PLI: Understanding the Securities Law 2014:

Derivatives, Structured Notes and other Alternatives to Traditional Securities Offerings
Alternatives to Traditional Offerings

- Traditional debt & equity offerings
  - SEC-registered
  - Rule 144A / Reg S

- Non-derivative / structured alternatives
  - PIPEs
  - Registered direct offerings
  - ATMs
  - Block trades
  - Rights offerings
  - Spin-offs / carve-outs
  - Reverse mergers
  - SPACs
  - BDCs
PIPEs

- **Private Investment in Public Equity**
  - Investment in public issuer through private placement of equity to accredited investors
  - **Private placement**
    - Generally conducted under Section 4(a)(2) or Regulation D
    - Securities are restricted (cannot be publicly resold), so investors usually request registration rights
    - Failure to file registration statement, get it declared or keep it effective generally results in liquidated damages
  - Because securities are restricted, typically sold at discount to market price & investors may get other rights (e.g., board seats)
  - Used when access to public markets is limited (e.g., distressed situation)
Advantages

- Can be used for various types of equity & also other securities
- Fast execution without potential delay from SEC review
- Generally requires disclosure to public only after investors commit
  - Potential investors generally agree to keep information confidential for limited time until offering completed or abandoned
- Generally lower transaction expense than public offering
- Can negotiate & customize terms
- Investor gets market discount and/or warrants
- Investor can achieve significant stake in thinly traded issuer
- In contrast to private placements of securities without a public market, investor can get liquidity through reg rights or hedging
Registered Directs

- Overview
  - Like a PIPE, but SEC-registered—i.e., can be sold to anyone
  - But typically marketed like a PIPE to institutions / accredited investors
  - Sometimes called “registered PIPEs”

- Advantages
  - Assuming shelf registration statement already effective, no SEC review
  - Because securities sold in registered offering, and therefore not restricted, may avoid pricing discount that PIPE can attract
  - Avoids going through purchase agreement / reg rights negotiation with investors & SEC registration process
  - Bolstered by relaxation of Form S-3 rules in 2008—SEC allowed smaller companies (float <$75m) to use primary shelf registration
Considerations

- Unlike PIPE, need effective shelf registration statement
- Targeted marketing may result in narrower distribution of securities than customary, fully marketed deal
- If selling ≥ 20% at discount to market price, even though SEC-registered, exchanges may not consider offering sufficiently “public” to allow use of public offering exemption from shareholder approval requirements
- Commonly used contingency structures—e.g., “all or none” or “min-max”—require escrowing proceeds until contingency is met
- FINRA approval needed if 1992 S-3 requirements (e.g., $150m public float) not met
At-the-Market Offering

- Also referred to as dribble-out program or arrangement
- Issuer sells equity, on continuing basis, through agent(s) into market at market prices

Advantages

- Significant timing flexibility (assuming no material non-public information)—particularly advantageous in volatile markets
- Allows issuer to set minimum price
- Minimizes disruption to stock price by dribbling into market, rather than selling large blocks
- Avoids risk of announcing large offering only to have it fail
- Typically, lower underwriting & other costs
Considerations

- Must maintain registration statement / prospectus & ongoing diligence procedures
- Regulation M—designed to prevent manipulative activity—may impose restrictions on issuer & agents, including in respect of stock repurchase & market-making activity
  - For issuer with sufficient “ADTV”, agents (but not issuers) benefit from exception
- Continuing offer over long period, so necessary to ensure compliance with appropriate restrictions on publicity & research
Additional Variations

- Forward Contract + ATM
  - Issuer enters into forward contract with affiliate of distribution agent
  - Max number of shares deliverable registered as ATM program
  - Agent borrows & shorts to sell shares under the ATM; issuer covers when forward settles
  - Can provide issuer with greater financing certainty
  - But may be more expensive than standard ATM & in some cases, limit issuer’s participation in upside appreciation in stock price

- Standby Commitments / Equity Lines
  - Issuer agrees with small number of investors that it can sell to those investors as & when necessary
  - May be difficult to locate investors

- Dividend Reinvestment Programs / Dividend Reinvestment & Stock Purchase Plans
  - Generally cheaper for investor than non-DRIP purchases; allows small purchases over time
  - Can be issuer-administered or bank-sponsored
  - Can permit both dividend reinvestment & optional cash investment
  - Offering shares at discount can be cheaper than paying underwriting fees
  - Promote shareholder loyalty / relations
Block Trades

- **Overview**
  - Underwriter buys stock from seller (issuer or selling shareholder) prior to commencing marketing efforts, with intent to resell promptly
  - Banks typically notified one day before expected launch & bid next day immediately after market closes
  - Lack of existing order book creates timing pressure on execution

- **Advantages**
  - Speed of execution, thereby potentially avoiding stock price dip associated with traditional launch

- **Considerations**
  - Substantial advance preparation required for issuer / selling shareholder & underwriters’ counsel—underwriters’ counsel typically designated well before the anticipated trade date
  - Must have effective registration statement & any necessary FINRA approvals
  - Underwriter diligence must be completed very quickly
Rights Offerings

Overview

- Issuer issues rights at no cost to existing stockholders entitling them to purchase pro rata portion of additional shares at given exercise price during exercise period
- Rights can be transferable or non-transferable
- Oversubscription rights also possible
- Backstop commitment can provide execution certainty
- Geography
  - United States: relatively uncommon outside bankruptcy context; may signal distress
  - Offshore: common, esp. in jurisdictions where shareholders have pre-emptive rights
Rights Offerings, cont.

- **Advantages**
  - Issuer can raise substantial proceeds
  - Issuer can obtain execution certainty through backstop
  - Shareholders obtain discounted equity investment
  - Shareholders can avoid dilution if wish or, if rights are tradable, sell to realize cash value
  - Backstop providers maintain or build existing equity stake if investors or earn fee income if classic underwriters

- **Considerations**
  - Typically takes several months to complete
  - Even though public offering for cash, domestic issuers may well need shareholder approval for backstopped rights offerings
  - Need to monitor change of control provisions in contracts & regulations to ensure not tripped (e.g., in indentures, in respect of NOLs, etc.)
Spin-Offs

- **Overview**
  - Distribution by issuer to shareholders of shares in one of its businesses

- **Advantages**
  - Allows non-core business to be separated
    - Focus management attention
    - More directly incentivize management & employees
    - Highlight high-growth business whose value is otherwise obscured
    - Eliminate conflict between businesses
    - Facilitate sale to a third party
  - Can be structured to be tax-free at issuer & stockholder levels
Spin-Offs, cont.

Considerations

- Separation is complex—operational, financial, accounting, legal, employment, tax, public company reporting & compliance, etc.
- Debt covenants may be tripped by significant transfer
- Shareholder vote typically required
- Need to ensure dividend permitted under corporate law—e.g., in Delaware, dividend must not exceed surplus
- SEC registration generally required unless
  - No consideration provided for shares
  - Pro rata to shareholders
  - Proxy / information statement provided to shareholders & shares are registered under 34 Act
  - Valid business purpose
  - If restricted securities distributed, holding period requirements met

Variations

- Carve-out offering—IPO of business for cash
- Tracking stock—synthetically liberate subsidiary using separate ticker, but no actual legal separation
Reverse Mergers

- **Overview**
  - Private issuer shareholders exchange shares for shares of public shell
  - Circumvents customary IPO process
  - Aka “reverse takeovers”

- **Advantages**
  - Can substantially shorten timeline to being public & obtaining associated liquidity & access to capital markets
  - Generally lower cost than traditional IPO
  - No SEC review, but comprehensive Form 8-K with audited financials required
  - No capital raising involved, so not dilutive to existing holders & not sensitive to market windows
Reverse Mergers, cont.

- **Considerations**
  - Avoiding traditional process may mean greater opportunity for abuse
    - Shells may have history of undisclosed problems
    - Often fail to remain viable after merger
    - May involve small auditing firms lacking appropriate capability
  - Even absent abuse, may raise reputational concerns
    - SEC investor bulletin suggesting caution
    - SEC has suspended trading due to concerns relating to accuracy & completeness of financial information
  - Even for legitimate enterprises, avoiding traditional IPO process means foregoing market feedback
    - In traditional IPO, if road show reveals insufficient demand, offering can be pulled and issuer can avoid going public & associated costs
SPACs

- **Special Purpose Acquisition Companies**
  - Newly formed company with no assets or operations
  - Registers with SEC to sell stock & warrants publicly
  - Business plan: find operating company to buy with IPO proceeds
  - May or may not specify industry or geographic focus

- **Advantages**
  - SEC safeguards & liquidity of public stock, but private equity-like returns
  - Increasingly reputable in recent years, with backing by bulge-bracket underwriters

- **Considerations**
  - SEC reporting & compliance
  - Cannot have target at time of registration
  - Generally put 80-95% of proceeds in escrow until acquisition
  - Liquidates & returns funds if no acquisition in stated time (18-24 months)
  - Full proxy statement & vote before acquisition
  - Investors who vote “no” may ask for refund of share purchase price
BDCs

- **Business Development Companies**
  - SPAC designed to take a company public; buys company that essentially becomes the SPAC
  - By contrast, BDC is public pool used to make many investments in private companies, including in debt

- **Advantages**
  - Again, public company / private equity hybrid—i.e., liquidity & permanent capital
  - No corporate-level tax to extent at least 90% of ordinary income distributed annually & certain asset diversification & other tests met

- **Considerations**
  - SEC reporting & compliance
  - Must invest at least 70% of assets in certain types of investments, including private U.S. companies
Reverse Mergers

- Merge with public shell – well known include American Apparel, Jamba Juice, Texas Instruments, Blockbuster, Berkshire Hathaway, and technically also RMs were the NYSE, Burger King and Merck-Schering Plough

- Speedier, cheaper, simpler, less risky than IPO

- Some shady players at times (1980s, China in 2000s)

- Merger with contemporaneous financing called APO or alternative public offering

- SEC has enhanced regulation improving transparency & legitimacy but never outlawed
Reverse Mergers (cont’d)

- “Super” Form 8-K disclosure filing after transaction
- Special Rule 144 restriction (House Committee passed limit on this restriction in 2014)
- “Seasoning” restriction requiring OTC trading for a period of time passed in 2011

Legal Issues and Considerations of APOs
- Reverse Triangular Merger/share exchange
- Shell capitalization – splits and authorized stock
- Changes in board – Schedule 14F-1
- Changing the shell’s name
- Issuance of merger shares as offering
- Value of reps and warranties
- Shell due diligence – footnote 32/172
- SPACs – have unique advantages and issues
Reverse Mergers (cont’d)

- **Warning signs/issues**
  - Make sure going public makes sense
  - If IPO available compare costs and risks
  - Consider self-filing (next slide)
  - Carefully check out intermediaries and motives
  - Beware of messy or dirty shells (Form 10 shells clean)
  - Market support development – RM is not a liquidity event but a step
Self-Filings

- If IPO not available and shell merger not preferred
- Avoids various issues with shells (seasoning, etc.)
- Takes longer but trading upon completion
- Form 10 or Form S-1 depends on circumstances
Medium-Term Notes
Medium-Term Note Programs

• A medium-term note (“MTN”) program contemplates continuous issuances (rather than a delayed issuance).

• Usually offered by an MTN desk (a trading desk) at an investment bank, which is a dealer or manager of the MTN program.

• Dealers will post rates and bring offers for MTNs to the issuer to accept or to reject.

• Buyers for MTNs are often institutions like insurance companies, funds, municipalities.

• Dealers act on a best efforts basis or on a principal basis.
Principal Documentation for an MTN Program

• MTN Prospectus Supplement
• Pricing Supplements
  • May be very short for “plain vanilla notes”
  • May be very long for structured notes or other products
• Program Agreement
• Indenture and Authorization
• Opinions and Comfort Letters
• Forms of Notes
Other Types of Continuous Offering Programs: Debt and Structured Products

• Rule 144A Programs
• Bank Note Programs
  • OCC, Part 16.6
• Commercial Paper Programs
• EMTN Programs
  • Variations: Australian MTN, German MTN, etc.
• Because these are unregistered programs, there is typically an “agency agreement,” as opposed to an indenture.
Documentation for EMTN Program

• Offering Circular
  • If a listed program, must be approved by the relevant European stock exchange.
• Agency agreement, with forms of notes.
  • Governs arrangements for issuing notes, payments of principal and interest, and related matters.
• Program agreement.
• Form of pricing supplement. “Final terms” in European parlance.
• Program must be approved by the European clearing systems: Euroclear and Clearstream.
Continuous Offering Programs: Opinions and Comfort Letters

- Usually provided to the dealers at the time that the program is signed.
- Program agreement usually requires quarterly delivery of issuer’s counsel opinion, and comfort letter.
- Takedowns: varies from program to program.
  - Reliance on quarterly deliverables?
  - Every takedown?
  - Syndicated offerings only?
  - Offerings above a certain size?
Administrative Procedures Memo

- Describes steps for offering securities from a continuous offering program.
- Usually an exhibit to the program agreement and/or the agency agreement.
- Key participants: underwriter’s “back office,” and trustee or fiscal agent.
- Critical to have these parties carefully review the document.
- Critical to understand which parts of the process MoFo will be involved in.
Structured Products
Structured products

• Generally, a debt security or a bank deposit the payments (principal and/or interest) as to which are based on the performance of a reference asset
• FINRA: “…securities derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or a foreign currency.”
• NYSE: “….a security which is based on the value of another security.”
• However, there is no definitive definition, so if you are asked about a “structured product,” it is important to clarify and to seek to understand the specific financial instrument being discussed or contemplated
Who issues structured products?

• Generally, large financial institutions that are WKSI s issue structured products, usually on an SEC-registered basis.
• Foreign banks may issue structured products to US investors in reliance on the Section 3(a)(2) exemption or in a private placement.
• Usually, the broker-dealer affiliate of the financial institution issuer will be involved in structuring the product, distributing the product, and often will provide the issuer with a derivative that will allow the issuer to hedge the risk associated with the product.
Anatomy of a structured note

Index-linked Accelerated Return Note

Advisors are compensated based upon the $0.20 (2%) underwriting discount.

Periodic interest payments for the term of note (LIBOR+1.7%)

Issuer

Underwriter (hedging desk)

Hedge Counterparty

Price per note = $10

$9.80 per note

Note return due at maturity

Note return due at maturity

Price of Hedge

$0.20 per note

$0.20 underwriting discount

Issuer borrows $10 at an interest rate of LIBOR+1.7% (rate based on Issuer’s secondary credit curve minus the structured note funding discount)

• Issuer receives $9.80 from Underwriter and $0.20 from Hedging Desk
• Issuer pays Hedging Desk LIBOR + 1.7% p.a. for the life of the note

Issuer repays $10 per note at maturity

• Issuer pays note redemption value to investor via DTC
• If the note redeems above $10, Hedging Desk pays Issuer the difference
• If the note redeems below $10, Issuer pays Hedging Desk the difference

Summary of Economics for Underwriter:
Underwriter earns $0.275 per note consisting of:
• $0.20 (2%) earned as underwriting discount
• $0.075 (0.75%) earned as hedge-related charge

Summary of Economics for Investor:
Investor pays $10

At maturity, investor receives the payoff described in the prospectus

Summary of Economics for Issuer:
Issuer borrows $10 at an interest rate of LIBOR+1.7% (rate based on Issuer’s secondary credit curve minus the structured note funding discount)

• Issuer receives $9.80 from Underwriter and $0.20 from Hedging Desk
• Issuer pays Hedging Desk LIBOR + 1.7% p.a. for the life of the note

Issuer repays $10 per note at maturity

• Issuer pays note redemption value to investor via DTC
• If the note redeems above $10, Hedging Desk pays Issuer the difference
• If the note redeems below $10, Issuer pays Hedging Desk the difference

Summary of Economics for Investor:
Investor pays $10

At maturity, investor receives the payoff described in the prospectus

Summary of Economics for Underwriter:
Underwriter earns $0.275 per note consisting of:
• $0.20 (2%) earned as underwriting discount
• $0.075 (0.75%) earned as hedge-related charge

Summary of Economics for Investor:
Investor pays $10

At maturity, investor receives the payoff described in the prospectus
How are structured products issued?

- Are typically issued from:
  - Medium-Term Note Program
  - Bank Note Program
  - Rule 144A Program
  - European Structured Note Program
  - As structured certificates of deposit (also referred to as “market linked CDs”)
  - As warrants or “certificates”
Types of products

• May reference the performance of:
  • Individual stocks, or baskets of stocks
  • Individual indices, or baskets of indices
  • Foreign currencies
  • Commodities
  • Interest rates
  • Credit-linked securities

• May result in investor returns based on:
  • Increases in the value of the reference asset
  • Decreases in the value of the reference asset
  • A multiple of the increase or decrease (leveraged return)

• May guarantee the return of the investor’s principal (“principal protected”), subject to the issuer’s credit risk, or may not (“non-principal protected”)

• May pay cash, or in actual units of the underlying asset (so-called “physical delivery”)

• Usually not exchange traded, although Exchange Traded Notes (or ETNs) are also considered “structured products”
Why invest in a structured product?

• Retail investors as well as institutional investors
  • Meets an investment profile or objective not achievable by the purchase of traditional assets
  • Attractive yield
  • Neatly packages a group of assets/products in a simple, easy to understand form
  • “Access” to underlying assets that might otherwise be difficult to access for a retail investor
• Leverage
• Tax
Regulatory framework

- The regulatory framework applicable to the products will depend upon whether the instrument is a “security” or a “bank deposit” and whether it is SEC-registered or issued pursuant to an exemption from registration.
- Regardless, there are special disclosure concerns related to structured products:
  - Product names, risk disclosures, adequate disclosures of the pay-off, fee disclosures, disclosures of actual or potential conflicts of interest, appropriate disclosures relating to the reference assets, and disclosures relating to the estimated value at issuance of the securities.
- Also, FINRA (and its predecessor, the NASD) are closely focused on sales of structured products:
  - New product approval
  - Suitability considerations
  - Required training of brokers
  - Avoiding potential misselling
  - Appropriate compliance and supervisory policies and procedures
  - Heightened standards applicable to products deemed “complex”
Derivatives
Derivatives

• A public company may enter into derivatives transactions for a number of different purposes:
  • To hedge commercial risk
    • For example, an energy company or an agricultural company may enter into hedging arrangements to minimize risk related to its commodity costs
    • A company may enter into interest rate or currency swaps to hedge exposures under various financing arrangements
  • In connection with its stock repurchases
    • A company may find it more efficient to enter into an accelerated share repurchase transaction or a similar arrangement
  • In connection with a merger
    • A collar for stock deals
  • In connection with a 144A offering to minimize dilution
    • A company may enter into a call spread
  • In order to raise capital
    • A company may enter into a forward equity sale
Derivatives (cont’d)

• The regulatory framework relating to derivatives transactions has changed following the financial crisis

• Title VII of the Dodd-Frank Act:
  • Regulates products
    • Swaps
    • Security-based swaps (SBSs)
  • Regulates entities
    • Swaps dealers (SDs)
    • Security-based swap dealers (SBSDs)
    • Major swap participants (MSPs) and major security-based swap participants (MSBSPs)
    • Derivatives Clearing Organizations (DCOs)
    • Swap Execution Facilities (SEFs)
    • Swap Data Repositories (SDRs)
  • Splits regulation between the SEC and the SEC
Derivatives (cont’d)

• Status of implementation
  • Most of the regulations implementing Title VII have been finalized, including
    • SD and MSP registration and related conduct standards
    • Swap data reporting and recordkeeping
    • Initial clearing determinations
  • A number of important matters must still be addressed, such as:
    • Margin for uncleared swaps
    • Capital requirements for SDs/SBSDs that are not “banks”
    • The remaining rules to be promulgated by the SEC relating to SBSs
    • Harmonization of U.S. rules and European rules
Derivatives (cont’d)

• For a public company considering whether to enter into a derivatives transactions, it is important to understand the basic framework applicable to derivatives. There will be a number of important questions to address:

• Are you an “end-user”?
  • End-users are understood to be corporates or commercial entities, not “financial entities”
  • The definition of a “financial entity” is very broad

• If you are an end-user, do you want to avail yourself of the clearing exception?
  • An end-user may be eligible for an exception from the clearing and trade execution requirements under CEA Section 2(h)(&) and CFTC Rule 50.50
  • Are you hedging or mitigating commercial risk?
Derivatives (cont’d)

• Have you taken the necessary steps to document your intention to rely on the end-user exception?
  • Board/committee approval in the case of public companies
  • Reporting requirement
  • Enter into the ISDA DF Protocol (or a similar bilateral document)
  • Obtain an LEI/CICI
  • Evaluate margining arrangements

• As an end-user, you may also choose to clear
  • If so, you will need to establish clearing arrangements
  • This will require entering into and negotiating new documentation
Derivatives (cont’d)

• Evaluate the type of derivatives transaction that you will be entering:
  • Is it a swap or a SBS?
  • Will it be required to be cleared or is it relatively bespoke?
    • If not cleared, what are the margin requirements?
  • How will the transaction be documented?
  • Will it be executed through an exchange?
  • Are there reporting requirements?
  • Recordkeeping requirements?
Requirements for end-users

• Reporting for End-Users
  • Reporting counterparty reports the following data points to an SDR (or the CFTC):
    • whether the swap is subject to the end-user exception;
    • the identity of the exempt end-user; and
    • whether the end-user has filed an annual filing with the SDR (or the CFTC).
  • End-user is required to report annually (or, if it chooses, on a trade-by-trade basis) to an SDR (or the CFTC) containing the following information:
    • whether it is a financial entity or a finance affiliate;
    • whether the swap hedges or mitigates commercial risk;
    • whether it is an SEC reporting company, and, if so, whether the appropriate committee of its board of directors has reviewed and approved the decision to enter into swaps that are exempt from clearing; and
    • how it generally expects to meet its financial obligations:
      • a credit support agreement;
      • pledged assets;
Requirements for end-users (cont’d)

- a third-party guarantee;
- its own available financial resources; or
- other means.

- An end-user also has certain recordkeeping requirements