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Structured Thoughts

News for the financial services community.

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Fixed Versus Variable Priced Offerings

On July 21, 2010, the Securities and Exchange Commission (the "SEC") signed an order approving the Financial Industry Regulatory Authority, Inc.'s ("FINRA") proposed Rule 5141, "Sale of Securities in a Fixed Price Offering" (the "Rule"). The Rule is intended to protect the integrity of fixed price offerings by ensuring that securities are sold to the public at the stated public offering price, and not at an undisclosed better price. The Rule was proposed as part of the development of a consolidated FINRA rulebook after FINRA replaced the National Association of Securities Dealers (the "NASD"). In addition to replacing NASD rules 0120(h), 2730, 2740 and 2750 (known as the Papilsky rules), and associated interpretive materials, the Rule eliminates provisions, such as recordkeeping requirements, that are addressed elsewhere in the consolidated FINRA rulebook, and adds additional provisions to clarify ambiguities in the predecessor NASD rules and related interpretative materials.

The Rule prohibits the grant of certain preferences, such as selling concessions, discounts and other allowances, in connection with fixed price offerings of securities. For purposes of the Rule, fixed priced offerings include securities offerings in the United States or any territory thereof, whether or not registered under the Securities Act of 1933, as amended, but specifically exclude "exempted securities" or "municipal securities" as such terms are defined under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The Rule continues to apply to selling syndicate or selling group members, and clarifies that it is also applicable to single underwriters. The prohibition on granting certain preferences applies until the termination of the offering or until a member, or single underwriter, having made a "bona fide" public offering of the securities, is unable to continue selling such securities at the stated public offering price. This addresses "sticky deals."

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The Rule eliminates the general prohibition on transactions with related persons set forth in former NASD rule 2750. Section 5141(a) of the Rule permits a member of a selling syndicate or selling group, or a member that acts as a single underwriter, to sell securities in a fixed price offering to an affiliated person subject to the restrictions set forth in FINRA rule 5130. FINRA rule 5130 restricts the purchase and sale of initial equity public offerings and generally prohibits sales to and purchases by a broker-dealer and accounts in which a broker-dealer has a beneficial interest. Section 5141(b) clarifies that nothing in the Rule prohibits the purchase and sale of securities in a fixed price offering between members of the selling syndicate or selling group to ensure preservation of the underwriting process.

In addition, the Rule addresses certain ambiguities in the former NASD rules by adding new provisions under 5141.01, 5141.02, 5141.03, 5141.04 and 5141.05.

- Provision 5141.01 provides a definition of a "reduced price" and provides greater certainty as to which economic equivalents, such as overtrading and improper underwriting recapture, are prohibited by the Rule. A reduced price includes a reduction of an advisory fee.

- Provision 5141.02 clarifies that a member or person associated with a member that participates in a syndicate or selling group, or that acts as a single underwriter, is permitted to sell securities in the offering to a person or account to which it has provided or will provide research, provided that the person or account pays the state public offering price and the research is provided pursuant to Exchange Act Section 28(e).

- 5141.03 clarifies that transactions between a member of a selling syndicate or selling group, or between a single underwriter and an affiliated person that are part of the normal and ordinary course of business and are unrelated to the sale or purchase of securities in a fixed price offering will not be deemed to confer a reduced price under the Rule.

- Provision 5141.04 incorporates the NASD rule definition of "fixed price offering" with minor comments to bring the definition in line with the terms of the consolidated FINRA rulebook. Provision 5141.05 clarifies that a member who is an investment adviser may exempt securities that are purchased as part of a fixed price offering from the calculation of annual or periodic asset-based fees that the member charges a customer, provided that the exemption is part of the member's normal and ordinary course of business with the customer and not solely in connection with the offering.

The Rule streamlines the regulatory process, reduces duplicative requirements already addressed in the consolidated FINRA rulebook generally, and clarifies certain definitions that should make it easier for members to determine which activities fall within the scope of the Rule. To the extent that underwriting agreements require members to make certain filings or maintain certain records in accordance with NASD rules, such agreements should be reviewed and revised to reflect the requirements under the general FINRA consolidated rulebook and existing SEC rules. For issuers who offer discounts for high-volume trades, the references to Notice to Members 81-3 in the Rule's release and the decision not to repudiate this notice suggest that this practice is still permitted under the Rule provided that it meets the existing standard that the discount is not granted in a surreptitious manner and that it does not result in unfair discrimination vis-à-vis select investors. This position is further supported by the Rule's definition of "fixed price offering" which does not explicitly prohibit multiple price offerings, provided that the different fixed prices are adequately disclosed. With respect to issuers who sell fixed offering price securities to investment advisers who onsell to their customers, the Rule clarifies when a different fixed price may be offered. Although 5141.05 expressly permits such practice, provided that it is part of the member's normal and ordinary course of business with the customer, the Rule does not address the typical practice employed by members where two fixed price public offering prices are disclosed in the offering materials, one for general purchases and one for purchases made by persons who already pay fees to their investment advisers. The fact that this common practice is not expressly prohibited by the Rule suggests that it is still permitted. In either case, the issuer should disclose such arrangements in the offering documents.

The effective date has not been announced as of this writing.

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Section 3(a)(2) and Offerings by Banks

Section 3(a)(2) of the Securities Act of 1933 (the “Securities Act”) exempts from registration under the Securities Act any security issued or guaranteed by a bank. This exemption is based on the notion that, whether state or federal, banks are highly and relatively uniformly regulated, and as a result will provide adequate disclosure to investors about their finances in the absence of federal securities registration requirements. In addition, banks are also subject to various capital requirements that may increase the likelihood that holders of their debt securities will receive timely payments of principal and interest. This article provides an overview of how this exemption applies to a bank’s offering of securities, including structured notes.

What Is a Bank?

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

Securities Guaranteed by a Bank

As noted above, the Section 3(a)(2) exemption is also available for securities “guaranteed” by a bank. Whether an offering is guaranteed by a bank is interpreted broadly by the Securities and Exchange Commission (the “SEC”). The staff of the SEC has taken the position in no-action letters that the term “guarantee” is not limited to a guaranty in a legal sense, but also includes arrangements in which the bank agrees to ensure the payment of a security. However, in a typical guaranteed offering, a bank’s affiliate will serve as issuer of the relevant securities, and the entity that is a bank will execute a written guarantee of the payment obligations on those securities.

Non-U.S. Banks

U.S. branches of foreign banks are entitled to rely on the Section 3(a)(2) exemption. In 1986, the SEC announced its decision to cease granting no-action letters regarding securities issued or guaranteed by foreign bank branches and agencies, and formalized its position that a foreign branch 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.”[1] As a result, several U.S. branches of non-U.S. banks are currently frequent issuers of structured products and other debt securities in the U.S.

[1] SEC Release No. 33-6661.

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Types of Securities

The exemption under Section 3(a)(2) applies not only to securities issued or guaranteed by a bank but also, to the extent they are considered securities (instead of bank deposits), certificates of deposit issued or guaranteed by a bank. Additionally, structured notes linked to the performance of an index or another underlying asset are also commonly issued by banks in reliance on the Section 3(a)(2) exemption.[2] In these instances, even though the return of the note is linked to an underlying asset, the investor is buying debt of the issuer and must rely on the credit of the issuer for repayment of the note, no matter how the underlying asset performs. This strengthens the argument that the structured instrument is covered under the Section 3(a)(2) exemption.

Because bank notes are not subject to the SEC's registration requirements, structured bank notes sometimes are linked to different types of assets than registered structured notes, particularly when the investor is sufficiently sophisticated to understand the relevant risks. For example, because bank notes are not subject to the "strict liability" provisions of Sections 11 and 12 of the Securities Act, an issuer may be more comfortable linking the bank note to a complex underlying asset or investment strategy, which may be difficult to describe adequately in the context of a registered offering. In addition, registered offerings of equity-linked structured notes are typically linked only to large-cap U.S. stocks due to the "Morgan Stanley no-action letter."[3] However, some bank notes may be linked to debt securities (credit-linked notes), small-cap stocks, or securities that are traded only on non-U.S. exchanges. Of course, due to the liability and other concerns described in this article, issuers and underwriters must carefully craft the offering documents for these types of offerings, and broker-dealers must carefully determine the suitability of the relevant investors.

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 ("FINRA") for review under Rule 5110(b)(9), unless an exemption is available. Additionally, transactions under Section 3(a)(2) must be reported through the Trade Reporting and Compliance Engine ("TRACE").[4] All brokers and dealers who are FINRA members have an obligation to report Section 3(a)(2) transactions to TRACE.

OCC Registration

For national banks or federally licensed U.S. branches of foreign banks regulated by the Office of the Comptroller of the Currency (the "OCC"), an additional layer of federal regulation applies to securities offerings. Part 16 of OCC regulations provides that these banks may not offer and sell their securities until a registration statement has been filed and declared effective with the OCC, unless an exemption applies. An OCC registration statement has a detailed scope that is comparable to an SEC registration statement; as a result, most 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 to accredited investors
- Rule 144A offerings to qualified institutional buyers

[2] In addition to structured bank notes, banks may issue structured certificates of deposit, which are usually guaranteed by the FDIC. We will address those instruments in a forthcoming issue of this publication.
[3] Morgan Stanley & Co. Incorporated, June 24, 2006. Under the terms of this no-action letter, if a linked stock does not satisfy the specified requirements, the issuer of the structured note must include in the prospectus for the structured notes detailed information about the issuer of the underlying stock (the "underlying stock issuer"). Issuers are reluctant to include this type of information, as they would face the possibility of securities law liability for their own documents if the relevant information about the underlying stock issuer was incorrect.
[4] TRACE is the FINRA-developed vehicle that facilitates the mandatory reporting of over-the-counter secondary market transactions in eligible fixed-income securities.

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- Securities guaranteed by the federal government, such as the 2008 “Temporary Liquidity Guarantee Program”
- Regulation S offerings effected outside of the U.S.

In addition, Part 16.6 of the OCC regulations provides an exemption for offerings of “non-convertible debt” to accredited investors in denominations of $250,000 or more. Due to these rules, banks subject to OCC regulation will need to tailor their offerings to meet the Part 16 requirements if they intend to seek an exemption from the requirement to file a registration statement with the OCC. However, in light of these limitations, banks regulated by the OCC tend to have somewhat less flexibility in selling structured products and other types of securities compared to bank holding companies that have an SEC shelf registration statement, particularly with respect to sales to retail investors.

FDIC Guidance

Additionally, for federally-insured state banks and state-licensed branches of foreign banks, the Federal Deposit Insurance Corporation (the “FDIC”) adopted a Statement of Policy Regarding the Use of Offering Circulars in Connection with Public Distribution of Bank Securities for state non-member banks.[5] This policy requires that an offering circular include prominent statements that the securities are not deposits, are not insured by the FDIC or any other agency, and are subject to investment risk. The policy states that the offering circular should include detailed prospectus-like disclosure, similar to the type contemplated by Regulation A or 12 CFR 563g. The policy further states that the goals of the policy will be met if the securities are offered and sold in a transaction that, among other options, satisfied (i) the requirements of Regulation D of the Securities Act relating to private offers and/or sales to accredited investors or (ii) the information and disclosure requirements of the Office of Thrift Supervision’s (“OTS”) regulations regarding securities offerings, which require that debt securities be issued in denominations of $100,000 or more. To the extent an offering meets these requirements, it will be deemed to satisfy the FDIC requirements. Nonetheless, an issuer may still want to include more detailed disclosure, as the policy emphasizes the applicability of the anti-fraud provisions of the Securities Act and Exchange Act to offerings by banks.

Blue Sky Laws

Securities issued under Section 3(a)(2) are considered “covered securities” under Section 18 of the Securities Act; as a result, blue sky filings are not need in any state in which the securities are offered. Additionally, for intrastate offerings made by state banks, many states have their own exemptions.

Exchange Act Reporting

Securities issued by banks under Section 3(a)(2) are also not subject to the reporting requirements under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). Section 12(g)(2)(C) and 12(i) of the Exchange Act provide that the enforcement of Sections 12, 13, 14(a), 14(c), 14(d), 14(f), and 16 of the Exchange Act is vested in the Comptroller of the Currency with respect to national banks, the Federal Reserve Board as to member banks of the Federal Reserve System, the FDIC as to all other insured banks, and the OTS as to savings associations. Therefore, a bank which would be subject to the Exchange Act reporting requirements would submit its financial reports to the appropriate banking authority, and not to the SEC.

Securities Liability

Securities offerings by a bank or guaranteed by a bank under Section 3(a)(2) are not subject to the civil liability provisions under Section 11 and Section 12(a)(2) of the Securities Act. However, the anti-fraud provisions of Section 17 of the Securities Act are applicable to offerings under Section 3(a)(2). Additionally, offerings under Section

[5] The policy was most recently revised in September 1996, and may be found at 61 Fed. Reg. 46808, September 5, 1996.

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3(a)(2) are also subject to Section 10(b) of the Exchange Act and the anti-fraud provisions of Rule 10b-5 of the Exchange Act. Therefore, when considering an offering under Section 3(a)(2), a bank must take into consideration what disclosure is necessary to avoid liability under the anti-fraud provisions, even if the document does not need to comply with the specific form requirements of the SEC or another regulator. As a result, the form and content of structured note offering documents issued under Section 3(a)(2) are similar in many respects to that used for a registered offering.

Offering Documents

As a result of these various rules and regulations, the offering documentation for structured bank notes is somewhat similar to that of a registered offering. An issuer typically has a base offering document, usually called an “offering memorandum” or an “offering circular” (instead of a “prospectus”). That base document is supplemented for a particular offering by one or more “pricing supplements” and/or “product supplements.” The form of these documents is not subject to the relevant SEC form rules, and may vary somewhat from those used in a registered offering. However, the content (as well as the types of documents incorporated by reference) tends to be somewhat similar.

These offering documents may be supplemented by additional offering materials, including term sheets and brochures. Because these offerings are not registered with the SEC, these additional documents are not subject to the SEC’s “free writing prospectus” rules that apply to registered offerings. However, in order to ensure that the disclosure is adequate, the issuers and underwriters that use these documents are careful about their content.

Conclusion

Section 3(a)(2) provides bank issuers with the ability to issue securities, including structured notes, without registering the offering with the SEC. When relying on Section 3(a)(2), an issuer must carefully consider the disclosure included in its offering document, so as not to subject itself to liability under the anti-fraud provisions of the securities laws and to comply with the regulations and other guidance adopted by the various banking regulators. Banks and underwriters seeking to employ industry best practices typically utilize disclosures and suitability determinations that are very similar to those used in the context of registered offerings.

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Minimum Denomination Requirements

Banks have generally issued 3(a)(2) securities in minimum denominations of $100,000 or greater. The Securities Act, however, contains no requirements regarding minimum denominations for such securities. A review of no-action letters reveals that the SEC has not directly conditioned the granting of any no-action letter on a bank security being issued in a denomination of $100,000 or greater. Both the SEC in granting no-action letters and issuers in requesting no-action letters have occasionally identified measures taken to ensure issuance of bank securities only to accredited investors, including issuance in large denominations, as factors supporting the granting of a no-action letter. The SEC has granted many no-action letters in connection with securities or other instruments, including depository instruments, trust certificates or promissory notes, issued or guaranteed by various domestic or foreign banks in minimum denominations of $1,000. None of these no-action letters indicates that the staff of the SEC has taken into consideration the minimum denominations of securities when granting relief.

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Additionally, the SEC has not published any guidance or general statement indicating that the issuances of debt securities under Section 3(a)(2) are or should be conditioned on compliance with any sales restrictions or minimum denomination requirements. The no-action letters do not imply that any additional disclosure requirements or other requirements should be met because the securities are issued in small minimum denominations.

Section 16.6 of the Securities Offering Disclosure Rules

As discussed above, before the issuance of any security, national banks or federally licensed U.S. branches of foreign banks must file a registration statement with the OCC under Section 16.3 of the Securities Offering Disclosure Rules (the "OCC Rules"). Section 16.6(a)(3) exempts the sale of nonconvertible debt from registration with the OCC if, among other conditions, the debt is sold in minimum denominations of $250,000.

FDIC and OTS Regulations

Federally insured state banks and state licensed branches of foreign banks should comply with the Statement of Policy Regarding Use of Offering Circulars in Connection with Public Distribution of Bank Securities (the "FDIC Policy"), issued by the Federal Deposit Insurance Corporation (the "FDIC") for state non-member banks. Under the FDIC Policy, if an offering circular satisfies the requirements of the Office of Thrift Supervision's regulations regarding securities offering (the "OTS Regulations"), it does not need to include any statements which the FDIC otherwise requires. The OTS Regulations require a savings association to file an offering circular before the offer or sale of any security. Debt securities issued in denominations of $100,000 or more, however, are exempt from such registration.

Other Regulations

The FINRA Rules do not impose any minimum denomination requirements on securities offerings.
In summary, securities issued or guaranteed by federal or state banks or domestic branches or agencies of foreign banks are generally exempt from registration with the SEC and are not expressly required to be issued in large denominations under the Securities Act. Securities, however, must be sold in minimum denominations of $250,000 if issued by national banks or federally licensed U.S. branches of foreign banks and an exemption from filing requirements is sought, or $100,000 if issued by state banks or state licensed branches of foreign banks in order to be exempt from registration or disclosure requirements under the OCC Rules, the FDIC Policy, or the OTS Regulations, as applicable.

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Fitch Withdraws Ratings from Non-Principal-Protected Structured Notes

On September 1, 2010, Fitch announced that it completed implementation of its updated approach to rating structured notes. The Fitch action follows its earlier announcement in May 2010 and similar actions taken by Standard & Poor's and Moody's in 2009 and early 2010.

Fitch will withdraw ratings from structured notes with variable principal payments (non-principal-protected notes). The agency also will add a subscript ("emr") to principal protected notes that it will continue to rate to indicate the particular limitations associated with the rating, which only reflects the assessment of counterparty risk. Fitch further clarified that this new approach relates only to structured products issued directly by financial institution issuers, and does not extend to structured products issued by special purpose entities, unless such issuance benefits from a guarantee by a rated financial institution. Inflation-linked notes also are excluded from this new policy.

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