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EXEMPT STRUCTURED PRODUCTS PROGRAMS IN THE U.S.: ISSUES FOR NON-U.S. BANKs

Non-U.S. banks proposing to issue structured notes in an exempt offering must deal with a medley of securities and banking law regulations and business considerations. The authors provide an overview of the requirements and best practices, including available exemptions, consultations with regulators, restrictions on investors, required financial statements, and other program documentation.

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Non-U.S. banks that maintain a registered medium-term note program may wish to supplement that platform with an exempt bank note program for issuances of structured products. Other non-U.S. banks may wish to make the plunge into the U.S. market for the first time. Alternatively, a non-U.S. bank may have an existing exempt program, but has never contemplated using that program for issuances of structured products. In this article, we summarize the key issues to be considered prior to launching an exempt structured products program.

Which exemptions are available and is there any advantage to using any particular exemption?

Foreign banks may avail themselves of three exemptions from registration under the Securities Act of 1933. Rule 144A and Regulation D under the Securities Act are both transactional exemptions available to a non-U.S. bank or any other issuer, regardless of its business.[1] Regulation D is a safe harbor for private placements under Section 4(a)(2) of the Securities Act. There are significant restrictions on transfer and resale for Rule 144A or Regulation D securities.

Section 3(a)(2) under the Securities Act is an exemption for securities issued or guaranteed by a "bank." It is available for securities issued by certain U.S. branches or agencies of a foreign bank, but not to the securities of the foreign bank, except as discussed below.[2] The SEC deems a branch or agency of a foreign bank located in the United States to be a "bank," as defined in Section 3(a)(2), provided that the nature and extent of federal and/or state regulation and supervision

[1] In this article, we refer to issuers using the Rule 144A and Regulation D exemptions as "foreign banks," which term

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includes foreign financial institutions that may not be organized as a bank.

[2] For an extensive discussion of Section 3(a)(2) bank note programs, please see our FAQ *at* http://www.mofo.com/capital-markets-services/?op=richTextB&ajax=no.

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of the particular branch or agency is substantially equivalent to that applicable to U.S. federal or state banks doing business in the same jurisdiction.

The securities of a foreign bank are exempt under Section 3(a)(2) if they are guaranteed by a bank. Many non-U.S. banks use this structure by having the U.S. branch or agency guarantee securities issued by the non-U.S. headquarters or branch. Another alternative is the U.S. branch or agency act as the guarantor for securities issued by a finance subsidiary of the foreign bank. The guarantee is a legal requirement to qualify for the exemption; investors will typically not be looking to the U.S. branch or agency for payment, but rather to the home office. The guarantee must be full and unconditional.

Section 3(a)(2) bank securities have no investor or resale limitations, except as discussed below, and are generally freely transferrable and "public," as opposed to "private" securities issued under the Rule 144A or Regulation D transactional exemptions.

Why might a non-U.S. bank consider an exempt program in addition to an existing public program?

Any bank that already issues under a registered program may consider whether an exempt program would simply be redundant, or actually provide benefits to it. The following are among the reasons why many issuers maintain an exempt program in addition to their registered program:

- Particularly in the Rule 144A market, some investors wish to keep the terms of the securities that they purchase confidential, which is not feasible in connection with a registered offering.

- Some types of underlying assets are not contemplated by the SEC's "Morgan Stanley" no-action letter relating to registered structured notes, including credit-linked notes and small-capitalization stocks.[3]

- Practitioners generally believe that the potential for federal securities law liabilities in the event of a misstatement or omission in the offering documents is somewhat reduced in the case of an exempt offering. This feature might be particularly attractive in the case of complex securities or complex underliers that are used in an offering sold to institutional investors.

Does the foreign bank need to consult with any U.S. regulator prior to launching the program?

A foreign bank issuing under the Rule 144A exemption or the Regulation D safe harbor would not have to consult with, or be regulated by, any U.S. regulatory entity prior to issuing its securities, nor would it have to use a U.S. branch or agency to issue under those exemptions.

A U.S. branch or agency of a foreign bank should consult with its state and federal regulator prior to launching a structured product program. U.S. branches or agencies that have chosen to be regulated as a state bank (typically New York) should consult with their state banking regulator, the New York State Department

[3] Morgan Stanley & Co. Incorporated, SEC No-action Letter (June 24, 1996). Under the terms of the Morgan Stanley letter,

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an issuer of a debt security (the "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 U.S. 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 § 12 of the Securities Exchange Act of 1934 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.

of Financial Services (the "NYDFS"), and the Federal Reserve Bank of New York.

There are no formal federal or New York state bank regulatory application, registration, or notification requirements for the issuance of notes by a New York branch. However, advance consultation with the NYDFS on any structured notes program should be considered. The NYDFS may want the opportunity to review these types of programs, and to approve/not object to the terms and conditions of the program or a proposed offering.[4] Branches or agencies in other states should contact their state and federal regulators.

If the U.S. branch's or agency's primary regulator is the Office of the Comptroller of the Currency, the program must comply with 12 C.F.R. Part 16, the OCC's Securities Offering Disclosure Rules, as more fully discussed below. U.S. branches or agencies that have elected to be federal branches or agencies are regulated by the OCC.

An uninsured state-regulated U.S. branch of a foreign bank is subject to the deposit regulations of the International Banking Act of 1978, as amended.[5] Some types of notes issued by such a bank could be viewed as a "deposit" by the branch's state or federal regulators within the meaning of Section 3(l) of the Federal Deposit Insurance Act.[6] In order to avoid being considered a prohibited retail deposit of an uninsured domestic branch of a foreign bank, those types of deposits cannot be offered in denominations that are less than the "standard maximum deposit insurance amount," which is currently $250,000.[7] This limitation does not apply to notes issued by a foreign bank and guaranteed by its U.S. branch, and accordingly, that structure is more typically used for programs that are not planned to be limited to institutional investors.

Comparable requirements are applicable to an uninsured U.S. branch that is regulated by the OCC under the OCC's deposit-taking rules.[8] These restrictions are subject to a variety of exceptions set forth in the OCC's rules. The OCC is also authorized to grant exemptions to these limitations if the branch can demonstrate that the proposed activity is consistent with the policy of according foreign banks competitive opportunities equal to those of U.S. banks described in 12 C.F.R. § 28.16(a).

Are there any restrictions on investors?

Foreign banks and U.S. branches or agencies issuing notes under Rule 144A must sell only to "qualified institutional buyers," as that term is defined in Rule 144A(a)(1) ("QIBs"). Sales to individual retail investors are prohibited. Notes sold under Rule 144A also have significant restrictions on transfer; resales to other QIBs are allowed, but transfers to non-QIBs are subject to significant restrictions, which often prevent these transfers from occurring.[9] General solicitation can now be used in a Rule 144A offering, but sales can only be made to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs.[10]

Foreign banks and U.S. branches or agencies issuing structured notes under Rule 506 of Regulation D can sell to an unlimited number of "accredited investors," as that term is defined in Rule 405 under the Securities Act, and up to 35 non-accredited investors who meet certain "sophistication" requirements, if the appropriate resale limitations are imposed, any applicable information requirements are satisfied, and the other conditions of the rule are met.[11] General solicitation is now permitted

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[4] *See also* the note below on issuances by New York agencies.

[5] 12 U.S.C. § 3104(c)(1).

[6] In the past, the FDIC stated that it believed that certain types of bank notes issued by insured depository institutions, such as instruments marketed as "deposit notes," fall within Section 3(l)(1) of the Federal Deposit Insurance Act. 60 Fed. Reg. 66,952 (1995). In contrast, the FDIC has stated that a bank product that is structured as a non-principal protected instrument (like most – but of course, not all – structured notes) is a non-deposit obligation of the bank. Letter of Joseph A. Genova Jr., FDIC Senior Regional Attorney to Bankers Financial Services Corporation (February 27, 2002; *available at* https://www.indexedcd.com/bankers/public/datafiles/regulatory_review_fdic_insurability.pdf).

[7] 12 C.F.R. §§ 347(e), (v).

[8] 12 C.F.R. § 28.16.

[9] For a detailed discussion of Rule 144A programs, *see* the Morrison & Foerster LLP FAQ *at* http://www.mofo.com/capital-markets-services/?op=richTextB&ajax=no.

[10] To date, structured note issuers have not made much use of general solicitation in Rule 144A offerings.

[11] Under Rule 506(b)(2)(ii), each purchaser in a Rule 506 offering who is not an accredited investor must possess, or the issuer must reasonably believe before the sale of the securities that such purchaser possesses, either alone or with his or her purchaser representative, "such knowledge and experience in financial or business matters that he [or she] is capable of evaluating the merits and risks of the proposed investment." Generally, issuers of structured products using the Rule 506

in certain Rule 506 offerings, provided that all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors. A foreign bank can opt to issue structured notes under Rule 506 without using general solicitation.

Whether or not general solicitation is used in a Rule 506 offering, the new "bad actor" disqualification provisions will apply. These provisions prohibit issuers and others such as underwriters, placement agents, directors, executive officers, and certain shareholders of the issuer from participating in a Rule 506 offering if they have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws.[12]

Structured notes issued under Rule 144A or Rule 506 of Regulation D are "restricted securities," as that term is defined in Rule 144(a)(3) under the Securities Act, and are subject to restrictions on resale.

There are no minimum denomination requirements for a Rule 144A or Rule 506 offering of structured notes; however, concerns about preventing confusion between bank deposits and deposit products and bank notes may cause banks to issue in denominations of at least $1,000. In addition, many bank notes are issued in higher denominations in order to help address investor suitability concerns.

A U.S. branch or agency that is regulated by a state, rather than the OCC, can issue Section 3(a)(2) bank notes to all investors, including retail. However, an agency of a foreign bank subject to New York banking regulations would have to notify the Superintendent of the NYDFS of the upcoming transaction, and, absent objection from the Superintendent within 30 days of such notice, would be able to sell only to certain authorized institutional purchasers in minimum denominations of $100,000.

Under the OCC Rules, a federal branch or agency can issue bank notes under any of three exemptions from the OCC's registration requirements:

- Part 16.6 of the OCC Rules provides for issuances of non-convertible "investment grade" debt to accredited investors, in $250,000 minimum denominations, subject to certain disclosure requirements and a post-sale filing. Any resale of a bank note under Part 16.6 must be in a minimum denomination of $250,000.

- Part 16.5 provides exemptions for issuances of securities under Rule 144A or Regulation S under the Securities Act.

- Part 16.7 provides an exemption for issuances of securities under Regulation D.

Issuances of structured bank notes by a federal branch or agency under Rule 144A or Regulation D in compliance with the OCC Rules would be subject to the restrictions on the manner of offering, and the OCC's deposit-taking rules, each as discussed above.

What type of financial statements is required in the disclosure documents?

There are several threshold questions about financial statement requirements, and the answers will depend on the identity of the issuer and the exemption used for the issuance. For example, a foreign bank issuing structured notes in the United States under Rule 144A or Rule 506 would use its own financial statements. Preferably, the financial statements should be in English, audited, in a form understandable to U.S. investors, and publicly available. U.S. GAAP or IFRS are the choices that are most widely used in the U.S. market. In registered offerings, financial statements prepared under other accounting principles need to include a U.S. GAAP reconciliation footnote, and the bank and its distributors may wish to consider whether this is a desirable step for a non-registered program. For a continuous offering program, the bank should also publish unaudited financial statements, at least on a semi-annual basis. The statistical disclosures required in a registration statement by Industry Guide 3, *Statistical Disclosure by Bank Holding Companies*, may also be desirable to include.

Often, the most convenient situation would be if the foreign bank could incorporate its audited financial statements from a Form 20-F or 40-F filed with the SEC.[13] Although not required for an exempt offering, issuers incorporating their financial statements from a

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exemption do not offer or sell securities to non-accredited investors.

[12] For a detailed description of the bad actor provisions applicable to Rule 506 offerings, please *see* the Morrison & Foerster LLP Client Alert *at* http://www.mofo.com/files/Uploads/Images/130715-Bad-Actor-Disqualifications.pdf.

[13] This would be the case for a foreign bank that currently maintains a shelf registration statement and wishes to supplement its registered offerings with an exempt platform.

Form 20-F may wish to ensure that the form is filed prior to the financial statements becoming more than 15 months old.[14]

An alternative would be if the foreign bank's audited annual financial statements (and unaudited semi-annual or quarterly financial statements), meeting the requirements of its home jurisdiction, are posted and regularly updated on a website or an electronic delivery system generally available to the public in its primary trading market. Those financial statements can be incorporated by reference into the offering document.

Because a U.S. branch or agency will not have its own financial statements, market practice is to use the financial statements of the parent foreign bank, as they are recognized as one enterprise.

In all situations, the lead distributor for the proposed structured notes program should be consulted as to the form of the financial statements. Variations from the use of a Form 20-F or 40-F, and from U.S. GAAP or IFRS, may raise concerns with the distributors.

Rule 144A Offerings

Foreign banks, and U.S. branches or agencies of a foreign bank, issuing structured notes under Rule 144A, in each case not subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act nor exempt from reporting under Rule 12g3-2(b) thereunder, must make available to any purchaser of a structured note and a prospective purchaser designated by the holder the financial information required by Rule 144A(d)(4). That information includes financial statements for the last two fiscal years, which should be audited to the extent reasonably available.

Part 16

Federal branches and agencies using the OCC Part 16.6 exemption must provide the OCC the information specified in Rule 12g3-2(b) under the Exchange Act and provide investors with the information required by Rule 144A(d)(4)(i).

Regulation D

Foreign banks, or U.S. branches or agencies thereof, issuing under the Rule 506 exemption (including issuances by federal branches or agencies under OCC Part 16.7) to non-accredited investors must satisfy the requirements relating to financial and other information to be provided to non-accredited investors included in Rule 502(b) under the Securities Act. This step can cause offerings to these types of investors to be impractical or expensive; consequently, they are not common in the structured note market.

What regulatory issues arise from using a New York branch as the issuer, as opposed to acting as the guarantor?

While there are no specific rules on how New York branches of foreign banks may use the proceeds of their funding activities, Federal and New York bank regulatory authorities will want to understand the purpose of the issuances, where and how the funds will be used, and how the market risks will be hedged. In addition, regulators are likely to closely scrutinize any proposal to repatriate to the home office the proceeds of any funding activities, including the proceeds of notes issued by a New York branch. Federal and state authorities routinely monitor the exposures of U.S. branches to their home offices and may raise supervisory questions if those exposures become excessive. These determinations are made on a case-by-case basis.

The NYDFS currently does not have rules or regulations limiting on-lending. However, the NYDFS has an informal policy that may limit the amount a New York state-licensed branch or agency may be owed by its head office or any other affiliate to 50% of the assets of that branch or agency.

The NYDFS has stated that it no longer strictly applies the informal on-lending policy to limit the size of net due from head office accounts of New York state-licensed branches and agencies. Rather, the NYDFS applies the informal on-lending policy only to prohibit the use of a New York branch license solely as a funding vehicle for a bank's head office, and as a tool to monitor the asset quality of the branch or agency, especially in light of concentration of country exposure. If the institution of the head office is strong, the NYDFS is likely to be less concerned with a large amount due from the head office. A bank that plans to substantially increase its due from the head office because of on-lending of funds raised in the capital markets may wish to discuss the matter in advance with the NYDFS.

New York branches of foreign banks are also subject to asset segregation requirements that are intended to ensure the ability of the New York branch to satisfy its covered liabilities. In turn, any notes issued or

[14] *See* Item 8.A.4 of Form 20-F. This is a requirement for offerings for registered securities, and depending upon the nature of the program, the dealers may expect that the financial statements available to purchasers in an exempt offering be just as "fresh."

guaranteed by a New York branch would presumptively be considered liabilities for purposes of these financial regulatory requirements.

The NYDFS also will want to understand how the market risks arising from the notes will be hedged, and by which entity. Consideration should be given to whether the branch has the authority to carry a hedge book, and whether the branch has systems in place to hedge. Does the branch have people experienced in derivatives transactions and analyzing risk? Who will be the hedging counterparties? Hedging transactions should also be analyzed to avoid any violation of the affiliate transaction restrictions of Sections 23A and 23B of the Federal Reserve Act, should a hedging counterparty be an affiliate of the bank.

How early in the process should the issuer choose a lead dealer for the program?

Very early. Many banks have an affiliated broker-dealer that will be part of a structured note program. That affiliated dealer may or may not have expertise in the structured products market. If the affiliated dealer is unfamiliar with the structured products market, and the related distribution and sales issues, the issuer will likely seek to engage an unaffiliated dealer that is familiar with the structured products market for the following reasons:

- FINRA and a variety of other U.S. regulators are focused on the suitability of sales of structured products, particularly to retail investors. An issuer will benefit from engaging a dealer that has experience in the structured product market, and that has established internal compliance procedures to ensure that its sales of structured products do not violate FINRA's suitability rule.

- The dealer may have particular views and preferences with regard to acceptable financial statements (as discussed above) and forms of documentation (as discussed below). It is better to take into account the dealer's preferences and suggestions early in the process instead of completing documentation that is later found to be unacceptable to unaffiliated dealers due to market practices and preferences.

- If the dealer plans to distribute through third-party broker-dealers that will not be signed up as dealers on the structured note program, the issuer should inquire as to the dealer's "know your distributor" practices and procedures, with a view to preventing any future reputational risk.

- The available FINRA filing exemption (generally, that the structured bank notes are rated "investment grade" by a nationally recognized statistical rating organization, or are in the same class as such securities) will depend on whether an affiliated or unaffiliated broker-dealer is used for the program, and whether "conflicts of interest" (as defined by FINRA) disclosure should be included in the offering circular.

- The lead dealer will want to start its diligence early in the process in order to identify any potential issues, whether relating to the issuer's creditworthiness, disclosures in the offering documents, or other areas.

What types of documents are needed for the program?

Although the names are different, the documentation for a structured bank note program is similar in many respects to that in a registered offering:

- Offering Circular: Because an exempt offering is subject to the anti-fraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, the information in an offering circular tends to be consistent with that in a prospectus for a registered offering, even though there is no specific content requirement under the Securities Act or the banking regulations. At a minimum, the offering circular should contain the information required for an offering by a national bank under OCC Part 16.6 – a description of the business of the issuer similar to that contained in a Form 10-K, a description of the terms of the bank notes, the use of proceeds, and the method of distribution.

  — Disclosure about a branch or agency will be very limited, and often consists of only the address, primary business lines, and date of establishment. Because the branch or agency is the same legal entity as the parent or headquarters, disclosure about the parent or headquarters is typically sufficient.

  — If a guarantee structure is used, the terms of the guarantee must be fully disclosed.

  — Structured note issuers also may use forms of "product supplements" for particular structures, such as structures whose complexity would require a lengthy description, and a "pricing

supplement" containing the terms of a particular note being offered.

- Distribution Agreement: This document would also be very similar to a distribution agreement for a registered offering. Here, early contact with the lead dealer will be helpful in identifying a form that is acceptable for that dealer and that is also market standard. The issuer should not necessarily attempt to make this document too "issuer-friendly" if, for example, the lead dealer is an affiliate of the issuer. Doing so may make it difficult to add third-party dealers in the future.

  — Careful consideration should be given to the comfort letters and the scope of legal opinions to be delivered at the commencement of the structured notes program and also on a periodic basis. Usually, an annual comfort letter that occurs shortly after the issuance of the audited financial statements will be delivered, and semi-annual or quarterly comfort letters will be delivered after the issuance of the periodic, unaudited financial statements. The opinions delivered, usually on a quarterly, semi-annual, or annual basis, will cover corporate matters (e.g., due incorporation, no conflicts, no litigation), regulatory matters (compliance with banking regulations, no registration required under the Investment Company Act), and also include a Rule 10b-5 disclosure statement.

  — Counsel should be consulted early on in the process in order to negotiate the scope of the opinions and to sort out delivery of the opinions between internal and external counsel. Internal counsel may not be comfortable giving certain opinions, while external counsel, if not regularly engaged by the issuer, may not be in a position to give one or more of the corporate opinions described above. For example, the due incorporation, no-conflicts, no litigation, and regulatory compliance opinions are often given by internal counsel, while the opinions on the availability of the securities or transactional exemption, and the Investment Company Act exemption are often delivered by external counsel.

  — Does the issuer have a designated underwriters' counsel? If so, and if they are going to play a role in the structured products program, they too should be consulted early on in the process. They will provide comments on, and have a view about, the program documentation. If the issuer is new to the structured notes market, it may want to designate underwriters' counsel to help guide through the process. Designated underwriters' counsel may be required to deliver a letter as to the absence of misstatements or omissions in the offering documents.

  — The issuer should plan for regular periodic diligence sessions involving document review by outside counsel and telephonic meetings with the dealers. The issuer's financial and legal teams should be available to discuss financial, legal, and regulatory issues. These diligence sessions are normally conducted immediately after the publication of the issuer's annual and periodic financial statements.

- Paying Agency Agreement: The issuer should identify the party that will be the paying agent for the bank notes. Some issuers use an affiliated bank for this purpose. The form of paying agency agreement will typically be specified by the paying agent, with some input from the lead dealer.

Drafting Process

As a threshold matter, the issuer should identify the correct entities and individuals within its organization to be tasked with reviewing documents, with a goal to avoiding last minute changes required by a particular internal group or department that has not been consulted.

CONCLUSION

There is a lot of spadework to be done by a foreign bank prior to launching an exempt structured products platform in the United States. Issuers would be well served to work with their counsel and planned distributors early in the process to identify the necessary steps and required action items. ■