Coming to America

Anna Pinedo and Jerry Marlatt of Morrison & Foerster describe the framework regulating foreign banks' issuance of covered bonds into the US

Although the United States still lacks a statute that would permit US depository institutions to issue covered bonds, foreign banks have found that US investors are interested in covered bonds. Foreign banks have met investor demand by issuing covered bonds into the US relying on their domestic covered bond frameworks. The cover pools supporting these foreign-issued covered bonds have been comprised exclusively of assets located outside the US.

When issuing covered bonds into the US, foreign issuers must comply with US securities laws, including the Securities Act. This law requires that all securities issued and sold in the US be either registered or exempt from registration. To date, offerings of covered bonds by foreign banks have been structured as exempt offerings, although, as discussed below, recent developments may lead to a new approach.

Registration exemption

One approach for offering debt securities to US persons without pursuing a registered public offering is to rely on the exemption from registration provided by Rule 144A. Upon issuance, the covered bonds of foreign issuers are first offered in a private placement to the initial purchasers (the investment banks that distribute the securities) in reliance on Section 4(2) of the Securities Act. The initial purchasers will immediately re-sell the covered bonds to institutional investors that are qualified institutional buyers in reliance on the Rule 144A safe harbour. At the same time, the covered bonds also may be offered outside of the United States to non-US persons in reliance on Regulation S of the Securities Act.

If a foreign bank has a branch or agency in the US, it may be able to rely on the exemption from registration provided by Section 3(a)(2) of the Securities Act for issuances of securities by banks. To qualify for a Section 3(a)(2) offering, the covered bonds must be either issued or guaranteed by the US branch or agency. The US Securities and Exchange Commission (SEC) treats the US branch or agency of a foreign bank as a US branch or agency for purposes of Section 3(a)(2) if the foreign bank is a 'national bank' or a 'banking institution organized under the laws of any state' if the nature and extent of regulation and supervision of such foreign bank is 'substantially equivalent to that of applicable federal or state chartered domestic banks doing business in the same jurisdiction'. Additionally, if the covered bonds are guaranteed by such a branch or agency, the guaranty or assurance must cover the entire obligation. The guarantee or assurance cannot be for a partial repayment of the covered bonds.

Relying on the Section 3(a)(2) exemption has certain advantages compared to a Rule 144A offering. An offering made in reliance on Section 3(a)(2) is generally not subject to the prohibition against general solicitation and advertising that applies to a Rule 144A offering. (The prohibition against general solicitation and advertising has been relaxed by recently enacted legislation in the US; however, rulemaking is required to effectuate this change. It is not clear whether the relaxation of the prohibition will permit the use of general solicitation and advertising in combined Rule 144A/Regulation S offerings. Securities sold in reliance on Section 3(a)(2) are not classed as restricted securities, while securities sold in a private placement and resold in reliance on the Rule 144A safe harbour are. Many institutional investors are subject to limitations on the amount of restricted securities that they may purchase. Resales of Rule 144A securities may only be made to qualified institutional buyers, whereas 3(a)(2) securities may be sold to a broader universe of investors. Finally, restricted securities are not eligible to be included in bond indices and are therefore viewed as less liquid.

> **"It is relatively simple to amend an existing European covered bond programme to accommodate a US offering"**

Documentation

A European covered bond issuer with a current prospectus (prepared in accordance with UKLA or Luxembourg Stock Exchange standards) can access the US market relatively easily. The prospectus can be supplemented with a few additional sections for the US market. The additional sections to be added generally include: disclosure regarding US tax implications and Erisa (Employee Retirement Income Security Act) implications; settlement information for clearance of the covered bonds through the Depository Trust Company (DTC); the identity of the US paying agent, information regarding any selling restrictions and transfer restrictions in the case of a Rule 144A offering; and information regarding the role of any US branch of a foreign bank in offerings as well as financial data regarding such branch in the case of a Section 3(a)(2) offering.

It is relatively simple to amend an existing European covered bond programme to accommodate an offering in the United States. There is no requirement that the programme agreement be governed by US law, so the existing agreement remains largely unchanged. A few changes are necessary, however. First, a co-issuing agent must be appointed in the US under the existing agency agreement (or other agreement providing for the issuance of securities) to provide for issuance of, and payment on, the bonds. This change is often accomplished by notice, without amending the agency agreement. Second, as required by the DTC, the global bonds must be issued in the name of the DTC's nominee, Cede & Co, and physically held by the US issuing agent. This may require amending the agency agreement. The programme agreement (or other agreement governing the offering and distribution of the covered bonds) must be amended to include representations, warranties and

covenants typical for an offering to US investors, selling restrictions, US-style indemnification provisions for false or misleading statements or omissions contained in the offering document, typical market-out provisions, and a requirement that the issuer's accountants deliver a comfort letter and perform certain agreed upon procedures.

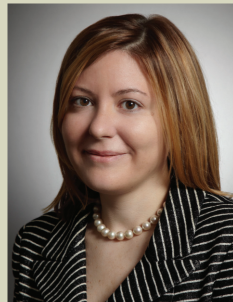
For a Section 3(a)(2) offering, steps must be taken to effect the issuance of the bonds through the US branch or agency of a foreign bank or for such branch or agency to guarantee the obligations evidenced by the covered bonds. In the case of an issuance of the covered bonds by the US branch or agency of a non-US bank, the final terms and subscription agreement or other documents to be executed for the issuance of a new series of bonds must be executed by the bank "acting through the branch [agency]" and the global bonds issued to the DTC should show the bank "acting through the branch [agency]" as the obligor. In the case of a guarantee by the branch, the bank "acting through the branch [agency]" would execute the final terms and the subscription agreement as guarantor. While it may initially appear strange that a branch office of a non-US bank would guarantee the obligations of the non-US bank, the structure is significant. The US branch or agency of a non-US bank is regulated by a US regulator and such branch or agency must often maintain separate capital in its local jurisdiction. In the case of the branch or agency's failure, the US banking regulator will marshal the assets of the branch or agency in the jurisdiction and apply those assets to repayment of claims against the branch or agency before releasing assets to the home office of the branch or agency or to insolvency proceedings in the home jurisdiction of the bank.

Due diligence

Several liability and diligence-related documents are commonly delivered at closing in connection with the issuance of debt securities into US markets. These documents include an auditor comfort letter, a pool audit letter (agreed upon procedures letter), and a 10b-5 letter. In a Rule 144A offering or a Section 3(a)(2) offering, an initial purchaser or dealer is subject to securities law liability in respect of losses if there are material misstatements or omissions contained in disclosure documents for the offering. The initial purchaser or dealer may, however, limit its liability if it can establish that it did not know and, in the exercise of reasonable care, could not have known of such misstatement or omission. This is often referred to as the due diligence defence. The diligence process will entail discussions with the issuer's management, review of certain documents, including the issuer's board minutes and material contracts and other similar agreements and a review of the issuer's mortgage business policies and procedures.

Some non-US issuers may find this inquiry intrusive, but the diligence process can be handled with due consideration for the confidentiality of sensitive information. Furthermore, the review relating to a debt offering by a regulated financial institution with publicly available financial data should not be a lengthy process. For a regulated financial institution, a great deal of information about the institution is publicly available. As part of the diligence process, there also will be various business and regulatory diligence conference calls and discussions with the issuer's accountants, counsel and other advisors. Naturally, conducting diligence for the very first offering will be more time-consuming than for subsequent offerings. Subsequent offerings require only a review of new

Author biographies



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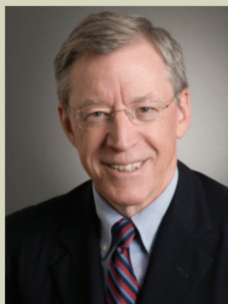
Anna Pinedo has concentrated her practice on securities and derivatives. She represents issuers, investment banks/financial intermediaries, and investors in financing transactions, including public offerings and private placements of equity and debt securities, as well as structured notes and other structured products. She works closely with financial institutions to create and structure innovative financing techniques, including new securities distribution methodologies and financial products, and has particular financing expertise in certain industries, including working with technology-based companies, telecommunications companies, healthcare companies, financial institutions, Reits and consumer finance companies.

In the derivatives area, Pinedo counsels a number of large financial institutions acting as dealers and participants in the commodities and derivatives markets. She advises on structuring issues, as well as on regulatory issues, monetisation, and hedging techniques. Her work focuses on foreign exchanges, equity and credit derivatives products, and structured derivatives transactions. She also has advised derivatives dealers regarding their Internet sites and other Internet and electronic signature/delivery issues.

Pinedo regularly speaks at conferences and participates in panel discussions addressing securities law issues, as well as the securities issues arising in connection with derivatives and other financial products.



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Jerry Marlatt specialises in corporate finance with a focus on structured capital markets. He represents issuers, underwriters and placement agents in covered bonds, surplus notes, structuring investment and specialised operating vehicles, insolvency restructuring of such vehicles, securities repackagings and public offerings and private placements of asset-backed securities in domestic and foreign capital markets. His representative transactions involve the first covered bond by a US financial institution, the first covered bond programme for a Canadian bank, surplus notes and common stock for a US monoline insurance company, eurobond offerings by US issuers and a variety of structured vehicles, including CBOs, SIVs, CDOs, derivative product companies, ABCP conduits and credit-linked investments. He is co-author of 'Considerations for Foreign Banks Financing' (IFLR, 2012), a contributor to *Covered Bonds Handbook* (Practising Law Institute, 2010), and a charter member of the United States Covered Bonds Council.

Marlatt was educated at the University of Southern California (BA, 1967) and Southwestern University School of Law (JD, 1977). He is recommended as a leading lawyer by *Chambers Global* 2012, *Chambers USA* 2012 and *Legal 500 US* 2012.

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agreements and new board minutes. It should also be noted that diligence conducted, for example, for a covered bond programme can also serve as the basis for diligence for other securities offerings by the same issuer, such as offerings pursuant to a medium-term note programme or a 3(a)(2) banknote programme. Accordingly, once initial diligence is completed, the issuer may achieve future efficiencies if the issuer and the dealers work with the same counsel on other offerings. The initial purchaser/dealer also will request that the issuer's counsel and its own counsel deliver Rule 10b-5 or negative assurance letters at closing.

"There are a number of significant advantages associated with SEC-registered covered bonds"

Registered covered bonds

A foreign issuer also may want to consider registering an issuance of covered bonds with the SEC, so that the issuer can offer the bonds in a public offering. Registering covered bonds entails different considerations for each jurisdiction and in some cases for each issuer within a jurisdiction. There are different issuance structures for covered bonds in different jurisdictions and sometimes more than one structure in the same jurisdictions. Moreover, individual issuers may have existing relationships with the SEC, may be subject to special accounting requirements, be subject to certain prohibitions on disclosure or otherwise present unique facts.

Foreign issuers would register securities with the SEC on Form F-1 for a one-time offering or on Form F-3 for a shelf offering. A shelf offering is usually desirable because it permits the issuer to register an amount of securities to be sold over three years and to come to market multiple times over the three-year period at times of the issuer's choosing. In order to qualify for use of Form F-3 for a registration statement, however, the issuing entity must have been reporting to the SEC for at least one year. If the issuer does not qualify for Form F-3, it must register its covered bonds on Form F-1.

"The diligence process can be handled with due consideration for the confidentiality of sensitive information"

The disclosure required in the prospectus for an issuing bank will include full financial statements, presented in standard IFRS or reconciled to US GAAP. Disclosure regarding the bank should be drafted in accordance with SEC Industry Guide 3, which is the disclosure guide applicable to banks. Periodic reporting will include annual filings on Form 20-F, interim reporting on Form 6-K and material event reporting on Form 8-K.

Based on the recent no action letter granted to Royal Bank of Canada (available May 18 2012), it is likely that SEC staff will expect disclosure about the cover pool assets consistent with the requirements of Regulation AB that are applicable to master trust structures, such as credit card master trusts or UK mortgage master trust for residential mortgage-backed security issuance. Prospectus disclosure will include static pool disclosure and statistical disclosure of the expected cover pool at the time of issuance, including delinquency and loss information. Static pool information is stratified disclosure of mortgage loans in the cover pool based on the year of origination of the loans. Periodic reporting of cover pool assets will include an annual filing on Form 10-K consistent with what an asset-backed security issuer would report (including an annual statement of the servicer of the mortgage loans regarding compliance with applicable servicing criteria, an attestation by an accounting firm on the servicer's statement, a statement from an authorised officer of the servicer regarding his review of the servicer's activities and its performance under the servicing agreement during the period and that based on such review and to the best of his knowledge the servicer has fulfilled all of its obligations under the servicing agreement; for a covered bond issuer using a single-tier issuance structure, such as a *Pfandbrief* issuer, the SEC may request different statements and disclosure), interim reporting on Form 10-D within 15 days of a distribution date of distribution amounts, application of collections on the assets and performance of the cover pool and material event reporting on Form 8-K.

As noted above, if a foreign issuer of covered bonds does not qualify for use of Form F-3 because it has not been reporting to the SEC for at least one year, the issuer must use Form F-1, which requires the filing of a registration statement for each offering. However, only one offering is required to begin the reporting process. If the issuer wishes to come to market frequently during the year and finds the filing and approval process for Form F-1 interferes with market timing for an offering, the issuer may wish to consider using a Rule 144A private placement or a Section 3(a)(2) offering to enable quick market entry during the year when it is building its reporting history. It is also possible to offer Rule 144A securities with registration rights to be followed by the filing of a Form F-1 to register those securities. At the end of the one-year reporting period, a Form F-3 can be filed.

Of course, the decision to register a covered bond offering will be easier for a foreign issuer that is already a US reporting entity. There are a number of significant advantages associated with SEC-registered covered bonds. An issuer would be able to offer securities to a broader array of investors, and the securities would be freely transferable, not restricted securities. The covered bonds would therefore be eligible for inclusion in bond indices. As a result, the offering may attract interest from funds that track bond indices. Although registered covered bonds are a relatively new alternative available to foreign issuers, foreign issuers should consider carefully their various issuance options when accessing the US market and in weighing the various benefits of each approach take into account all of their funding needs. As we note above, documentation and diligence for one issuance programme may well be leveraged and used in connection with other issuance platforms and result in significant efficiencies for the issuer.