Offering Alternatives

November 10, 2015
Agenda

• Deposit products
• Short-term instruments
• Exempt securities
  • Bank notes – the Section 3(a)(2) exemption
• Exempt transactions
  • The Section 4(a)(2) exemption
  • The Regulation D safe harbor
  • Rule 144A
• Registered continuous offering programs
Certificates of Deposit
Types of CDs

- Can be “plain vanilla”
  - Fixed rate, floating rate
  - Akin to a traditional CD, but held through brokerage account
- Can be structured CDs, linked to an underlying asset
- Can be “lightly structured”
  - Fixed to floating rate CDs, step up callables, CMS-linked
Structured CDs - features

- Can link to assets that are similar to those of registered notes: indices, ETFs, single stocks, currencies, interest rates.
- Technically, possible to link to a broader range of assets, since the SEC’s “Morgan Stanley” letter doesn’t apply.
- Interest bearing or non-interest bearing.
- Fixed, floating or indexed interest payments.
- Callable vs. non-callable.
- Participation rate – greater than, equal to, or less than, any increase in the underlying asset.
Structured CDs – features (cont’d)

• Survivor’s Option: upon death (or incompetence) of investor, estate can obtain deposit amount prior to maturity.
  • Feature is associated with some, but not all, structured notes.
  • Typically subject to aggregate limits in the course of a year.

• Key difference from structured notes: may not pay less than principal at maturity. Otherwise, the FDIC would take the position that they are not “deposits,” and not subject to FDIC insurance.
  • But: may sell for less than principal if sold prior to maturity.
  • That is, “principal protection” applies only at maturity.
Limitations on brokered deposits

• Brokered deposits are considered by some to be a risky banking tool.
  • Less likely to be rolled over at maturity, since another bank may offer better rates.
• FDIC 337.6 (Under Section 29 of the Federal Deposit Insurance Act): restricts use of brokered deposits and limits rates paid on interest-bearing deposits that are solicited by insured institutions that are less than “well-capitalized.”
• If less than well-capitalized, issuer must seek a waiver to accept new brokered deposits.
  • FDIC will consider traditional safety and soundness concerns in determining whether to grant a waiver.
• The rates on these CDs cannot “significantly exceed” the prevailing rates in the applicable market area.
Securities Law Issues

• “Certificates of deposit” are included in the 1933 Act’s definition of a “security.”

• However, under relevant case law, FDIC insured CDs are typically not treated as a “security.”
  • Guaranteed payment of principal.
  • Other regulatory protections provided to holders under applicable banking laws.
  • Similar concept of exemption from OCC registration for national banks.

• When is a certificate of deposit a security?
  • See “Gary Plastics,” a 1985 Second Circuit decision.
  • Bad facts:
    • Broker marketed CDs that it had obtained from other banks.
    • Broker promised to maintain a secondary market to guarantee liquidity.
    • Broker represented to investors that it had reviewed the financial soundness of the issuing banks.
FDIC Insurance

- Current limit is $250,000
- Application may vary, depending upon type of investment account.
  - Guidance is available to the public on the FDIC’s website.
- Not all payments are guaranteed:
  - Principal and guaranteed interest payments are covered.
  - The FDIC has taken the position that contingent payments at maturity, and any indexed interest payments, are not insured until determined.
    - Impact: if bank fails before a “determination date,” that payment will not be covered by FDIC insurance.
  - FDIC insurance will not cover any amount paid in excess of principal, such as the payment of a premium in a secondary market transaction.
    - e.g., investor pays $1,001 for a CD with a face amount of $1,000. That additional dollar is not insured.
Truth in Savings Act

• Federal Reserve Regulation DD implements the Truth-in-Savings Act.
• Provisions are applicable to the issuing banks, as well as to deposit brokers.
• Banks may not advertise deposits in any way that is inaccurate or misleading, and the regulation provides examples.
• Required disclosures of “annual percentage yield,” “penalty fees” that may be imposed for early withdrawals, and any other fees.
• In addition, the Federal Trade Commission Act prohibits unfair or deceptive acts or practices.
  • Applies to all aspects of a depository institution's consumer products and services, including advertisements.
FINRA Issues

• Because structured CDs are (usually) not “securities,” a variety of FINRA rules do not technically apply.
  • e.g., corporate financing rule, suitability.
  • However, most broker-dealers apply a comparable degree of compliance procedures to these instruments as they do in the case of securities.

• Key areas of FINRA regulation implicated by structured CDs:
  • Retail communications – accuracy and completeness.
    • FINRA has made substantive comments to broker-dealer marketing materials for these instruments.
  • Training.
  • New product approvals.
Third party distribution and KYD

- Many structured CDs are distributed through third party brokers.
- Often subject to a dealer agreement between (a) the dealer that is in privity with the issuer and (b) downstream distributors.
  - A separate form of agreement is typically needed that differs from the type used for securities.
    - Different regulatory regime.
    - FDIC record-keeping requirements.
- Market-wide concern that “bad acts” by downstream distributor could result in liability or reputational risk for issuer or primary distributor.
  - Agreements are filled with negotiated representations and warranties, covenants and indemnification, usually for the benefit of the primary distributor.
  - To date, FINRA’s proceedings with respect to structured products have generally imposed liability on the responsible entity.
Disclosure documents for CDs

• No specific form requirements. (In contrast, registered securities are subject to the form requirements of S-3/F-3 and Regulation S-K.)
• Truth-in-Savings Act, FINRA communication rules, and “best practices” require full and accurate disclosure.
• Often quite similar to the offering documents for registered notes – similar set of brokers, similar set of investors.
• Estimated Value Disclosures:
  • CDs are not subject to the 2012 SEC “sweep letter.”
  • However, many regard it as a good disclosure, any many distributors request its disclosure.
Additional documentation for CD programs

- Program or similar agreement with lead dealers.
  - Similar in some respects to agreements used for registered notes, but tailored for the bank regulatory structure.
- If applicable, paying agency agreement with third party paying agent.
- Forms of master certificates representing the issuances.
- Agreements with hedging counterparties.
Short-Term Instruments
What is commercial paper?

- Commercial paper is a term that tends to be used to refer to corporate short-term debt securities. Typically maturities are less than 12 months.
- Classically, commercial paper meant debt securities issued under Section 3(a)(3) of the Securities Act.
- There has also developed a market in short-term corporate debt issued under Section 4(a)(2) of the Securities Act.
- There are differences between the two types of commercial paper in terms of investor base, use of proceeds and securities law requirements for issuance.
Historical roots

• The legislative history of the Securities Act of 1933 provides an explanation of the genesis of Section 3(a)(3).

• Commercial paper was issued by merchants and manufacturers for short-term financing of operations and was sold primarily to banks through commercial paper dealers.

• There was a concern that if short-term paper that arises out of or finances current transactions and rarely bought by private investors were required to be registered, it would radically interfere with commercial banking transactions.

• The original Federal Reserve Act included commercial paper as an investment rediscordable by Federal Reserve banks.

• In 1933, the Federal Reserve requested an exemption for commercial paper and provided the language that became Section 3(a)(3).
Section 3(a)(3) requirements

• Section 3(a)(3) provides an exemption from the registration requirements of the Securities Act for:
  • 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;

• In 1961, the SEC stated in Rel. 33-4412:
  • The legislative history of the Act makes clear that Section 3(a)(3) applies 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 discountable by Federal Reserve banks.

The staff of the Commission has interpreted Section 3(a)(3) to exclude as not satisfying the nine-month maturity standard, obligations payable on demand or having provisions for automatic “roll-over.”
Section 3(a)(3) requirements (cont’d)

• The SEC imposed six separate characteristics as necessary for qualifying for Section 3(a)(3):
  • Negotiable
  • Prime quality
  • Eligible for discount at Federal Reserve banks
  • Not ordinarily purchased by the general public
  • Used to facilitate current transactions
  • Maturity of nine months or less with no automatic roll-over.
Current transactions

- Through a long series of no-action letters, the staff has defined current transaction for various types of businesses.
- Traditionally, it was necessary to trace the use of proceeds to identifiable current transactions.
- Today, following a 1986 staff response, it is only necessary to demonstrate that current transactions on the balance sheet exceed the amount of commercial paper outstanding at any time.
- Inventories and accounts receivable have long been accepted. Also operating expenses, such as salaries, short-term lending, federal, state and local taxes, and various types of bank loans with maturities not exceeding five years, have been accepted.
- However, acquisition financing is NOT considered a current transaction.
Section 3(a)(3) as public offering

• Section 3(a)(3) of the Securities Act provides an exemption from the requirement in Section 5 of the Securities Act to register any offer or sale of securities with the SEC.

• Section 3(a)(3) commercial paper is not a privately placed security
  • This is important, for example, in connection with Investment Company Act exemptions under Sections 3(c)(1) and 3(c)(7), which may not be used if the issuer is making a public offering.

• To meet the “not ordinarily purchased by the general public” standard, commercial paper is normally issued in minimum denominations of $100,000, although occasionally you will see $25,000 minimum denominations.

• Section 3(a)(3) commercial paper is usually rated “A-1” to satisfy the prime quality standard.
Continuous issuance

• Commercial paper is issued in continuously offered programs.
• Typical maturities are in the range of 7 to 21 days
  • See FRB H.15 releases and the Commercial Paper releases for maturity distributions and other statistics.
• Proceeds of commercial paper are often used to pay off maturing commercial paper.
• In the days before shelf registration, it would have been impossible to issue this frequently if registration were required.
• And even today, the registration costs would be prohibitive considering the high frequency of issuance.
Book-entry considerations

• Since 1990, virtually all commercial paper is issued in book-entry form through DTC or other clearing entities.
• The issuing and paying agent (or depositary bank) holds a master note for the benefit of DTC and records on its records daily issuance and redemptions.
• There is generally no involvement of counsel in daily issuance.
• Companies issue commercial paper by direct calls to a dealer’s commercial paper desk.
• Upon agreement on terms, dealers will buy the entire daily issuance and resell to investors.
Privately issued commercial paper

• Nowadays, commercial paper may also be issued under Section 4(a)(2) of the Securities Act as a private placement of securities.
• Historically, the 3(a)(3) market was larger and deeper than the 4(a)(2) market because privately placed securities are restricted securities.
• Today the two markets provide about the same liquidity.
• The advantage of Section 4(a)(2) is that the section does not have any maturity limitations, so longer dated paper can be issued, and there is no restriction on use of proceeds.
• Most privately placed commercial paper is issued in Rule 144A programs, although some programs still issue to institutional accredited investors.
4(a)(2) requirements

• Historically, private placements were conducted under old Section 4(2) with resales to a limited number of investors under the so-called Section 4(a)(1½) exemption. This sharply limited the size of the market.
• Today, between Regulation D and Rule 144A, the private placement market is approaching the public securities market in size.
• Until the enactment of the JOBS Act, the prohibition on general solicitations in Rule 502(c) applied to commercial paper issued under Section 4(a)(2).
  • Occasionally, issuers would trip over this limitation and have to stay out of the market for 30 to 60 days.
Use of proceeds of 4(a)(2) paper

• One of the advantage of 4(a)(2) commercial paper is that there is no current transactions limit on issuance.
• 4(a)(2) commercial paper programs are often used to finance acquisitions until term financing can be arranged.
• Proceeds can be used for any legitimate purpose consistent with the board resolutions for the program.
Disadvantages of 4(a)(2) paper

- 4(a)(2) commercial paper is still a “restricted security.”
- Some investors have limits on the amount that they can invest in restricted securities.
- This might have some impact in the secondary market, but generally the secondary market is a dealer market, i.e., most sales in the secondary market are back to dealers who may hold or may resell the paper to other customers.
Conversion of 3(a)(3) to 4(a)(2)

• It is not uncommon for issuers to convert 3(a)(3) commercial paper programs to 4(a)(2) programs.
• Historically, there were transition issues in moving from a public offering program to a privately placed program to avoid integration of the private program with the public program while losing the 3(a)(3) exemption.
• This was addressed by covenants to use the proceeds for current transactions, but to make sales only to QIBs, for a six month period.
• With the changes brought about by the JOBS Act, this overlap should no longer be necessary to deal with the general solicitation issues created by the 3(a)(3) programs.
Side-by-side programs

- Some issuers still operate side-by-side 3(a)(3) and 4(a)(2) programs.
- Historically, there had to be careful segregation of proceeds and use of proceeds, and perhaps different maturities to deal with the integration issue.
- Today, after the JOBS Act, the integration concern from general solicitation is removed but also perhaps there is no longer a reason to operate two programs.
Asset-Backed CP

• Starting in the 1980s, asset-backed commercial paper programs become common.
• Under accounting rules at the time, the sponsor of the program could operate the program off-balance sheet, so no capital was required to be held against the assets.
• Numerous ABCP programs foundered during the financial crisis and today they are much less common; ABCP volumes have declined from a high of about $1.2T to around $300B today.
• Revised accounting rules and other regulatory developments have made it increasingly difficult to maintain these programs off-balance sheet, so much of the reason for their separate existence is gone.
• They are still used, however, for trade receivables financing and other short-term, maturity-matched lending situations.
1940 Act considerations

• With ABCP, because the issuer is an SPV and not an operating company, it is necessary to consider what exemption from the Investment Company Act may be available.
• Many ABCP programs previously relied on Sections 3(c)(1) or 3(c)(7) for an exemption.
• For bank sponsors, the Volcker Rule will now require a careful examination of other possible exemptions under the Investment Company Act or exemptions under the Volcker Rule from the definition of “covered fund.”
• Section 3(c)(5) of the Investment Company Act or Rule 3a-7 are possibilities and also compliance with the definition of “qualifying asset-backed commercial paper conduit” under the Volcker Rule.
• If swaps are used in the program, attention must also be paid to the Commodity Exchange Act.
Disclosure considerations

- Disclosure practices for commercial paper developed from the historical antecedent of Section 3(a)(3), where commercial paper was used for commercial banking transactions.
- Section 3(a)(3) itself does not impose any disclosure requirements.
- Disclosure documents for commercial paper have traditionally been very brief, providing little more than identification of the issuer. Accordingly the offering documents may be little more than a term sheet.
- Section 4(a)(2) commercial paper adopted the same disclosure approach.
- As a consequence, 10b-5 letters from counsel are not utilized in the commercial paper market.
Issuing documents

- Issuing Agreement
  - Issuing and Paying Agency Agreement
  - Depositary Agreement
- Agreement with distributing dealer
  - Commercial Paper Dealer Agreement
  - Private Placement Agreement
- Disclosure Document
  - Offering Circular
  - Private Placement Memorandum
- Liquidity Agreement
Practical considerations

• Maturity limits on 4(a)(2) commercial paper:
  • Seldom sold with maturities longer than 390 days, a limit determined by money market fund considerations, as money market funds have traditionally been very active purchasers of commercial paper;
  • MTN and senior note programs are usually established for issuance of maturities of one year or more;
  • Generally, investment banks have separate desks for commercial paper and MTN and senior note programs;
  • MTN and senior note programs have more traditional prospectus disclosure; at longer maturities, the rationale for brief disclosure documents isn’t supported.
Securities law liability

- No Section 11 liability for issuers either under 3(a)(3) or 4(a)(2) programs.
- After Gustafson v. Alloyd, there is not Section 12(a)(2) liability for privately placed commercial paper.
- Securities Act Section 17 will support SEC actions, but not investor actions.
- Sections 12(a)(2) and 17 apply to 3(a)(3) commercial paper notwithstanding the exemption provided by Section 3(a)(3).
- For investors, Rule 10b-5 provides principal remedy against both dealers and issuers.
  - Consider the exclusion from the definition of a “security” in Section 3(a)(10) of the Securities Exchange Act for “any note which has a maturity at the time of issuance of not exceeding nine months,” which appears to exclude 3(a)(3) commercial paper. However, notes which fail the ‘prime quality’ standard have been held to fall outside this exclusion.
Securities law liability (cont’d)

- After the SEC’s enforcement proceeding settlement against Goldman Sachs in the 1974 arising out of the Penn Central bankruptcy and commercial paper default, many dealers have assumed that they will be unable to avoid liability for any defaulted commercial paper.
- The SEC stated that Goldman had failed to conduct a reasonable investigation of Penn Central and had implicitly represented to its customers that the issuer was creditworthy.
Due diligence

- Classic due diligence inquiry not possible due to issuance mechanics.
- No 10b-5 opinions are given.
- No accountant’s comfort letters are received.
- There is no questioning of management prior to each issuance.
- Some dealers established credit departments to monitor their issuers continuously.
- Generally, dealers act defensively and rating downgrades or headline events can lead to dealers and investors refusing to roll over an issuer’s commercial paper, forcing the issuer to rely on bank lines of credit.
Exempt Securities
Section 3(a)(2) and offerings by banks

• Section 3(a)(2) of the Securities Act exempts from registration under the Securities Act any security issued or guaranteed by a bank.

• Basis: banks are highly regulated, and provide adequate disclosure to investors about their finances in the absence of federal securities registration requirements. 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.
What Is a “bank”? 

• Under Section 3(a)(2), the institution must meet both of the following requirements:
  • It must be a national bank or any institution supervised by a state banking commission or similar authority; and
  • Its business must be substantially confined to banking.

• Examples of entities that do not qualify:
  • Bank holding companies
  • Finance companies
  • Investment banks
  • Foreign banks

• Regulated U.S. branches and agencies of foreign banks may qualify
Guarantees

• Another basis for qualification as a bank: securities *guaranteed* by a bank.
  • 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.
  • The guaranty or assurance of payment, however has to cover the entire obligation; it cannot be a partial guarantee or promise of payment.
  • Again, guarantees by foreign banks (other than those of an eligible U.S. branch or agency) would not qualify for this exception.
  • The guarantee is a legal requirement to qualify for the Section 3(a)(2) exemption; investors will *not* be looking to the US branch guarantor for payment/credit. Investors will look to the home office.
  • Finance companies can issue under Section 3(a)(2), if the securities are guaranteed by a bank.
Non-U.S. banks/U.S. offices

- U.S. branches/agencies of foreign banks are conditionally entitled to rely on the Section 3(a)(2) exemption.
- 1986: the SEC takes the position that a foreign branch/agency will be deemed to be a “national bank” or a “banking institution organized under the laws of any state” if “the nature and extent of federal and/or state regulation and supervision of that particular branch or agency is substantially equivalent to that applicable to federal or state chartered domestic banks doing business in the same jurisdiction.”
- As a result, U.S. branches/agencies of foreign banks are frequent issuers or guarantors of debt securities in the U.S. Most issuances or guarantees occur through the N.Y. branches of these banks.
Non-U.S. banks/U.S. offices (cont’d)

Examples of Issuing Entities:

• U.S. branch as direct issuer: ANZ, CBA, CS, NAB and UBS
• U.S. branch as guarantor, headquarters as issuer: BNP, CASA, Rabo, SocGen, Svenska
• U.S. branch as guarantor, SPV/Cayman branch as issuer: BNP, Fortis
  • More banks are using a guarantee structure to allow greater flexibility for use of proceeds

Which Regulator?

• Most U.S. branches have elected the N.Y. State Banking Commissioner as their primary regulator with their secondary regulator the Federal Reserve.
• Some U.S. branches have opted for the Office of the Comptroller of the Currency as their primary regulator.
OCC registration/disclosure

- National banks or federally licensed U.S. branches/agencies of foreign banks regulated by the Office of the Comptroller of the Currency (the “OCC”) are subject to OCC securities offering (Part 16) regulations.
- Part 16 of OCC regulations provides that these banks or banking offices may not offer and sell their securities until a registration statement has been filed and declared effective with the OCC, unless an exemption applies.
- An OCC registration statement is generally comparable in scope and detail to an SEC registration statement; as a result, most national bank issuers prefer to rely upon an exemption from the OCC’s registration requirements. Section 16.5 provides a list of exemptions, which includes:
  - Regulation D offerings
  - Rule 144A offerings
- General solicitation would be allowed for Regulation D offerings and Rule 144A offerings; the Rule 506 “bad actor” disqualifications would also apply.
Part 16.6 of the OCC regulations

- 12 CFR 16.6 provides a separate partial exemption for offerings of “non-convertible debt” to accredited investors in denominations of $250,000 or more.
- Federal branches/agencies, as issuers, may rely on this exemption by furnishing to the OCC parent bank information which is required under Exchange Act Rule 12g3-2(b), and to purchasers the information required under Securities Act Rule 144A(d)(4)(i).
- The securities are “investment grade” – the new definition focuses on the probability of repayment, rather than an external investment-grade rating (Dodd-Frank Act requirement).
- The offering document and any amendments are filed with the OCC no later than the fifth business day after they are first used.
Denominations

• The 3(a)(2) exemption does not require specific minimum denominations in order to obtain the exemption.

• However, for a variety of reasons, denominations may at times be significantly higher than in retail transactions, including:
  • Offerings targeted to institutional investors.
  • Complex securities.
  • Relationship to 16.6’s requirement of $250,000 minimum denominations.
Deposits versus other liabilities

• Foreign banks may elect to issue debt instruments in the form of deposit liabilities as opposed to “pure” debt:
  • Yankee CDs (US$-denominated deposit liabilities of a foreign bank or its US branch).
  • Other types of deposits (e.g., structured deposits).
• What are the legal differences between deposit liabilities and other debt issuances?
  • In the case of foreign banks, less than meets the eye.
  • Foreign banking organization (“FBO”) deposit liabilities are not insured and generally are issued in large denominations (minimum $100,000 and usually higher).
  • For capital equivalency/asset segregation purposes, deposits and non-deposit liabilities generally are treated in the same manner.
FINRA requirements

- Even though securities offerings under Section 3(a)(2) are exempt from registration under the Securities Act, public securities offerings conducted by banks must be filed with the Financial Industry Regulatory Authority, Inc. ("FINRA") for review under Rule 5110(b)(9), unless an exemption is available.

- Exemption: the issuer has outstanding investment grade rated unsecured non-convertible debt with a term of issue of at least four years, or the non-convertible debt securities are so rated.
FINRA requirements (cont’d)

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

• Transactions under Section 3(a)(2) must also be reported through FINRA’s Trade Reporting and Compliance Engine (“TRACE”). TRACE eligibility provides greater transparency for investors. Rule 144A securities are also TRACE reported.
Blue Sky regulation

- Securities issued under Section 3(a)(2) are considered “covered securities” under Section 18 of the Securities Act.
- However, because bank notes are not listed on a national securities exchange, states may require a notice filing and a fee in connection with an offering of bank notes.
- Generally, blue sky filings are not needed in any state in which the securities are offered.
- State blue sky laws should be examined to ensure that either no notice filing or fee is required, or the state’s existing exemption for securities issued by banks does not require a filing.
- A state may not view an agency of a foreign bank, whose securities are eligible for the Section 3(a)(2) exemption, as within the state’s exemption for securities issued by banks.
- Rule 144A offerings of bank notes will fall within a state’s institutional purchaser exemption.
Section 3(a)(2) offering documentation

• The offering documentation for bank notes is similar to that of a registered offering.
• Base offering document, which may be an “offering memorandum” or an “offering circular” (instead of a “prospectus”).
• For foreign issuers, IFRS financials or “home country” GAAP financials are acceptable.
• Annual audited and at least semi-annual unaudited financial statements; and
• Consider including Guide 3 statistical disclosures.
Section 3(a)(2) documentation (cont’d)

• The base document is supplemented for a particular offering by one or more “pricing supplements” and/or “product supplements.”

• These offering documents may be supplemented by additional offering materials, including term sheets and brochures.
1940 Act issues

• Investment companies are subject to registration under the Investment Company Act of 1940, unless an exemption is available.

• An investment company is defined broadly as an entity that holds itself out as being engaged primarily, or proposing to engage, in “investing, reinvesting or trading in securities” and also includes entities engaged, or that propose to engage, in the business of investing, reinvesting, owning, holding or trading in securities if securities represent 40% or more of the value of its total assets (excluding cash and government securities).
  • As a result, issuers that are banks or specialized finance companies may inadvertently fall within the definition of an “investment company.”
1940 Act Issues – exemptions

• Exemptions:
  • U.S. banks are exempted under Section 3(c)(3) of the 1940 Act.
  • Foreign banks are exempted under Rule 3a-6 under the 1940 Act, subject to certain conditions.
  • U.S. branches or agencies of foreign banks are exempted under an interpretive release (1940 Act Release No. 17681 (Aug. 17, 1990)).
  • Finance subsidiaries of U.S. or foreign banks are exempted under Rule 3a-5, subject to certain conditions.

• Rule 3a-6 defines a “foreign bank” as a banking institution incorporated or organized under the laws of a country other than the United States, or a political subdivision of a country other than the United States, that is:
  • Regulated as such by that country's or subdivision's government or any agency thereof;
  • Engaged substantially in commercial banking activity; and
  • Not operated for the purpose of evading the provisions of the Act.
Section 3(a)(2) and U.S. Branches of Foreign Banks

- In the SEC’s 1986 release confirming that securities issued by a U.S. branch or agency of a foreign bank are within the Section 3(a)(2) exemption, reference was made to a series of previous no-action letters confirming that debt securities sold in minimum denominations ranging from $25,000 to $100,000 or sold only to certain types of sophisticated investors were exempt under Section 3(a)(2).

- The release also stated that the SEC would no longer express any view, or issue any no-action letters, regarding whether debt securities issued or guaranteed by a U.S. branch or agency of a foreign bank must satisfy any minimum denomination requirement, be sold to any type of investor or be principal protected, nor does the release require that such debt securities be subject to any of those limitations.

- Consequently, in opining on the availability of the Section 3(a)(2) exemption for notes issued or guaranteed by a U.S. branch or agency of a foreign bank, many firms will issue an opinion stating that the notes “should be exempt,” rather than the notes “are exempt.”
Exempt Transactions
Securities Act of 1933 – Registration Framework

• § 5 - Must register all transactions absent an exemption from the registration requirements
• § 3 – Exemptions for specific types of securities
• § 4 - Transactional exemptions
  • § 4(a)(2) - Private placement exemption
    • “Transactions by an issuer not involving any public offering”
• Section 4(a)(1½) exemption evolved in practice
  • Not embedded in the Securities Act
Section 4(a)(2)
Section 4(a)(2)

• Issuer exemption
  • Provides an exemption for an offering by an issuer that does not involve a “public offering”
  • Application of the private placement exemption, however, has been the subject of significant debate due in large part to the brevity of its wording and the fact that “public offering” is not defined
  • SEC v. Ralston Purina is the most significant case

• Restricted securities – securities sold in a private placement may not be resold absent registration or exemption from registration
Safe harbors

- Rules and regulations that set forth conditions the satisfaction of which will ensure that there has not been a public offering
- Regulation D for offerings, which includes
  - Exemption for certain offerings by issuers under $5 million (Rules 504 and 505)
  - Private placement safe harbor (Rule 506)
- Non-exclusive safe harbor
- § 4(a)(2) still available (to the extent general advertising and general solicitation are not used)
Resale limitations

- Rule 502(d)
  - “The issuer shall exercise reasonable care to assure that the purchasers of the securities are not underwriters”

- Reasonable care
  - Reasonable inquiry of purchasers
  - Written disclosure to purchasers that resale is restricted
  - Legends on the securities
Blue Sky considerations

• Securities that are sold pursuant to Rule 506 are considered “covered securities” for purposes of Section 18(b)(4)(D) of the Securities Act
  • This means that securities sold in reliance on Rule 506 are exempt from state securities review
• An issuer that relies on Section 4(a)(2) will need to consider state securities requirements
Rule 506 safe harbor

• Rule 506 is the most widely used safe harbor under Regulation D, accounting for the overwhelming majority of capital raised under Regulation D

• Traditional requirements of a Rule 506 private placement include:
  • No dollar limit on size of transaction
  • Unlimited number of accredited investors and no more than 35 unaccredited investors
  • No general solicitation or advertising (*now prohibition against general solicitation has been eliminated for 506(c) offerings*)
  • Resale limitations
  • Disclosure required for non-accredited investors
  • Form D filing within 15 days of first sale of securities
  • Good faith effort to comply (Rule 508)
Rule 506 purchasers

- Accredited Investors (Rule 501)
  - Institutional investors such as banks, S+Ls, broker-dealers, insurance companies, investment companies
  - Corporations or trusts with assets in excess of $5 million
    - Not formed for purpose of making the investment (look-through rule)
  - Directors and officers of the issuer
  - Individuals with
    - Income > $200,000 or joint income > $300,000
    - Net worth or joint net worth > $1 million*
  - Entity in which all equity owners are accredited investors

- Verification of accredited investor status is required in connection with Rule 506(c) offerings

* Dodd-Frank Act of 2010 amended definition to eliminate ability of individuals to include the equity value of primary residences in calculation of net worth
General solicitation or advertising

• Prohibition in Rule 502 applied to issuer and its agents
• Before the JOBS Act, the prohibition applied to all offerings made in reliance on Regulation D
  • No general solicitation or advertising
  • No seminar with attendees invited by general solicitation or advertising
• Importance of preexisting substantive relationship with offerees
• Importance of process safeguards
• Rule 135c
  • Safe harbor for limited issuer announcement of exempt offering
The JOBS Act: Rule 506 changes

• The JOBS Act contains various provisions that affect exempt offerings
• Title II of the JOBS Act directed the SEC to eliminate the ban on general solicitation and general advertising for certain offerings under Rule 506 of Regulation D, provided that the securities are sold only to accredited investors, and under Rule 144A offerings, provided that the securities are sold only to persons who the seller (and any person acting on behalf of the seller) reasonably believes is a QIB
Relaxation of the Ban on General Solicitation

• In September 2013, the SEC’s final rules became effective; final rules implement a bifurcated approach to Rule 506 offerings
  • An issuer may choose to conduct a private offering in reliance on Rule 506(b) without using general solicitation
• The SEC adopted a new paragraph (c) in Rule 506, which permits the use of general solicitation, subject to the following conditions:
  • The issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors;
  • All purchasers of securities must be accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors or the issuer reasonably believes that they qualify as accredited investors, at the time of the sale of the securities; and
  • The conditions of Rule 501 and Rules 502(a) and 502(d) are satisfied
Reasonable Steps to Verify Investor Sales

• The adopting release includes principles-based guidance, highlighting that the inquiry to be undertaken may differ depending on the facts and circumstances. The SEC provides a list of factors to consider:
  • The nature of the purchaser. The SEC describes the different types of accredited investors, including broker-dealers, investment companies or business development companies, employee benefit plans, and wealthy individuals and charities
  • The nature and amount of information about the purchaser. Simply put, the SEC states that “the more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it would have to take, and vice versa”
  • The nature of the offering. The nature of the offering may be relevant in determining the reasonableness of steps taken to verify status, i.e., issuers may be required to take additional verification steps to the extent that solicitations are made broadly, such as through a website accessible to the general public, or through the use of social media or email
General Solicitation and Rule 144A

- In addition to the changes to Rule 506, the SEC also amended Rule 144A to eliminate references to “offer” and “offeree,” and thus require only that the securities are sold to a QIB or to a purchaser that the seller and any person acting on behalf of the seller reasonably believe is a QIB.
- Resales of securities pursuant to Rule 144A could be conducted using general solicitation, so long as the purchasers are limited in this manner.
- The SEC reiterated that general solicitation in connection with a Rule 144A offering will not be viewed as a “directed-selling effort” in connection with a concurrent Regulation S offering.
Private offerings

- Title II of the JOBS Act does not modify the statutory private placement exemption, Section 4(a)(2)
- Title II of the JOBS Act and the SEC final rules only affect offerings conducted pursuant to Rule 506(c) and Rule 144A offerings
- The final SEC rules do not amend or modify the requirements relating to existing Rule 506(b)
- The release does not address other communications safe harbors that may be affected by the relaxation of the ban on general solicitation, nor does it address integration issues
“Bad Actor” disqualification

- Unlike Rule 505 of Regulation D, Regulation E and Regulation A, Rule 506 of Regulation D historically did not contain “bad actor” disqualification provisions.
- The SEC proposed the adoption of “bad actor” provisions in 2007, but did not take final action on that proposal.
- In May 2011, the SEC proposed amendments to rules promulgated under Regulation D to implement Dodd-Frank Act Section 926’s provision regarding the “bad actors” for Regulation D.
- Final bad actor rule was adopted in conjunction with the adoption of final rule relating to Rule 506 offerings; it became effective September 2013.
- The amendment added a new Section 506(d) to Regulation D.
- The provisions are applicable only in the context of Rule 506 offerings, regardless of whether general solicitation is used.
Covered Persons

• The disqualification provisions apply to the following “covered persons”:
  • The issuer and any predecessor of the issuer or affiliated issuer;
  • Any director, executive officer, other officer participating in the offering process, general partner, or managing member of the issuer;
  • Any beneficial owner of 20% or more of any class of the issuer’s voting equity securities, calculated on the basis of voting power;
  • Any investment manager to an issuer that is a fund and any director, executive officer, or other officer participating in the offering, general partner, or managing member of the manager, as well as any director, executive officer or officer participating in the offering of any such general partner or managing member;
  • Any promoter connected with the issuer in any capacity at the time of the sale;
  • Any person that has been or will be paid, directly or indirectly, remuneration for solicitation of purchasers in a securities offering (a “compensated solicitor”); or
  • Any director, executive officer, other officer participating in the offering, general partner, or managing member of such compensated solicitor.
Disqualifying Events

The rule includes the following categories of disqualifying events:

- Criminal convictions;
- Court injunctions and restraining orders;
- Final orders of certain state regulators (such as securities, banking, and insurance) and federal regulators;
- SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers, and investment companies and their associated persons;
- Certain SEC cease-and-desist orders;
- Suspension or expulsion from membership in, or suspension or barring from association with a member of, a securities self-regulatory organization (“SRO”);
- SEC stop orders and orders suspending a Regulation A exemption; and
- U.S. Postal Service false representation orders.
Bad Actor waivers

- The rule permits the SEC to grant waivers upon a showing of good cause.
- The rule does not articulate standards for granting waivers.
- The adopting release lists various circumstances that might be relevant to a waiver, such as a change of control, a change of supervisory personnel, absence of notice and an opportunity for hearing, and a relief from a permanent bar for a person who does not intend to apply to reassociate with a regulated entity.
- Waivers may also be granted by the SEC.
# Regulation D — Summary

<table>
<thead>
<tr>
<th></th>
<th>Rule 504</th>
<th>Rule 505</th>
<th>Rule 506(b)</th>
<th>Rule 506(c)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Aggregate Offering Price Limitation</strong></td>
<td>$1,000,000 (12 mos.)</td>
<td>$5,000,000 (12 mos.)</td>
<td>Unlimited</td>
<td>Unlimited</td>
</tr>
<tr>
<td><strong>Number of Investors</strong></td>
<td>Unlimited</td>
<td>35 plus unlimited accredited</td>
<td>35 plus unlimited accredited</td>
<td>Unlimited; only AIs</td>
</tr>
<tr>
<td><strong>Investor Qualifications</strong></td>
<td>None required</td>
<td>None required</td>
<td>Purchaser must be sophisticated (alone or with representative); accredited presumed to be qualified</td>
<td>Accredited investors only, subject to enhanced verification</td>
</tr>
<tr>
<td><strong>Sales Commissions</strong></td>
<td>Permitted</td>
<td>Permitted</td>
<td>Permitted</td>
<td>Permitted</td>
</tr>
<tr>
<td><strong>Limitations on Manner of Offering</strong></td>
<td>Usually no general solicitation permitted</td>
<td>No general solicitation permitted</td>
<td>No general solicitation permitted</td>
<td>General solicitation permitted</td>
</tr>
<tr>
<td><strong>Limitations on Resale</strong></td>
<td>Usually restricted</td>
<td>Restricted</td>
<td>Restricted</td>
<td>Restricted</td>
</tr>
<tr>
<td><strong>Issuer Qualifications</strong></td>
<td>No Exchange Act reporting “blank-check” or investment companies</td>
<td>No investment companies or issuers disqualified under Regulation A (except upon SEC determination)</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td><strong>Notice of Sales</strong></td>
<td>5 copies of form D to be filed with SEC within 15 days after first sale (called for by Regulation D, but not required for exemption).</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Information Requirements</strong></td>
<td>None</td>
<td>1. If purchased solely by accredited investors, no information specified.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Regulation D — Summary (cont’d)

<table>
<thead>
<tr>
<th>Information Requirements</th>
<th>Rule 504</th>
<th>Rule 505</th>
<th>Rule 506(b)</th>
<th>Rule 506(c)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>N/A --- cannot be sold to nonaccredited investors</td>
</tr>
</tbody>
</table>

2. If purchased by nonaccredited investors,

   a. nonreporting companies under the Exchange Act must furnish the same kind of information as in a registered offering, or in a Regulation A offering if eligible, but with somewhat modified financial statement requirements;

   b. reporting companies must furnish (i) specified Exchange Act documents or (ii) information contained in the most recent specified Exchange Act report or Securities Act registration statement on specific forms, plus, in any case, (iii) updating information and limited additional information about the offering.

   c. Issuers must make available prior to sale:

      i. Exhibits
      ii. Written information given to accredited investors;
      iii. Opportunity to ask questions and receive answers;

   d. Issuers must advise purchasers of the limitations on resale.
Rule 144A
Rule 144A – an overview

• Rule 144A under the Securities Act provides a (non-exclusive) safe harbor from Section 5’s registration requirements for resales of restricted securities to “qualified institutional buyers” (“QIBs”)

• The premise: not all investors need the full protections of the prospectus requirements of the Securities Act

• The rule applies to offers made by persons other than the issuer of the securities – resales

• The rule applies to securities that are not listed on a U.S. national securities exchange or quoted on a U.S. automated inter-dealer quotation system
  
  • So, no such thing as a Rule 144A offering of an issuer’s listed common stock
Rule 144A – overview (cont’d)

• A reseller may rely on any available exemption from the registration requirements of the Securities Act when selling restricted securities (e.g., Rule 144 under the Securities Act (“Rule 144”) or Regulation S under the Securities Act)

• Securities acquired in Rule 144A transactions are deemed to be “restricted securities” under Rule 144
Rule 144A – offering structure

- The issuer initially sells restricted securities to investment bank(s) in a Section 4(a)(2) or Regulation D private placement
- The investment bank immediately resells the securities to QIBs under Rule 144A

Issuer $\rightarrow$ Initial Purchaser $\rightarrow$ QIBs

- Often combined with a Regulation S offering and referred to as a Rule 144A/Reg S offering
Rule 144A – How are these offerings conducted?

• In some ways, similar to a registered offering
  • The offering document will typically include the type of business disclosure, risk factors, MD&A, management disclosure and financial information found in a registration statement on Form S-1 (although companies that already have 10-Ks and 10-Qs on file with the SEC may be able to incorporate that information by reference).
  • Many offering documents by debt issuers that are not already public companies include executive compensation disclosures that do not comply with all of the SEC requirements or omit such disclosures in their entirety.
  • Issuers and initial purchasers may also decide to use other disclosures that are non-SEC rule compliant (such as presenting fewer years of financial statement information) on a case-by-case basis.

• “Road show” with a preliminary offering memorandum, addressed to institutional investors
Rule 144A – How are these offerings conducted? (cont’d)

• Confirmation of orders with the final offering memorandum (the offering memorandum may be delivered electronically)
• The purchase agreement is executed at pricing, together with the delivery of a comfort letter
• Closing on a “T+3” basis, or as otherwise agreed with the investors
• Publicity: generally limited to a Rule 135(c) compliant press release. While general solicitation is now permitted, it is typically not used.
Rule 144A – Conditions

- Resales only to a QIB, or to a purchaser that the reseller or any persons acting on its behalf reasonably believe to be a QIB
- The QIB must purchase for its own account or for the account of another QIB
- Reseller must take steps to ensure that the buyer is aware that the reseller may rely on Rule 144A in connection with such resale
- The securities resold (a) when issued were not of the “same class” as securities listed on a U.S. national securities exchange or quoted on a U.S. automated inter-dealer quotation system and (b) are not securities of an open-end investment company, UIT, etc.
- For an issuer that is not a reporting company or exempt from reporting pursuant to Rule 12g3-2(b) under the Exchange Act, the holder and a prospective buyer designated by the holder must have the right to obtain from the issuer, upon the holder’s request, certain reasonably current information
Rule 144A – What is a QIB?

• The following qualify as “QIBs”:
  • Any corporation, partnership or other entity (but not an individual) that owns and invests on a consolidated basis $100 million in the aggregate in securities of non-affiliates (other than bank deposits and loan participations, repurchase agreements and securities subject thereto, and currency, interest rate and commodity swaps);
  • Registered dealers that own or invest $10 million of such non-affiliate securities or are engaged in “riskless principal transactions” on behalf of QIBs (to qualify, the QIB must commit to the broker-dealer that the QIB will simultaneously purchase the securities from the broker-dealer);
  • Any investment company that is part of a “family” that has the same investment adviser and together own $100 million of such non-affiliate securities; and
  • Any U.S. or foreign bank or S&L that owns and invests on a consolidated basis $100 million in such non-affiliate securities and has a net worth of at least $25 million

• A QIB can be formed solely for purpose of conducting a Rule 144A transaction
Rule 144A – How can a reseller ascertain that a purchaser is a QIB?

• A reseller may rely on the following (as long as the information is no more than 16 months old):
  • The purchaser's most recent publicly available annual financial statements;
  • Information filed with the SEC or another government agency or self-regulatory organization;
  • Information in a recognized securities manual, such as Moody’s or S&P;
  • Certification by the purchaser’s chief financial or other executive officer specifying the amount of securities owned and invested as of the end of the purchaser’s most recent fiscal year; and
  • A QIB questionnaire

• The SEC acknowledges that the reseller may use other information to establish a reasonable belief of eligibility
Rule 144A – Legending

• The reseller will make the buyer aware that the security is a Rule 144A security by:
  • Legending the security (i.e., the security must include language that it is not registered under the Securities Act);
  • Including an appropriate statement in the offering memorandum;
  • Obtaining an agreement that the purchaser understands that the securities must be resold pursuant to an exemption or registration under the Securities Act; and
  • By obtaining a restricted CUSIP number
Rule 144A – “Same Class” determination

• How does one determine whether the securities are of the “same class” as those listed or quoted on an exchange?
  • Common stock
    • If it is of substantially similar character and the holders enjoy substantially similar rights
    • Note: if ADRs are publicly traded in the U.S., the underlying securities would also be considered publicly traded
  • Preferred stock
    • If its terms relating to dividends, liquidation preference, voting rights, convertibility, redemption and similar characteristics are substantially identical
  • Convertible or exchangeable security
    • If it has an effective conversion premium on issuance (at pricing) of less than 10% and a warrant with a term less than three years or an effective exercise premium on issuance (at pricing) of less than 10%, will be treated as the “same class” as the underlying security
    • SEC Release No. 33-6862 (1990) provides examples of how to calculate the effective conversion premium
Rule 144A – Current information requirements

• For securities of a non-public company, the holder and a prospective purchaser designated by the holder have the right to obtain from the issuer, upon request, the following information:
  • A brief statement of the nature of the business of the issuer and its products and services; and
  • The issuer’s most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for such part of the two preceding fiscal years as the issuer has been in operation.

• The financial statements should be audited, to the extent reasonably available

• The information must be reasonably current
Rule 144A – Time of sale information

- Although Rule 159 is not expressly applicable to Rule 144A offerings, many investment banks apply the same treatment, in order to help reduce the risk of liability.
- Use of term sheets and offering memoranda supplements, to ensure that all material information is conveyed to investors at the time of pricing.
- Counsel is typically expected to opine as to the “disclosure package,” as in the case of a public offering.
Registration rights vs. “144A for life”

• Drawbacks of Rule 144A “for life” (no registration rights)
  • For fixed income—potentially higher yield than freely tradable securities
  • For investment-grade debt, lack of registration results in exclusion from market-standard indices

• Registration rights
  • Registration may take the form of an exchange offer or a resale shelf
  • Additional interest if issuer fails to register

<table>
<thead>
<tr>
<th>Resale registration rights</th>
<th>“Exxon Capital” (A/B) registration rights</th>
<th>Contingent registration rights</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Issuer agrees to file a registration statement covering resales of securities initially placed under Rule 144</td>
<td>• Issuer agrees to conduct a registered offer to exchange the securities placed under Rule 144A for new securities with identical terms</td>
<td>• Practices changed after Rule 144 holding period was reduced in 2008</td>
</tr>
<tr>
<td>• The securities become freely tradable when sold</td>
<td>• The new securities, acquired in the exchange offer, are freely tradable</td>
<td>• Registration obligation applies only if securities do not become freely tradable</td>
</tr>
<tr>
<td></td>
<td>• Generally, only available for non-convertible debt</td>
<td>• More prevalent with convertible securities</td>
</tr>
</tbody>
</table>
# Rule 144A debt offering versus 4(a)(2) placement

<table>
<thead>
<tr>
<th></th>
<th>Rule 144 A Debt Offering</th>
<th>Institutional Private Placement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Contractual Structure</strong></td>
<td>Initial purchasers make a firm commitment to purchase, at a discount to offering price</td>
<td>Issuer sells directly to investors. Placement agent receives a placement fee.</td>
</tr>
</tbody>
</table>
| **Diligence**    | Initial purchasers conduct due diligence:  
Document review  
Management due diligence  
Auditor due diligence | Investors conduct limited due diligence:  
Investor counsel review documents  
Investors conduct management Q&A through the placement agent  
No meetings with auditors |
| **Offering Document** | Offering memo with information similar to registered offering prospectus  
Drafted by issuer’s counsel; reviewed by initial purchasers’ counsel  
At pricing, pricing term sheet with security terms, other pricing terms and any additional disclosures | Streamlined marketing document  
Drafted by issuer with input from placement agent  
Streamlined term sheet |
| **Marketing**    | Timing: less than one day to a full week or more  
Can include investor call, roadshow, e-roadshow | Timing: Typically a few weeks  
Investor conference call with management; occasionally, in-person meetings |
## Rule 144A debt offering versus 4(a)(2) placement (cont’d)

<table>
<thead>
<tr>
<th></th>
<th>Rule 144 A Offering</th>
<th>Institutional Private Placement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pricing</strong></td>
<td>Issuer and initial purchasers sign a purchase agreement</td>
<td>No agreement signed</td>
</tr>
<tr>
<td></td>
<td>Auditor delivers a comfort letter</td>
<td>No comfort letter</td>
</tr>
<tr>
<td><strong>Documentation of Securities</strong></td>
<td>Indenture similar to registered offering</td>
<td>Note purchase agreement</td>
</tr>
<tr>
<td><strong>Registration Rights</strong></td>
<td>Exchange offer registration vs 144A “for life”</td>
<td>No registration rights</td>
</tr>
<tr>
<td><strong>Closing</strong></td>
<td>Counsel to issuer and initial purchasers provide legal opinions (including “no registration” opinion) and 10b-5 negative assurance letter</td>
<td>Counsel to issuer provides opinion (including “no registration” opinion). Counsel to investors provides “no registration” opinion; no 10b-5 negative assurance letters</td>
</tr>
<tr>
<td></td>
<td>Accountants provide bring-down comfort letter</td>
<td>No comfort letter</td>
</tr>
<tr>
<td></td>
<td>Investors pay the offering price to the initial purchasers, who pay the purchase price to the issuer</td>
<td>Each investor pays the issuer directly</td>
</tr>
<tr>
<td></td>
<td>Global notes (one for the 144A tranche and one for the Regulation S tranche) are deposited into DTC system</td>
<td>Physical note certificates are delivered to each purchaser</td>
</tr>
</tbody>
</table>
Rule 144A debt offering versus 4(a)(2) placement (cont’d)

<table>
<thead>
<tr>
<th></th>
<th>Rule 144 A Offering</th>
<th>Institutional Private Placement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Secondary Trading</strong></td>
<td>Through DTC; relatively liquid</td>
<td>Individually negotiated; physical delivery; relatively illiquid</td>
</tr>
<tr>
<td><strong>Covenant Practices</strong></td>
<td>Typically, incurrence-based covenants</td>
<td>Typically, maintenance-based covenants</td>
</tr>
<tr>
<td><strong>Ratings</strong></td>
<td>Assigned prior to pricing by one or more of Moody’s, S&amp;P or Fitch</td>
<td>Assigned post-pricing by the National Association of Insurance Commissioners</td>
</tr>
<tr>
<td><strong>Transaction Size</strong></td>
<td>Size matters to liquidity – less than $250mm is suboptimal</td>
<td>Issue size can be small</td>
</tr>
<tr>
<td><strong>Funding</strong></td>
<td>All funding at closing – typically T+3, but can be as long as T+10</td>
<td>Delayed funding is possible, to match issuer’s need to apply proceeds</td>
</tr>
</tbody>
</table>
Regulation S
Regulation S – Overview

• Regulation S provides an exemption from the registration requirements of Section 5 of the Securities Act for securities offered and sold outside the U.S. to non-U.S. persons

• The premise: “principles of comity.”

• Recurring themes: whether the securities are to be purchased outside of the U.S., and the risk of flowback into the U.S.

• Reg S (Rules 901 to 905 under the Securities Act) provides non-exclusive safe harbors for (1) offers and sales by issuers, distributors and their affiliates and (2) resales by others (i.e., investors)

• In practice, issuers try to comply with the safe harbors, particularly in connection with a significant primary offering. However, if an issuer fails to comply with a specific safe harbor, it may still argue that the registration requirements should not apply to the transaction
Regulation S – Overview (cont’d)

• In general: (1) there must be an “offshore transaction” (i.e., an offer cannot be made to a person in the U.S. (“U.S. person”) and the buyer must be outside the U.S. or the seller must reasonably believe the buyer is outside the U.S.) and (2) neither the issuer nor any distributor (or any affiliate of either) may engage in any “directed selling efforts” (i.e., activities that may condition the U.S. market for the securities)

• For many offerings:
  • There is a “distribution compliance period” during which no offer or sale may be made to a U.S. person for 40 days or, in some cases, for one year; and
  • The offering documents and underwriting agreements must reflect certain restrictions on sales to U.S. persons
Regulation S – Rule 903 – Sales by an Issuer

• Most Regulation S offerings are Rule 903 offerings
• Rule 903 provides an issuer safe harbor for sales of securities offshore
  • Directed selling efforts made by the issuer or any distributor will eliminate the safe harbor
    • Result: robust representations and covenants
    • Prohibition applies during the distribution, and any “distribution compliance period”
  • Three categories of securities, based on the probability of flowback into the U.S. and the type/amount of information available in the U.S., the first category being the least restrictive, and the third is the most restrictive
  • Different restrictions apply to equity and debt securities. For purposes of the categories, warrants are treated like equity securities and convertible securities are treated like the underlying security
Categories 1, 2 and 3

• Criteria:
  • Nationality of the issuer
  • Reporting status of the issuer under the 1934 Act
  • Degree of U.S. market interest in the issuer’s securities (“substantial U.S. market interest”)

• Implications of the Criteria:
  • Foreign issuers are generally subject to fewer restrictions
  • Offerings by reporting issuers would require fewer restrictions because of the availability of information
  • Securities with U.S. market interest would generally be subject to more restrictions
Regulation S – Offshore Transaction

• In order to qualify for both safe harbors, the offer or sale must be made in an “offshore transaction”
  • No offer is made to a person in the U.S.
  • Either of the following additional conditions must be met:
    • At the time of the buy order, the buyer is, or the seller reasonably believed that the buyer is, outside the U.S., or
    • The transaction is executed on (1) a physical trading floor of an established foreign securities exchange, in the case of Rule 903, or (2) on a designated offshore securities market and the seller does not know that the transaction has been pre-arranged with a buyer in the U.S., in the case of Rule 904
The following are “U.S. persons”:  
- Any natural person in the U.S.  
- Any partnership or corporation organized or incorporated under the laws of the U.S.  
- Any estate of which any executor or administrator is a U.S. person  
- Any trust of which any trustee is a U.S. person  
- Any agency or branch of a foreign entity located in the U.S.  
- Any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated or (if an individual) residing in the U.S.  
- Any partnership or corporation, if:  
  - Organized or incorporated under the laws of any foreign jurisdiction; and  
  - Formed by a U.S. person principally for the purpose of investing in securities not registered under the Securities Act, unless it is organized or incorporated, and owned, by accredited investors (as defined in Rule 501(a) under Regulation D) who are not natural persons, estates or trusts
Regulation S – Directed Selling Efforts

• In order to qualify for both safe harbors, no “directed selling efforts” may be made in the U.S.
  • Directed selling efforts include “any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States” for securities being issued under Regulation S.
  • The definition of “directed selling efforts” in Rule 902 contains various exceptions and safe harbors.
  • JOBS Act rules clarified that what is a permitted general solicitation for purposes of Rule 144A will not be deemed to be “directed selling efforts” for purposes of Regulation S.
Regulation S – Substantial U.S. Market Interest

“Substantial U.S. market interest” means:

- Equity: In the shorter of the last fiscal year or since the issuer incorporated: (a) the single largest market for such class of securities was in the U.S. or (b) 20% of trading took place in the U.S. and less than 55% of such trading took place in a single foreign market
- Debt: (a) $1 billion or more of debt securities are held by U.S. persons, (b) 20% or more of the issuer’s debt securities are held by U.S. persons and (c) the issuer’s debt securities are held of record by 300 or more U.S. persons
- Warrants and convertible securities: For warrants, the level of market interest in the underlying securities, and for convertible securities, the level of market interest in either the convertible security or the security into which it may be converted
Regulation S – Rule 904

• Rule 904 provides a safe harbor for resales of securities offshore
  • Resales by (a) any persons other than the issuer and (b) any officer or director of the issuer or who is an affiliate solely by virtue of holding such position, are deemed to have occurred outside the U.S., if the general conditions of Reg S apply (i.e., the offering is offshore and there are no directed selling efforts) and any applicable additional resale requirements are met

• Additional resale requirements
  • Resales by dealers and persons receiving selling concessions: May resell the securities in Categories 2 and 3 during the applicable restricted period only if they reasonably believe the offeree or buyer is not a U.S. person; and if the seller or its representative knows that the purchaser is a dealer, or is a person receiving a selling concession or other fee as to the securities, the seller or its representative must notify the buyer of the applicable distribution compliance period

  • Resales by certain affiliates: For an offer or sale by an officer or director of the issuer, who is an affiliate of the issuer or distributor by holding that position, no selling concession, fee or other remuneration is paid in connection with the offer or sale other than the usual and customary broker’s commission that would be received by a person executing the transaction as an agent
Regulation S – Rule 905

Rule 905 imposes resale limitations for equity securities.

- Equity securities acquired from the issuer, a distributor or their respective affiliates in a transaction subject to the conditions of Rules 901 or 903 are deemed to be restricted securities as defined in Rule 144.
- An offshore purchaser therefore can resell such securities only in accordance with Reg S or the registration requirements of the Securities Act.
- Any restricted securities or equity securities of a domestic issuer will continue to be restricted securities despite the fact that such securities were acquired in a resale transaction pursuant to Rule 904.
- The resale of restricted securities offshore under the safe harbor does not eliminate the restricted status of such securities.
Regulation S offering documents

- Can vary considerably, depending upon the jurisdictions in which sales are made, and degree of regulation in the relevant jurisdictions
- Size of offering, relevant types of investors, types of legal opinions contemplated will all dictate the scope of the disclosure
- And of course, Regulation S contemplates appropriate language and legends for Category 2 and Category 3 offerings
## Comparison of alternatives

<table>
<thead>
<tr>
<th></th>
<th>SEC Registered</th>
<th>Section 3(a)(2)</th>
<th>Rule 144A</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Required issuer:</strong></td>
<td>No specific issuer or guarantor is required.</td>
<td>Need a US state or federal licensed bank as issuer or as guarantor.</td>
<td>No specific issuer or guarantor is required.</td>
</tr>
<tr>
<td><strong>Exemption from the Securities Act:</strong></td>
<td>No. Bonds are publicly offered and registered with the SEC.</td>
<td>Section 3(a)(2).</td>
<td>Section 4(a)(2) / Rule 144A.</td>
</tr>
<tr>
<td><strong>No Action Letter:</strong></td>
<td>Required.</td>
<td>Not required.</td>
<td>Not required.</td>
</tr>
<tr>
<td><strong>FINRA Filing Requirement:</strong></td>
<td>Subject to filing requirement and payment of filing fee.</td>
<td>Subject to filing requirement and payment of filing fee.</td>
<td>Not subject to FINRA filing.</td>
</tr>
<tr>
<td><strong>Blue Sky:</strong></td>
<td>Generally exempt from blue sky regulation.</td>
<td>Generally exempt from blue sky regulation.</td>
<td>Generally exempt from blue sky regulation.</td>
</tr>
<tr>
<td><strong>Listing on an exchange:</strong></td>
<td>May be listed if desired.</td>
<td>May be listed if issued in compliance with Part 16.6.</td>
<td>Not in the U.S., but may be listed on UKLA or other European exchange.</td>
</tr>
<tr>
<td><strong>“Restricted”</strong></td>
<td>No.</td>
<td>No.</td>
<td>Yes.</td>
</tr>
</tbody>
</table>
## Comparison of alternatives (cont’d)

<table>
<thead>
<tr>
<th>Required governmental approvals:</th>
<th>SEC Registered</th>
<th>Section 3(a)(2)</th>
<th>Rule 144A</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>SEC filing and registration fee.</td>
<td>Banks licensed by the OCC are subject to the Part 16.6 limitations, unless an exemption is available.</td>
<td>Generally none.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Permitted Offerees:</th>
<th>SEC Registered</th>
<th>Section 3(a)(2)</th>
<th>Rule 144A</th>
</tr>
</thead>
<tbody>
<tr>
<td>All investors.</td>
<td></td>
<td></td>
<td>Only to QIBs. No retail.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Resale restrictions:</th>
<th>SEC Registered</th>
<th>Section 3(a)(2)</th>
<th>Rule 144A</th>
</tr>
</thead>
<tbody>
<tr>
<td>None</td>
<td></td>
<td></td>
<td>Only to QIBs. No retail.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Investment Restrictions:</th>
<th>SEC Registered</th>
<th>Section 3(a)(2)</th>
<th>Rule 144A</th>
</tr>
</thead>
<tbody>
<tr>
<td>None</td>
<td></td>
<td></td>
<td>Restricted securities; a limited bucket for some investors.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Minimum denominations:</th>
<th>SEC Registered</th>
<th>Section 3(a)(2)</th>
<th>Rule 144A</th>
</tr>
</thead>
<tbody>
<tr>
<td>All denominations.</td>
<td></td>
<td></td>
<td>Typically $200,000 or more</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Role of Manager/Underwriter:</th>
<th>SEC Registered</th>
<th>Section 3(a)(2)</th>
<th>Rule 144A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Either agented or principal basis.</td>
<td></td>
<td></td>
<td>Must purchase as principal.</td>
</tr>
</tbody>
</table>
Comparison of alternatives (cont’d)

<table>
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<tr>
<th></th>
<th>SEC Registered</th>
<th>Section 3(a)(2)</th>
<th>Rule 144A</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>40 Act:</strong></td>
<td>Banks not considered investment companies; consideration must be given to 40 Act treatment of a guarantor.</td>
<td>Banks not considered investment companies; consideration must be given to 40 Act treatment of a guarantor.</td>
<td>Non-bank issuer should consider whether there is a 40 Act issue; consideration must be given to 40 Act treatment of a guarantor.</td>
</tr>
<tr>
<td><strong>Settlement:</strong></td>
<td>Through DTC, Euroclear/Clearstream</td>
<td>Through DTC, Euroclear/Clearstream</td>
<td>Through DTC, Euroclear/Clearstream</td>
</tr>
<tr>
<td><strong>Repatriation of Proceeds:</strong></td>
<td>No restrictions.</td>
<td>May be restrictions.</td>
<td>No restrictions</td>
</tr>
<tr>
<td><strong>Eligible for Bond Index:</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>No.</td>
</tr>
<tr>
<td><strong>Orphan Bonds:</strong></td>
<td>No</td>
<td>Not fungible with 144A bonds or later SEC registered bonds</td>
<td>Not fungible with 3(a)(2) bonds or SEC registered bonds</td>
</tr>
<tr>
<td><strong>Prospectus Compatibility:</strong></td>
<td>May be different from UKLA prospectus</td>
<td>Similar to UKLA prospectus, but with a wrapper for branch/agency guarantee</td>
<td>Similar to UKLA prospectus, but with tax and offering and transfer restriction disclosure</td>
</tr>
</tbody>
</table>


This is MoFo. 108
REGISTERED CONTINUOUSLY OFFERED PROGRAMS
Continuous offering 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.
Documentation

- 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
Variants

- 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.
Deliverables

- 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?