They may satisfy their reporting requirements by filing Canadian periodic disclosure filings on Form 40-F for annual reports and Form 6-K for interim reports, supplemented by additional disclosure requirements under the Dodd- Frank Act and the Sarbanes-Oxley Act that are reflected in the instructions to Form 40-F. Forms 40-F and 6-K must be filed in English.

The SEC generally will not review periodic reports filed using the MJDS forms. Instead, the SEC will typically rely on the review conducted by Canadian regulators. However, as required under section 408 of the Sarbanes-Oxley Act, the SEC will review, at least every three years, the periodic filings of MJDS filers whose securities are listed on a US national securities exchange.

### **Exchange Act filing exemptions**

Rule 12g3-2 under the Exchange Act exempts FPIs from the periodic reporting requirements under sections 13(a) and 15(d) of the Exchange Act. Rule 12g3-2(a) exempts issuers with fewer than 300 holders resident in the US and Rule 12g3-2(b) exempts FPIs that (1) are not subject to Exchange Act periodic reporting requirements; (2) currently maintain a listing on an exchange in their home jurisdiction that is their primary trading market; and (3) publish disclosure documents made public in their home jurisdiction on their website or through an electronic information delivery system. These exempt issuers are also exempt from the corporate governance, accounting and certification requirements of the Sarbanes-Oxley Act, since they do not have securities registered under the Exchange Act. MJDS companies whose periodic reporting obligations arise solely from filing a Form F-7, F-8 or F-80 are exempt from the reporting requirements of section 15(d) of the Exchange Act under Rule 12h-4 of the Exchange Act.

### **Sections 14 and 16 of the Exchange Act**

Rule 3a12-3 under the Securities Act exempts FPIs, including MJDS companies, from complying with the US proxy solicitation rules under section 14 (except for the tender offer related provisions) and section 16 of the Exchange Act. Therefore, an MJDS company does not have to file with the SEC a proxy statement prepared in accordance with Schedule 14A, and is exempt from certain reporting obligations and the short-swing trading profit and insider trading recovery rules under section 16 of the Exchange Act. However, MJDS companies will typically file with the SEC the Canadian version of the proxy statement called the Management Proxy Circular or Management Information Circular on Form 6-K.

### **Form 40-F**

MJDS companies may use Form 40-F to file their annual report. The Form 40-F must be filed on the same day that the information included in the form is due to be filed with the applicable Canadian securities commission or regulatory authority. Form-40 includes the issuer's annual information form (the Canadian version of an annual

report), audited annual financial statements and management's discussion and analysis for the fiscal year ended prepared in accordance with Canadian disclosure requirements. In addition, under the requirements of the Sarbanes-Oxley Act, the issuer must include:

- a management's annual report on internal control over financial reporting;
- an attestation report from a registered public accounting firm on management's assessment of internal control over financial reporting; and
- additional disclosure on:
  - disclosure controls and procedures;
  - internal control over financial reporting;
  - any financial experts on their audit committee or lack thereof;
  - principal accountant fees and services;
  - off-balance sheet arrangements; and
  - tabular disclosure of contractual obligations.

A Form 40-F filer also is required to include as exhibits copies of:

- materials incorporated by reference;
- certifications required under sections 302 and 906 of the Sarbanes-Oxley Act from each principal executive officer and principal financial officer, or persons performing similar functions at the time the Form 40-F is filed;
- any notices required by Rule 104 of Regulation BTR sent in the past fiscal year to directors and executive officers concerning any equity security subject to a blackout period;
- a copy of the filer's code of ethics; and
- a Form F-X for service of process information in the US, unless a Form F-X was previously filed with a registration statement.

At this time, Form 40-F filers do not have to include exhibit hyperlinks in their exhibit lists for exhibits that were previously filed with the SEC.

### **US GAAP reconciliation and Form 40-F**

If the financial statements included in the Form 40-F are prepared in accordance with IFRS, reconciliation to US GAAP is not required. All publicly accountable enterprises in Canada have transitioned to IFRS for their financial years beginning on or after January 1 2011 under the rules adopted by the Canadian Securities Administrators.

### **Form 6-K**

Reporting requirements under the Exchange Act require an FPI to furnish interim reports on the basis of their home country's regulatory and stock exchange practices, rather than the quarterly reports on Form 10-Q and current reports on Form 8-K required for US companies.

An MJDS company may use Form 6-K to furnish (1) information it has made public or is required to make public under Canadian securities laws, (2) information it has filed or is required to file with the applicable stock exchange on which its securities are traded, and (3) information it has distributed or is required to be distributed to its shareholders. This information is limited to material information with respect to the MJDS company and its subsidiaries and may be related to any of the following:

- changes in business;
- changes in management or control;
- acquisitions or dispositions of assets;
- bankruptcy or receivership;
- changes in the MJDS company's certifying accountants;
- financial condition and results of operations;
- material legal proceedings;
- changes in securities or in the security for registered securities;
- defaults upon senior securities;
- material increases or decreases in the amount of securities or indebtedness outstanding;
- the results of the submission of matters to a vote of security holders;
- transactions with directors, officers or principal security holders;
- the granting of options or payment of other compensation to directors or officers; and
- any other information which the MJDS company deems as materially important to its shareholders.

This information must be furnished promptly after the information is made public, and a copy of any information incorporated by reference must be attached as an exhibit to the Form 6-K. Information on Form 6-K is deemed furnished, and not filed for liability purposes under section 18 of the Exchange Act.

However, an MJDS company that is filing a registration statement may elect to deem the Form 6-K information as filed by specifying that the information is incorporated by reference into the registration statement.

MJDS companies should note that although they are only required to furnish information made public in Canada, if the applicable Canadian disclosure requirements are less comprehensive than US disclosure requirements, MJDS companies should consider complying with the Form 8-K requirements for similar events to make sure all material information has been provided, in order to help avoid potential liability under section 10 and Rule 10b-5 of the Exchange Act.

FPIs, including MJDS companies, are not subject to US Regulation FD, which requires prompt disclosure of

material, non-public information that has been unintentionally disclosed to market professionals or security holders. However, FPIs, including MJDS companies, can voluntarily comply with US Regulation FD by publicly furnishing the relevant information in a Form 6-K filing. Doing so can help avoid any reputational risk or potential liability under Rule 10b-5 under the Exchange Act.

## **Securities liability issues for MJDS companies**

### **Sections 11 and 12 of the Securities Act**

Under section 11 of the Securities Act, an MJDS company that issues securities in the US will be strictly liable to purchasers of its securities if its registration statement at the time of effectiveness ‘contains an untrue statement of a material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading’. In addition, every person who signs the registration statement and current directors or certain persons who are about to become directors are also subject to potential liability under section 11 for material misstatements or omissions in the registration statement.

An MJDS company that issues securities in the US is also subject to potential liability under section 12 of the Securities Act. Under section 12(a)(1), an MJDS company will be subject to strict liability for offering or selling a security in violation of the registration requirements of Section 5 of the Securities Act. Under section 12(a)(2), an MJDS company is subject to strict liability for material misstatements or omissions in any prospectus or prospectus supplement relating to the offering filed under Rules 424 or 497 under the Exchange Act, a free writing prospectus, any communication that is an offer of securities or any oral or written test-the-water communications made under section 5(d) of the Securities Act by the MJDS company as an EGC under the JOBS Act. However, if an MJDS company elects to file as an EGC, under section 105 of the JOBS Act, the MJDS company will not be subject to section 12(a)(2) liability for research reports issued in connection with its initial public offering or other public equity securities offerings.

Underwriters participating in an MJDS offering also are subject to potential liability under sections 11 and 12 of the Securities Act. However, unlike the issuer who has strict liability, the underwriters have a due diligence defence against such potential liability. Therefore, underwriters participating in an MJDS offering will generally require, among other things, company representations, a comfort letter and legal opinions from US and Canadian counsel regarding adequate disclosure in the MJDS filings to help establish their due diligence defense.

*Anti-fraud liability.* MJDS companies who issue their

securities in the US also are subject to anti-fraud rules under Section 17 of the Securities Act and Exchange Act section 10(b) and Rule 10b-5. Under section 17, an MJDS company issuing securities in the US will be subject to liability for material misstatements or omissions in the disclosure package provided to an investor prior to or at the time of the contract of sale or any fraudulent activities in connection with a sale of securities. Under section 10(b) and Rule 10b-5, an MJDS company will be subject to liability for use of manipulative or deceptive practices in connection with a purchase or sale of a security and for false statements about, or omission of, a material fact in connection with, the issuance of securities.

As discussed earlier, the MJDS allows eligible Canadian issuers to meet the US disclosure and periodic reporting requirements through use of a document prepared in accordance with Canadian disclosure standards and periodic filings made in their home jurisdiction. Therefore, MJDS companies are not required to comply with the line-item disclosure requirements of US filing forms unless specifically required in the applicable MJDS form. However, MJDS forms require disclosure of all material information necessary to make the required statements not misleading. Therefore, MJDS issuers should consider whether additional information should be disclosed to avoid potential liability under US securities law.<sup>7</sup>

## **Liability under Form 6-K**

Information disclosed in a Form 6-K is furnished not filed for purposes of section 18 of the Exchange Act. In other words, an MJDS company is not subject to section 18 liability based on the disclosure in a Form 6-K. However, if a Form 6-K contains materially misleading information or omits material information, the SEC may bring administrative proceedings against the MJDS company which can result in significant fines. Moreover, if a Form 6-K is incorporated by reference in a registration statement, an MJDS company will be subject to potential liability under sections 11, 12 and 17 of the Securities Act based on the Form 6-K information, which becomes part of the registration statement.

An MJDS company may also be subject to liability if it fails to make a Form 6-K filing. Failure to make a Form 6-K filing would be a violation of sections 13(a) and 15(d) of the Exchange Act, subjecting a company to SEC administrative proceedings. Failure to file a Form 6-K may also be considered an omission or a failure to disclose material information which may lead to liability under Exchange Act section 10(b) and Rule 10b-5.

## The Dodd-Frank Act and the MJDS

The Dodd-Frank Act contains disclosure requirements that apply to all SEC reporting companies, including MJDS companies. Among the several requirements of the Dodd-Frank Act, the following are most frequently applicable to MJDS companies:

- additional corporate governance requirements relating to compensation committees or any other board committee that oversees executive compensation;
- the repeal of Rule 436(g) under the Securities Act, relating to the disclosure of credit ratings; and
- additional specialised disclosure requirements relating to conflict minerals, government payment in connection with resource extraction and mine safety.

## Corporate governance requirements

Under Section 952 of the Dodd-Frank Act, the SEC adopted rules implementing Section 10C of the Exchange Act, which prohibits national securities exchanges from listing equity securities of companies that do not comply with the following Dodd-Frank Act requirements:

- the independence of each compensation committee member;
- the compensation committee's authority to retain or obtain advice from compensation advisers;
- the compensation committee's evaluation of the independence of compensation advisors and consultants;
- funding requirements for payments to compensation advisers;
- the adoption of a claw-back policy that provides for recoupment of executive incentive compensation if financial statements are restated due to a material noncompliance with financial reporting requirements;
- the disclosure of policies regarding incentive-based compensation based on publicly reported financial information; and
- additional disclosure in proxy or consent solicitation materials for an annual meeting of the shareholders relating to the use of compensation consultants and any conflict of interests relating to such consultants.

MJDS companies are exempt from having an independent compensation committee as long as they disclose in their annual reports to shareholders the reason why they do not have an independent compensation committee. It is unclear whether the other requirements apply to MJDS companies; however, given that MJDS companies are exempt from the proxy rules of section 14 of the Exchange Act and are generally exempt from the corporate governance rules of national securities exchanges, MJDS companies likely would be exempt from

these requirements. However, the SEC's proposed clawback rules<sup>8</sup> would, by their terms, apply to MJDS companies.

## Repeal of Rule 436(g)

The repeal of Rule 436(g) under the Securities Act pursuant to the Dodd-Frank Act has required registrants to obtain and file consents from the applicable credit rating agency when including ratings information in their registration statements. Since credit rating agencies are reluctant to grant their consent, these ratings have largely been removed from US prospectuses.

**Annex A**

**Comparison of MJDS and other SEC registration forms**

	<b>FPI</b>	<b>MJDS-eligible issuer</b>	<b>US domestic issuer</b>
Exchange Act registration forms (required when listing in the US)	Form 20-F, which requires SEC-specified disclosure regarding the FPI and is subject to SEC review.	Form 40-F, which consists of all material information made public in Canada since the end of the previous fiscal year and is generally not subject to SEC review.	Form 10, which requires SEC-specified disclosure regarding a US domestic issuer and is subject to SEC review.
Exchange Act reporting forms (required when registering a class of securities under the Exchange Act or offers and sales of securities under a Securities Act registration statement)	Form 20-F for annual information, including annual audited financial statements.  Form 6-K for all other material information disclosed by the FPI according to home-country or stock exchange requirements.	Form 40-F for annual information, including the Canadian annual information form, audited annual financial statements and accompanying MD&A.  Form 6-K for all other material information disclosed by an MJDS- eligible issuer under Canadian or stock exchange requirements.	Form 10-K for annual information required by the SEC, including annual audited financial statements.  Form 10-Q for interim period financial and other information.  Form 8-K for disclosure of specified material events.
Securities Act registration forms (required when registering the offer and sale of securities in the United States)	Form F-1, which requires a long form prospectus that includes SEC-prescribed material information about the FPI.  While the disclosure required by Form F-1 is in accordance with US disclosure standards, the disclosure requirements are somewhat less demanding than what would be required by Form S-1. Among other things, Form F-1 contains less specific requirements about the description of business, and permits disclosure of executive compensation in the aggregate, unless otherwise disclosed on an individual basis.	Form F-10 is available for the registration of any security other than certain derivative securities by an MJDS- eligible issuer with a public float of \$75 million or more.  Form F-10 consists of a prospectus filed with the SEC, certain other information and exhibits. The disclosure in the prospectus is governed by disclosure requirements applicable in Canada, except that the MJDS prospectus may omit information that is applicable solely to Canadian investors and not material to US investors. The MJDS prospectus also must contain specified legends and a list of all other documents filed as part of the registration statement.	Form S-1, which is the registration statement available for initial public offerings by US domestic issuers and when such issuers are not eligible to use other forms.  Form S-1 includes the most extensive disclosure requirements, which specify the material information that must be included in the prospectus that is part of the registration statement. Form S-1 also requires disclosure of other specified information and exhibits.

## ENDNOTES

1. SEC Release No. 33-6902 (June 21 1991).
2. Rule 405 under the Securities Act. See also Securities Offering Reform Questions and Answers, Nov. 30 2005, *available at* [www.sec.gov/divisions/corpfin/faqs/securities\\_offering\\_reform\\_qa.pdf](http://www.sec.gov/divisions/corpfin/faqs/securities_offering_reform_qa.pdf).
3. SEC Release No. 33-9245; 34-64545 (July 27 2011).
4. Form F-10, *available at* [ustwww.sec.gov/about/forms/formf-10.pdf](http://ustwww.sec.gov/about/forms/formf-10.pdf).
5. Finra Rule 5110.
6. National Instrument 44-102. See also General Instruction II.L. to Form F-10.
7. For an example of potential liability for MJDS companies based on material misstatements and omissions in MJDS filings, *see In the Matter of Sony Corporation and Sumio Sano*, Release No. 34-40305 (August 5 1998).
8. *See* [www.sec.gov/rules/proposed/2015/33-9861.pdf](http://www.sec.gov/rules/proposed/2015/33-9861.pdf).

## 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 US 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.<sup>1</sup> 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 favourable than Schedule B.<sup>2</sup>

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.<sup>3</sup> 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.<sup>4</sup>

### **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 US;
- 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. In addition, sovereign debt issuances over the last several years have included collective action clauses, under which the payment terms relating to principal, interest and maturity may be amended with only the consent of a qualified majority of debtholders (typically 75%), rather than the consent of all affected debtholders.

## **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.<sup>5</sup> 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.<sup>6</sup> 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.<sup>7</sup> 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.<sup>8</sup>

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.<sup>9</sup> 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 US. 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 US 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.<sup>10</sup> 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 US; (2) an act performed in the US in connection with a commercial activity of the sovereign elsewhere; or (3) an act outside the territory of the US in connection with a commercial activity of the sovereign elsewhere that causes a direct effect in the US.<sup>11</sup> 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.<sup>12</sup>

### 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 security holders 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 US 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 US to enforce a judgment in the US 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 US 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.<sup>13</sup>

In cases where the sovereign debt securities are not rated investment grade, the SEC staff has granted no-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:<sup>14</sup>

- 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 \$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 US 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 is a participant. Under Finra Rule 5110, no Finra member or any of its associated persons may participate in any manner in any public offering of securities unless certain documents and information relating to the offering

have been filed and reviewed by Finra, subject to certain exceptions. In addition, under Finra Rule 5121, 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 five percent 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).
- 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 defence 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, 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, eg,* 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, eg,* 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, eg,* 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).



