



ACCESSING THE U.S. CAPITAL MARKETS

SECURITIES PRODUCTS

An Introduction to United States Securities Laws

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INTRODUCTION

This is one of three volumes of our 2009 edition of *Accessing the U.S. Capital Markets* and focuses on securities products commonly used in the U.S. capital markets. The other two volumes of *Accessing the U.S. Capital Markets* focus on the U.S. offering and listing process for, and the U.S. securities and other laws that apply to, foreign private and governmental issuers (the *Non-U.S. Issuers* volume) and U.S. issuers (the *U.S. Issuers* volume), respectively. This *Securities Products* volume is intended to be used with both. It may also be used separately as a guide to issues arising in connection with the offering of the securities products discussed herein. Each securities product chapter in this volume assumes information that is set out in the other volumes of *Accessing the U.S. Capital Markets*. The public issuance of common stock that is discussed in Chapter 1, for example, requires the preparation of disclosure, the compliance with registration procedures, the negotiation of certain agreements and attention to other matters that are not discussed, or are discussed only briefly, in this book. In this volume, we have focused on the matters that are distinctive to specific securities products.

We have also included, in Appendix A (*U.S. Tax Considerations For Non-U.S. Issuers Accessing the U.S. Capital Markets*) of this volume, a discussion of the U.S. tax considerations that foreign private issuers should consider when issuing securities in the U.S. capital markets.

None of the securities product chapters in this volume are intended to be exhaustive reviews of all issues relating to the securities products discussed. Each securities offering is made in the context of particular facts and circumstances that will impact the characteristics of the securities being offered. For advice on particular securities products, please contact a Sidley lawyer.

Sidley Austin LLP
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GENERAL

This chapter focuses on selected issues that confront an issuer making its initial public offering (“IPO”) of common equity¹ in the U.S. capital markets. An IPO typically involves registering the common equity securities with the U.S. Securities and Exchange Commission (the “SEC”) under the Securities Act of 1933 (the “1933 Act”), offering the securities through underwriters and listing the securities on a U.S. securities exchange.² The matters addressed in this chapter differ, and may not apply at all, if the issuer’s IPO is made outside the United States and the U.S. component of the offering is exempt from registration under the 1933 Act or the issuer’s common shares (or American Depositary Receipts (“ADRs”) representing those shares) are already listed on a U.S. securities exchange. This chapter also does not address other types of common equity transactions such as the issuance of stock pursuant to employee stock option plans or venture capital, private equity transactions, private offerings in the U.S. capital markets as part of IPOs listed outside the United States, or rights offerings.

Although the primary purposes of most equity offerings are to increase equity and raise funds, issuers may raise equity in the capital markets for other reasons. An IPO of common equity in the U.S. capital markets may:

- create greater access to a market in which the issuer can raise debt or additional equity on an ongoing basis;
- increase equity to improve credit ratings or reduce leverage;

¹ In the United States, these securities are denominated by state corporation laws as common stock or common shares. Outside the United States, this type of equity security may be referred to as “ordinary stock” or by other terminology. In this volume, for convenience, we refer to this category of equity securities as common equity securities.

² For a more detailed discussion of the U.S. offering process and the U.S. securities laws and U.S. securities exchange rules that apply to a U.S. securities exchange-listed IPO of common equity, see the other volumes of *Accessing the U.S. Capital Markets*.

- give the issuer an equity currency to use in an acquisition program;
- enable the issuer to attract and retain talented employees by providing incentives through stock option, restricted stock, stock purchase or other equity-based employee compensation programs;
- enable existing shareholders (which may include private equity investors) to achieve liquidity by selling shares in a public market; and
- raise the issuer's profile generally among current and potential customers, suppliers, employees and acquisition targets.

Identifying the desired goals to be met may be helpful in structuring the offering in a manner that maximizes the benefits to the issuer. For example, establishing a directed share program open to employees, suppliers or customers may create substantial goodwill among these groups.³

STRUCTURING ISSUES

Amendment of Charter and Bylaws

It is typical for the issuer to restate its charter and bylaws (or similar organizational documents) in connection with an IPO. The terms of the amended and restated charter and bylaws are described in the preliminary prospectus, although the actual amendment and restatement often does not take place until shortly before closing.

The amended and restated charter and bylaws typically reflect an increase in the number of shares of authorized common stock and preferred stock in order to accommodate both the issuance in the offering and future issuance of common stock under stock incentive plans, in connection with business combinations and to fund the issuer's operations. In addition, the amended and restated charter and bylaws often incorporate anti-takeover provisions. Although certain anti-takeover devices (such as shareholder rights plans) have fallen into disfavor among institutional investors, and while there continues to be pressure on issuers to reduce the scope of their anti-takeover measures, the following anti-takeover provisions are often seen:

- advance notice requirements for shareholder nominations of directors or for proposing matters to be voted on at a shareholders meeting;
- provisions prohibiting shareholders from calling a special meeting or acting by written consent;
- "staggered board" provisions dividing the board of directors into three classes, with each class serving a staggered three-year term, and provisions that directors may be

³ For a description of directed share programs, see the discussion in this chapter below under the heading "— Directed Share Programs."

- removed only for cause and that vacancies on the board of directors may be filled only by the directors then in office;
- provisions requiring a supermajority vote of shareholders to amend certain provisions of the charter or bylaws; and
 - “blank check preferred” provisions authorizing the board of directors, without the approval of shareholders, to issue one or more classes or series of preferred stock with terms and provisions established by the board of directors.

Termination of Agreements Among Shareholders

Shareholders of a private issuer (especially if those shareholders include venture capital or private equity investors) often have agreements among themselves or with the issuer. These may include voting agreements, co-sale agreements, registration rights agreements and other shareholder agreements. In addition, private equity groups may enter into agreements to provide management and advisory services to their portfolio companies for which they are paid a fee. It is common practice for all of these agreements to terminate at the time of the IPO, except for registration rights agreements and certain rights to indemnification. However, automatic termination often requires that the issuer receive a specified minimum dollar amount of proceeds from the IPO, and it may therefore be necessary to amend the agreements appropriately if it is expected that the offering proceeds will be below the specified threshold. Likewise, some of these agreements, or selected provisions of these agreements, may not provide for automatic termination upon an IPO. Once again, it may be necessary to seek amendments directly from shareholders to terminate these agreements in connection with the offering. Accordingly, these agreements should be reviewed early in the offering process to allow sufficient time to obtain any necessary amendments or waivers.

Consider Increased Staffing

An institution considering an IPO should evaluate whether its existing staffing levels are sufficient to handle the increased workload associated with being a public company. In particular, it may be appropriate to add additional accounting, internal control and legal personnel, given the requirements imposed by the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley” or “SOA”)⁴ and the provisions of the Securities Exchange Act of 1934 (the “1934 Act”) and the SEC’s rules and regulations thereunder. For issuers whose financial statements are not prepared in accordance with United States generally accepted accounting principles (“U.S. GAAP”) or in accordance with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (the “IASB”), management should consider whether it should add accounting personnel familiar with U.S. GAAP to assist in preparing the reconciliation between home country GAAP and U.S. GAAP required by the SEC.

⁴ For additional information concerning Sarbanes-Oxley, see the other volumes of *Accessing the U.S. Capital Markets*.

Independent Directors and Committees

For an issuer's common stock to be listed on the New York Stock Exchange (the "NYSE"), the NYSE Amex or the The National Association of Securities Dealers Automated Quotation System ("NASDAQ"), except as described below, its board of directors and certain board committees must meet the independence standards imposed under that exchange's listing rules.⁵

As a general matter, the NYSE, the NYSE Amex and NASDAQ require that a majority of the board of directors meet standards of independence specified by the exchange, and that all members of the audit committee and other specified committees also meet those independence standards.⁶ An issuer listing on the NYSE, the NYSE Amex or NASDAQ in connection with its IPO is given a period of one year following the IPO to comply with board and committee independence requirements. There are a number of phase-in periods for those requirements following an IPO, which are described below. However, prospective underwriters often suggest that issuers comply with most, if not all, of these independence requirements at the time of the offering, given the importance some institutional investors place on corporate governance matters.

Board of Directors

The issuer must have:

- one independent director at the time of the IPO; and
- a majority of independent directors within one year of the IPO.

Board Committees

The audit committee and any other committees required by stock exchange rules must have:

- one independent member at the time of the IPO;
- a majority of independent members within 90 days of the IPO; and
- all independent members within one year of the IPO.

⁵ For a further discussion of listing rules, see Chapter 6 (*Listing on U.S. Securities Exchanges*) of the other volumes of *Accessing the U.S. Capital Markets*.

⁶ Certain non-U.S. corporations have two-tiered or "split" boards, each having a distinct set of statutory responsibilities to the shareholders, as required by the corporate law of their home jurisdictions. In those situations, the independence requirements should be applied to the policy-making board and not to the board charged with responsibility for day-to-day operations. Likewise, board committees required by the NYSE, the NYSE Amex or NASDAQ rules should be composed of members of the policy-making board.

Audit Committee

In addition to the foregoing requirements, the audit committee must have a minimum of three members, each of whom must be “financially literate.”

Additional Committees

In addition to an audit committee, issuers listed on the NYSE must also have a nominating/corporate governance committee and a compensation committee, although there are no requirements as to the minimum number of members. Issuers listed on NASDAQ or NYSE Amex are not required to have any committees other than the audit committee. However, if a NASDAQ or NYSE Amex listed issuer does not have a compensation committee or a nominating committee, the functions of those committees must be performed by a majority of the independent directors.

Controlled Issuers

Issuers of which more than 50% of the voting power is held by an individual, a group or another issuer are exempt from the director and committee independence requirements of the exchanges, other than the audit committee requirements. However, the prospective underwriters may suggest that a controlled issuer will be more attractive to prospective investors if it voluntarily complies with the full independence requirements even if it is not required to do so.

Foreign Private Issuers

Although technically exempt from most of the independence standards imposed by the U.S. stock exchanges as well as certain other corporate governance requirements, some foreign private issuers may nonetheless choose to voluntarily comply with these standards in an effort to reduce the required disclosure of differences between their home country corporate governance requirements and those applicable to U.S. issuers, or to build a reputation for following “best practices” with respect to corporate governance.

Foreign private issuers are permitted to follow their home country corporate governance practices rather than comply with the independence standards imposed by the exchange, subject to limited exceptions. A foreign private issuer that chooses to follow its home country practice in lieu of the applicable stock exchange requirements must disclose in its annual reports that it is following home country practices, as well as describing the differences between such practices and the requirements imposed by the exchange rules on a U.S. issuer. In addition, SEC rules require that an issuer disclose in its annual report on Form 20-F or 40-F whether or not at least one member of the audit committee is an “audit committee financial expert,” and if not, why not.

Equity Incentive Plans

Issuers often establish new stock incentive plans in connection with their IPO. Outstanding options, shares of restricted stock and other equity incentives issued under any prior plans usually remain outstanding (subject to adjustment to reflect any pre-IPO stock split), and will continue to be governed by the terms of those prior plans. However, the issuer will typically

state in the prospectus that it will cease issuing awards under the prior plans and, following its IPO, will issue equity awards only under its new plans.

The number of shares reserved for issuance under a new equity incentive plan is typically a matter for discussion between the underwriters and the issuer. Overly large equity incentive plans may have negative marketing implications because of the “market overhang” they create. Conversely, underwriters may be concerned if management does not have sufficient equity incentives to help align their interests with the shareholders.

OFFERING SIZE AND PRICE RANGE

The SEC requires that a preliminary prospectus distributed to prospective investors in connection with an IPO specify the number of shares being offered and the estimated offering price per share. The typical procedure is initially to file the registration statement for an IPO with the SEC without a price range and then to add the price range in an amendment to the registration statement filed with the SEC shortly before marketing commences. The price appearing in the preliminary prospectus is typically expressed in the form of a price range per share (*e.g.*, \$15 to \$17 per share). It is typical to see a \$1 price range if the anticipated offering price is less than \$10 per share, a \$2 price range if the anticipated offering price is between \$10 and \$20 per share and a \$2 or \$3 price range if anticipated offering price is above \$20 per share. The SEC’s stated administrative position is that the estimated price range may be up to \$2 if the public offering price is less than \$20 per share and up to 10% of the high end of the range if the public offering price is \$20 or more.

The size and price range of the offering typically are determined shortly before the preliminary prospectus is printed. This allows the managing underwriters to refine their valuations of the issuer in light of market conditions existing shortly before the road show begins. Based on these valuations, the managing underwriters and the issuer agree upon the size and price range. In certain offerings, a pre-effective amendment to the registration statement may be required to price an offering outside the stated price range.

The managing underwriters will often recommend that the transaction be structured so that the actual price at which shares are sold to the public is between \$15 and \$25 per share (although exceptions abound). In order to achieve this result, it is usually necessary to effect a stock split or, less commonly, a reverse stock split. The stock split ratio is established at the same time that the size of the offering and price range are determined and is also disclosed in the preliminary prospectus. However, the stock split is usually effected only shortly before the closing date of the offering. For foreign private issuers whose shares will trade primarily on a non-U.S. exchange, this price per share may greatly exceed the typical price per share for the home stock exchange. In such situations, underwriters typically recommend the establishment of an ADR program,⁷ which bundles a certain number of the issuer’s shares into one ADR that is designed to trade initially within the target price range.

⁷ For a further discussion of ADRs, see Chapter 2 (*Depositary Receipts (ADRs and GDRs)*) of this volume.

UNDERWRITERS' OVER-ALLOTMENT OPTION

In addition to the shares that the underwriters are obligated to purchase from the issuer and any selling shareholders, the underwriters typically will receive an over-allotment or “Green Shoe” option to purchase additional shares. Under the rules of The Financial Industry Regulatory Authority, Inc. (“FINRA”),⁸ the number of shares that the underwriters have the option to purchase may not exceed 15% of the number of shares that the underwriters are obligated to purchase. For example, in a 2 million share offering, the option may cover up to an additional 300,000 shares. It is customary that the option be granted for the full 15%, although it may be exercised in part or in whole. The option shares may be sold to the underwriters by the issuer, by selling shareholders or by any combination of the issuer and selling shareholders.

CHEAP STOCK

It is standard practice for the SEC, in reviewing the registration statement for an IPO, to analyze all stock options granted within the 12 to 24 months prior to filing to determine whether any of those options had an exercise price below the fair market value of the shares at the time the options were granted. If the SEC determines that the exercise price was below fair market value, it will require the issuer to recognize a non-cash charge for so-called “cheap stock” that is amortized over time. Whether cheap stock has been issued pre-IPO is not always clear given the many different ways that the valuation of a pre-IPO issuer can be calculated. This issue should be addressed early in the process through an analysis of all existing stock option plans and historical grant activity under such plans. An independent financial expert may be needed to assess the validity of the option pricing, although such determination is not binding on the SEC. Cheap stock issues also may arise in connection with (i) evaluating the charge to earnings in connection with any stock granted as compensation or to pay for goods or services or (ii) expenses associated with any warrants issued to lenders or other financing sources.

LOCK-UP AGREEMENTS

In connection with IPOs of common equity, the issuer enters into an underwriting agreement with the underwriters that is typically prepared by underwriters' counsel and contains issuer representations, covenants and disclosure indemnity and contribution provisions. To avoid the adverse impact caused by sales of shares by key officers, directors and existing shareholders for a period after the closing, the underwriters, in the terms of the underwriting agreement, may require these persons to enter into lock-up agreements imposing a contractual restriction on their ability to sell shares for a period of time. These lock-up periods often are 180 days after pricing in the case of an IPO, and 90 days in the case of a follow-on offering. However, there may be a variety of reasons why these periods may be different in certain cases.

FINRA rules prohibit a manager or co-manager of a public offering from publishing a research report concerning the issuer during the 15 days before and after the expiration or waiver

⁸ FINRA is a private, not-for-profit organization established in June 2007 through the consolidation of the National Association of Securities Dealers, Inc. (“NASD”) and the member regulation, enforcement and arbitration functions of the NYSE, and is registered with the SEC under Section 15A of the 1934 Act.

of a lock-up agreement.⁹ This prohibition does not apply to research reports distributed under Rule 139 under the 1933 Act regarding issuers with “actively traded securities” as defined in Regulation M, which means, as a practical matter, that the prohibition applies primarily to IPOs and certain follow-on offerings. In the case of issuers that are subject to this rule, it is market practice to include “booster shot” provisions, which automatically extend the lock-up agreements by up to an additional 34 days if earnings are to be released or certain other material events occur near the time that the lock-up agreement would otherwise have expired.

SELLING SHAREHOLDERS

During the course of preparing an issuer for its IPO, the underwriters and the issuer will determine the degree of participation by existing shareholders. The level of participation will depend on a number of commercial factors, including the desires of the existing shareholders, the issuer’s capital requirements and any registration rights granted to existing shareholders. Sales by existing shareholders must be balanced against the potentially negative investor perceptions created by significant sales by existing shareholders. Sales by institutional holders may be viewed differently than sales by an issuer’s management or strategic investors.

In the event selling shareholders will participate in the IPO, selling shareholders should be identified early in the process. When selling shareholders are present, underwriters will typically require legal opinions at closing from counsel to the selling shareholders as to the due authorization, execution and delivery of the underwriting agreement and good title to the shares being purchased. Depending on the jurisdictions involved, negotiating those opinions can be time-consuming, and it is helpful to have the respective counsel for the selling shareholders identified early in the process.

Selling shareholders are typically required to enter into a power of attorney and a custody agreement prior to pricing of the offering. Pursuant to the custody agreement, the shares to be sold by the selling shareholders, together with stock powers endorsed in blank, are delivered to a custodian (typically the transfer agent for the common stock) prior to pricing to ensure that those shares will be available for timely delivery at closing. The power of attorney typically empowers one or more individuals to sign the underwriting agreement and closing certificates on behalf of all of the selling shareholders, thereby simplifying logistics where a large number of selling shareholders are involved. Certain of these arrangements may be waived in the case of established institutional selling shareholders.

DIRECTED SHARE PROGRAMS

Issuers sometimes establish directed share programs (also known as “DSPs” or “friends and family” programs) in connection with an IPO. Pursuant to a DSP, a portion (often 5%) of the shares offered to the public is set aside for sale to a specific group of investors identified by the issuer (*i.e.*, the friends and family). This group will typically include employees of the issuer, and may also include suppliers, customers or other business associates. To the extent that

⁹ For further information regarding research reports, see the discussion under the heading “Research Reports” in Chapter 1 (*The U.S. Offering Process*) of the other volumes of *Accessing the U.S. Capital Markets*.

these shares are not purchased by this group of investors, they are offered to the public as part of the overall offering.

A DSP is typically administered by one of the managing underwriters. The first step is for the issuer to provide the DSP administrator with a list of prospective investors who are to be offered the opportunity to purchase shares pursuant to the DSP. Investors wishing to purchase in the DSP must meet certain eligibility standards under applicable FINRA rules, must complete various forms provided by the DSP administrator and typically must provide a non-binding indication of interest as to the number of shares they wish to purchase. Shortly after the offering is priced, the DSP administrator will advise each prospective investor as to the number of shares they have been allocated (which may be less than the number of shares that the investor indicated an interest in purchasing), at which point the investor may either decline or accept the allocation. To facilitate delivery of shares, DSP investors are typically required to make their purchases through brokerage accounts at the DSP administrator. In addition, these investors often are required to sign “lock-up agreements” restricting their transfer of shares for a specified period after the IPO.

Because of the need to obtain properly signed and completed questionnaires and other forms from DSP investors, the administration of a DSP program, particularly a program with hundreds of prospective investors, can present certain logistical difficulties. However, a number of investment banks have implemented web-based DSP programs in which questionnaires and other forms are completed by investors on-line, thereby facilitating wider access to such programs and lowering the administrative burden on the DSP administrator.

In the case of DSP investors located outside the United States, it is important to ensure that the offer and sale of shares to those investors comply with local securities laws. This may prove challenging in certain jurisdictions, given that DSP investors are typically individuals and therefore certain institutional investor exemptions will not be available. It is therefore important to identify the jurisdictions in which DSP shares will be offered early in the process and to contact local counsel as appropriate. In certain cases, it may be necessary to prepare a supplement to the prospectus for use in particular countries.

LIMITATIONS ON PUBLICITY

The 1933 Act prohibits offers to sell securities before a registration statement is filed with the SEC (subject to certain exceptions), and also prohibits written offers other than by means of a preliminary prospectus, final prospectus or free writing prospectus. Offers made in violation of these prohibitions are typically referred to as “gun-jumping.” If the SEC determines that a gun-jumping violation has occurred, it may require that the issuer delay the offering by several months (a so-called “cooling-off period”). In addition, written offers made other than by a preliminary prospectus, final prospectus or free writing prospectus may give the investors to whom those offers were made a right to “put” the securities they purchased in the offering back to the issuer for a period of one year.

Under Rule 163A under the 1933 Act, oral and written offers made more than 30 days before the date a registration statement is first filed generally do not constitute gun-jumping, so long as those statements do not refer to the proposed securities offering and the issuer takes

“reasonable steps” to prevent the further distribution or publication of the communication during the 30 days prior to filing. Notwithstanding this safe harbor, issuers should generally not make any oral or written statements that could be deemed to constitute an offer of securities from the time that a decision is reached to pursue an IPO until the registration statement is filed with the SEC. In particular, the issuer must be careful to avoid any unusual publicity in the United States that could be viewed as conditioning the U.S. market for the sale of its securities.

The financial media (and, sometimes, more general media sources) may publish extensively on pending IPOs. Therefore, issuers may need to be vigilant in counseling officers and others to avoid contact with the media that could result in gun-jumping issues. In particular, issuers should be careful in granting interviews to reporters, as the issuer will have no control over when the resultant article actually appears in the media. Draft press releases are often submitted to counsel for both the issuer and the underwriters for review prior to release.¹⁰

BASIC DOCUMENTS

Set forth below is a list of basic transaction documents for a U.S. IPO. Please refer to Appendix B (*Basic Documents for Securities Offerings in the U.S. Capital Markets*) of this volume, as well as the other volumes of *Accessing the U.S. Capital Markets*, for a further description of these documents.

1. Publicity memorandum.
2. Due diligence request lists and questionnaires.
3. 1933 Act registration statement.
4. Offering documents, including the following:
 - a preliminary, or “red herring,” prospectus;
 - a free writing prospectus/term sheet;
 - a final prospectus; and
 - any non-U.S. supplements or “wrappers.”
5. FINRA filings.
6. State securities law or “blue sky” filings.

¹⁰ For further information regarding publicity restrictions and “gun-jumping,” see the discussion under the heading “Limitations on Publicity” in Chapter 1 (*The U.S. Offering Process*) of the other volumes of *Accessing the U.S. Capital Markets*.

7. Selling securityholder documents (if applicable).¹¹
8. Underwriting or purchase agreement and lock-up agreements.
9. Road show materials.
10. Corporate documents, including the following:
 - amended and restated charter and bylaws, constitution and similar organization documents;
 - board and committee resolutions;
 - equity incentive and other employee benefit plans;
 - employment agreements with key personnel; and
 - a corporate code of ethics and board committee charters (if applicable).
11. Transfer and paying agent agreements.
12. Form of share certificate.
13. Deposit agreements and form of ADR (if applicable).¹²
14. Form F-6 registration statement (if applicable).
15. The Depository Trust Company (“DTC”) letter of representations.
16. Listing documents.
17. 1934 Act registration statement.
18. Legal opinions and 10b-5 statements.¹³

¹¹ Where existing shareholders are selling shares as part of a U.S. IPO, the underwriters typically require that the selling shareholders enter into powers of attorney and custody agreements. These agreements must be executed and delivered before the pricing of the offering.

¹² A deposit agreement, ADRs and an ADR registration statement will be required if the shares are offered by a foreign private issuer in the form ADRs. For a further discussion, see Chapter 2 (*Depository Receipts (ADRs and GDRs)*) of this volume.

¹³ A “10b-5 statement” is a statement to the underwriters by U.S. counsel to the effect that nothing has come to such counsel’s attention to cause it to believe that the registration statement (in the case of a 1933 Act-registered offering) or the offering document (in the case of a 1933 Act-exempted offering) contains (including, in either case, information incorporated by reference) any material misstatement or omits any material fact necessary in order to make the statements therein, in the light of the circumstances under which they were made, not misleading.

19. Auditor's comfort letter(s) and related documents.
20. Other closing documents.

CHAPTER 2**DEPOSITARY RECEIPTS (ADRS AND GDRS)**

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GENERAL

A depositary receipt (“DR”) is a negotiable receipt, resembling a stock certificate, that is issued by a U.S. depositary bank (the “Depositary”) to evidence one or more depositary shares (“DSs”), which in turn represent an interest in segregated equity shares of a foreign private issuer (“Underlying Shares”) that have been deposited at a custodian bank in the country of origin.¹ A single DS may represent one share of a foreign private issuer, or it may represent several shares (*e.g.*, when the shares trade in their local market at a price per share that is far lower than that to which U.S. investors are accustomed), or it may represent a fraction of a non-U.S. share, effectively splitting a high-priced stock. A DR holder generally can exchange DRs for the Underlying Shares at any time. An American depositary receipt (“ADR”) evidencing American depositary shares (“ADSs”) is normally issued to U.S. investors while a global depositary receipt (“GDR”) indicates that a DR has been issued to investors in several trading markets simultaneously.²

An ADR program makes a foreign private issuer’s shares more attractive for investment by U.S. investors in several ways, including providing a means to trade shares in U.S. dollars, facilitating share transfers, creating a mechanism that permits investment in shares in bearer form, avoiding stamp duty on transfers, avoiding the cost and inconvenience of arranging for safe deposit facilities outside the United States, converting dividends paid in a foreign currency to U.S. dollars and adjusting round lots to a size to which U.S. investors are accustomed. ADRs also have been used successfully to facilitate offerings under Rule 144A and combined offerings under Regulation S and Rule 144A. Other applications include the use of ADRs in mergers and

¹ The Depositary will often use its own branch in the country of origin as custodian. DRs normally evidence DSs that represent the equity securities of a foreign private issuer, although they could in theory also represent debt securities.

² In practice, the terms “ADR” and “ADS” are used interchangeably. For simplicity, we will use only the term “ADR” and, depending on the context, this term may refer to either the physical certificate or the security evidenced by such certificate.

acquisitions, restructurings, foreign governmental debt issues and employee benefit and compensation plans.

An ADR program may be established on either a “sponsored” or “unsponsored” basis, depending on whether the issuer of the Underlying Shares joins the Depositary in the creation or operation of the program.

As discussed below, Rule 12g3-2(b) exempts any foreign private issuer from the reporting requirements of the 1934 Act, regardless of how many U.S. residents hold its securities, provided it makes available to U.S. investors in accordance with the rule the information the issuer provides to investors in its home country and satisfies certain other conditions.³ Until recently, Rule 12g3-2(b) required the submission of written materials to the SEC both to claim and to maintain the exemption from registration. Amendments adopted in 2008 significantly revised the terms of the exemption, substituting electronic publication for paper filings and effectively removing the SEC staff from the administration of the rule.⁴ A foreign private issuer can now qualify for the Rule 12g3-2(b) exemption automatically and without regard to the number of its U.S. shareholders by posting on the Internet certain information, including information the issuer has made or is required to make public pursuant to law or stock exchange regulation in its home jurisdiction or the jurisdiction of its principal securities market or has distributed or is required to distribute to its securityholders. Since a foreign private issuer no longer needs to claim the exemption provided by Rule 12g3-2(b), an unsponsored ADR facility can now be established without the issuer’s active participation or consent. The adoption of these amendments to Rule 12g3-2(b) resulted in a substantial increase in the number of unsponsored ADR facilities established and maintained with the Depositary.

ADR facilities are generally described in terms of three basic categories, based on the extent to which the issuer of the Underlying Shares has accessed the U.S. capital markets. The first two categories describe facilities for ADRs evidencing existing (outstanding) securities issued by a foreign private issuer where no distribution (offering) of the Underlying Shares is involved. The third category describes ADRs issued in connection with the issuance and offering of new securities. Generally, an unsponsored facility may only be a Level One facility. Sponsored facilities may be organized under any of the three categories. The three categories are as follows:

Level One: The ADRs are issued against shares of the foreign private issuer trading in its home market or elsewhere that have been deposited with the custodian bank under the ADR facility. These ADRs trade in the U.S. over-the-counter market through market makers that publish quotations or indications of interest in the “Pink Sheets.” These ADRs are not listed on a U.S. national securities exchange or quoted on the “OTC Bulletin Board” (an over-the-counter quotation service maintained by FINRA), and have not been sold in the United States as part of a 1933 Act-registered public offering.

³ For more information on Rule 12g3-2(b), including further detail on its requirements, see the discussion under the heading “Information Reporting under Rule 12g3-2(b) for Foreign Private Issuers” in Chapter 3 (*The Securities Registration and Reporting Process*) of *Accessing the U.S. Capital Markets — Non-U.S. Issuers*.

⁴ See SEC Release No. 34-58465 (Sept. 5, 2008) (<http://www.sec.gov/rules/final/2008/34-58465.pdf>).

Level Two (Listed Facility): The ADRs are issued against shares of the foreign private issuer trading in its home market or elsewhere that have been deposited with the custodian bank under the ADR facility. These ADRs are listed on a U.S. national securities exchange (*e.g.*, the NYSE, the NYSE Amex or NASDAQ), but have not been sold in the United States as part of a 1933 Act-registered public offering.

Level Three (Listed and Registered Offering): The ADRs are issued against new shares of the foreign private issuer that have been deposited with the custodian bank under the ADR facility. These ADRs are listed on a U.S. national securities exchange and have been sold in the United States as part of a 1933 Act-registered public offering.

In addition, an ADR facility may be established in connection with a U.S. private placement of Underlying Shares in which the ADRs have been privately sold or resold in reliance on Rule 144A under the 1933 Act. This facility is typically called a Rule 144A ADR facility. A concurrent U.S. public offering or private placement of ADRs may also be made simultaneously with an offering of the Underlying Shares or ADRs or GDRs representing the same class of security outside the United States in reliance on Regulation S.

Foreign private issuers that maintain or establish a Level Two or Level Three facility are required to file annual reports on Form 20-F and interim reports on Form 6-K with the SEC and are subject generally to the provisions of Sarbanes-Oxley, the provisions of the 1934 Act and the SEC's rules and regulations thereunder, as well as to the corporate governance standards imposed on foreign private issuers by, as applicable, the NYSE, the NYSE Amex or NASDAQ.

This chapter examines the general features of ADRs as well as issues typically encountered in using ADRs in connection with securities offerings.

1933 ACT REGISTRATION

General

For purposes of the 1933 Act, ADRs and Underlying Shares are considered separate securities, although the ADRs merely represent the Underlying Shares. The issuance of each security is subject to the registration requirements of the 1933 Act unless an exemption from those requirements is available. A U.S. public offering of ADRs representing a new issuance of Underlying Shares would require registration of both the ADRs and the Underlying Shares. This would be a Level Three ADR facility. Conversely, ADRs may be registered under the 1933 Act and issued when neither the foreign private issuer nor an affiliate is engaging in a public offering of the Underlying Shares and, therefore, registration of the Underlying Shares under the 1933 Act is not required. This would be a Level One or Level Two ADR facility. For example, when an investor purchases securities of a foreign private issuer in the secondary market in the home country and deposits those securities in an ADR facility, ordinarily that transaction is exempt

from 1933 Act registration. However, the ADRs to be issued upon such deposit must be registered, unless a separate exemption is available.⁵

Form F-6: Registration of ADRs Under the 1933 Act

The SEC has adopted Form F-6 for the registration of ADRs under the 1933 Act. Three eligibility requirements must be satisfied in order to use Form F-6:

- (1) the holder of the ADRs must be entitled, upon delivery of the ADRs to the Depositary for cancellation, to withdraw the Underlying Shares evidenced by those ADRs at any time, subject only to certain restrictions;⁶
- (2) the Underlying Shares must be offered or sold in transactions registered under the 1933 Act or in transactions that would be exempt from registration if made in the United States;⁷ and
- (3) as of the filing date of Form F-6, the issuer of the Underlying Shares must be a reporting company under the 1934 Act or must be exempt from the reporting requirements of the 1934 Act pursuant to Rule 12g3-2(b) thereunder, unless the issuer of the Underlying Shares concurrently files a 1933 Act registration statement on another form for the Underlying Shares.⁸

⁵ Because the issuance of ADRs upon the deposit of securities constitutes a separate offer and sale for purposes of the 1933 Act, ordinarily a Form F-6 registration statement will be prepared and filed with the SEC to satisfy the 1933 Act registration requirement and permit unrestricted delivery and transfers of the ADRs. However, it is possible to structure the issuance of ADRs as a private placement exempt from registration under the 1933 Act. This method has been employed for ADR programs relying on Rule 144A in connection with a U.S. private offering and is discussed below.

⁶ The withdrawal right must be subject only to (1) temporary delays caused by closing transfer books of the Depositary or the issuer of the Underlying Shares or the deposit of shares in connection with voting at a shareholders' meeting, or the payment of dividends, (2) the payment of fees, taxes, and similar charges, and (3) compliance with any laws or governmental regulations relating to ADRs or the withdrawal of Underlying Shares. In some countries, regulations relating to withdrawal of Underlying Shares are so onerous as to pose a problem for the SEC regarding whether this eligibility requirement can be satisfied. On the other hand, in Rule 144A ADR programs (see the preceding footnote), because there is no requirement to register the ADRs with the SEC and therefore no need to use Form F-6, the Form F-6 requirement regarding withdrawal rights does not apply. In fact, in such programs, the foreign private issuer and the Depositary may agree in the deposit agreement to contractual restrictions on withdrawal to suit the needs of the issuer or the particular market. It is important in these arrangements, however, to be mindful of issues that may arise under the Investment Company Act of 1940 (the "1940 Act").

⁷ Typically, the purchase of Underlying Shares in the home country market or stock exchange for deposit in a Level One facility is exempt from the registration requirements of the 1933 Act pursuant to Section 4(1) and/or Section 4(3) or Section 4(4) of the 1933 Act.

⁸ Because 1934 Act registration is required for Level Two and Level Three facilities, the third eligibility requirement may not be satisfied by establishing a Rule 12g3-2(b) exemption. A foreign private issuer may establish a Rule 12g3-2(b) exemption in connection with a Rule 144A ADR facility as a convenient way to comply with the Rule 144A information requirements.

Rule 12g3-2(b) provides an exemption from the 1934 Act reporting requirements for a foreign private issuer that maintains a listing of its equity securities in its primary trading market located outside the United States and publishes electronically in English specified information, provided, among other things, that the foreign private issuer has not become subject to the 1934 Act reporting requirements by making a public offering in the United States or listing on a national securities exchange or trading on the OTC Bulletin Board.⁹

The Form: Disclosure Requirements

Form F-6 consists of a facing cover sheet and Parts I and II. The facing sheet must set forth such information as the name and address of the foreign private issuer of the Underlying Shares and the Depositary, as well as the calculation of the registration fee for SEC filing purposes.

The “registrant” required to sign the registration statement is the “legal entity created by the agreement for the issuance of [the ADRs].” The Depositary may sign on behalf of that entity. If the foreign private issuer sponsors the ADR facility, then the registration statement must also be signed by the issuer.¹⁰

Part I of Form F-6

Part I sets forth two items of information required to be included in the prospectus. This is ordinarily satisfied simply by including a form of the ADR certificate.

Item 1. The registrant must provide a description of the ADRs being registered, including the following:

- (1) the name of the Depositary and the address of its principal executive office;
- (2) the title of the ADRs and the Underlying Shares, and provisions, if any, regarding the amount of Underlying Shares represented by one unit of ADRs, any procedure for voting the Underlying Shares, the procedure for collecting and distributing dividends, the procedures for transmitting notices, reports and proxy soliciting material, the sale or exercise of rights, the deposit or sale of securities resulting from dividends, splits or plans of reorganization, amendment, extension or termination of the deposit arrangements, the rights that holders of ADRs have to inspect the books of the Depositary and the list of ADR holders, any restrictions on the right to transfer or withdraw the Underlying Shares, and any limitation on the Depositary’s liability; and

⁹ See *supra* footnote 3.

¹⁰ For purposes of potential liability under the 1933 Act, the Depositary is not deemed to be an issuer, a person signing the 1933 Act registration statement or a person controlling an issuer; however, the existence of 1933 Act liability for the issuer of the Underlying Securities has not been unambiguously resolved. See SEC Release No. 33-6894 (May 23, 1991) (hyperlink unavailable).

- (3) a description of all fees and charges which may be imposed directly or indirectly against the holders of the ADRs, indicating the type of service, the amount of fees or charges and to whom paid. However, the amounts charged may be omitted if a general description of the fees and services is provided and the Depositary undertakes to provide a separate fee schedule upon request and to provide holders with at least 30 days notice of any change to the fee schedule.¹¹

Item 2. The registrant must provide the information in either (a) or (b) below, whichever is applicable.

- (a) State that the foreign private issuer publishes information in English required to maintain the exemption from registration under Rule 12g3-2(b) on its web site or through an electronic information delivery system generally available to the public in its primary trading market, and disclose the address of the foreign private issuer's web site or the electronic information delivery system in its primary trading market. (In the case of an unsponsored ADR facility, the representation that the foreign private issuer publishes information in English required to maintain the 12g3-2(b) exemption may be based upon the Depositary's reasonable, good faith belief after exercising reasonable diligence.)
- (b) State that the foreign private issuer is subject to the periodic reporting requirements of the 1934 Act and accordingly files reports with the SEC, and disclose that these reports are available for inspection and copying through the SEC's Next-Generation Electronic Data Gathering, Analysis, and Retrieval System ("EDGAR") or at public reference facilities maintained by the SEC in Washington, D.C.

Part II of Form F-6

Part II sets forth requirements for information that must be provided to the SEC in the registration statement but is not required to be included in the prospectus.

Item 3. The following are the principal exhibits required to be filed with or, if applicable, incorporated by reference in, the registration statement on Form F-6:

- (1) the deposit agreement;
- (2) other agreements relating to the custody of the Underlying Shares or the issuance of the ADRs;
- (3) certain material contracts between the Depositary and the issuer of the Underlying Shares; and
- (4) an opinion of counsel as to the legality of the ADRs.

¹¹ Notice is not required for changes in state transfer or other taxes and other governmental charges, transfer or registration fees, cable, telex or facsimile transmission costs, delivery costs or other such expenses.

Item 4. The Depositary must undertake to do the following:

- (1) make available at its principal office in the United States, for inspection by holders of the ADRs, any report or communication it has received from the issuer of the Underlying Shares that has been made generally available to holders of the Underlying Shares; and
- (2) notify each registered holder of ADRs thirty days before any change in the fee schedule and, if the amounts of fees charged are not disclosed in the prospectus (or the ADR), as described above, promptly provide a separate fee schedule on request.

1934 ACT REGISTRATION

If a foreign private issuer's ADRs trade in the U.S. over-the-counter market in a Level One facility (and not on a U.S. national securities exchange or the OTC Bulletin Board) and the foreign private issuer has no other 1934 Act-registered or, with certain exceptions, 1933 Act-registered securities, the foreign private issuer may claim the exemption from registration under the 1934 Act pursuant to Rule 12g3-2(b), as discussed above. A foreign private issuer that is registering the Underlying Shares under the 1933 Act and/or listing the ADRs on a U.S. national securities exchange (in connection with a 1933 Act registration or otherwise) must register the Underlying Shares under the 1934 Act and therefore becomes subject to the obligation to file annual reports on Form 20-F and interim reports on Form 6-K with the SEC. The information required in respect of a 1934 Act registration is virtually the same as that required under a 1933 Act registration.

PRIVATE PLACEMENTS AND REGULATION S OFFERINGS USING DRs

General

A foreign private issuer may privately place securities represented by ADRs in the United States in accordance with Rule 144A under the 1933 Act. Alternatively, the issuer might consider a global offering in which the portion of the offering outside the United States is structured in accordance with Regulation S under the 1933 Act, while the U.S. portion is structured in accordance with Rule 144A and Section 4(2). The SEC permits a Regulation S offering to be made outside the United States concurrently with a private offering in the United States exempt from registration under the 1933 Act.

Rule 144A provides a safe harbor from the registration and prospectus delivery requirements of the 1933 Act for resales of unregistered securities to certain highly sophisticated "qualified institutional buyers" or "QIBs." To take advantage of the Rule 144A safe harbor, the foreign private issuer must first issue its securities for deposit with a custodian bank and issue the related ADRs pursuant to the exemption from the registration requirements afforded by Section 4(2) of the 1933 Act. This initial issuance of the ADRs pursuant to Section 4(2) will usually be made to one or more investment banks or their affiliates. These initial purchasers will then resell the ADRs to QIBs in reliance on Rule 144A.

GDR Structures for Unregistered Global Offerings

Three GDR structures have evolved to enable foreign private issuers to make global offerings without registration under the 1933 Act. These structures are discussed below.

Rule 144A Structure

Generally, Rule 144A ADR facilities are structured to permit new deposits of underlying shares by purchasers (QIBs or offshore purchasers) in the secondary market who are willing to accept unregistered (restricted) ADRs. A Rule 144A ADR facility is known as a “restricted” facility since Rule 144A ADRs and Rule 144A Underlying Shares are “restricted” securities within the meaning of Rule 144. Under Rule 144, a “restricted” security generally cannot be publicly offered or resold without registration under the 1933 Act until the applicable restricted period has elapsed since its sale by the issuer or an affiliate. Before the restricted period expires, a holder of ADRs may seek to rely on the safe harbor provided by Rule 144A or Regulation S to make a resale.¹² Following the initial deposit by the issuer in connection with the offering, neither the issuer nor any affiliate should deposit additional shares or purchase Rule 144A ADRs or Underlying Shares for resale. Otherwise, the restricted period would be adjusted to commence from such new deposit.

Combined or Unitary Structure

In this offering structure, securities of the foreign private issuer are offered in its home country and perhaps elsewhere outside the United States in reliance on Regulation S. Simultaneously, DRs are offered both to QIBs in reliance on Rule 144A (or pursuant to another exemption) and to offshore purchasers outside the United States in reliance on Regulation S. All such DRs are issued pursuant to the same deposit agreement and represent the same class of Underlying Shares.

The SEC has indicated that all DRs issued pursuant to this type of facility (as well as the Underlying Shares represented by such DRs) must be treated as restricted securities within the meaning of Rule 144 and must be assigned one CUSIP number, regardless of whether the DRs were issued (or resold by the initial purchasers) in reliance on Rule 144A or Regulation S. As in the case of the Rule 144A structure, the DRs and the Underlying Shares must be subject to deposit, withdrawal and resale restrictions.

Bifurcated Structure

In this offering structure, securities of the foreign private issuer are offered in its home country and perhaps elsewhere outside the United States in reliance on Regulation S. In

¹² Rule 144A and Regulation S are non-exclusive safe harbors from the 1933 Act registration requirements. For example, a Rule 144A program may be structured as a “Rule 144A-only” offering or a “Rule 144A-eligible” offering. Rule 144A-only programs generally permit resales only to QIBs. Rule 144A-eligible programs generally permit resales pursuant to Rule 144A or any available exemption from registration under the 1933 Act. A foreign private issuer should decide which approach to take in consultation with its investment bankers and U.S. legal counsel.

addition, two separate classes of DRs are offered simultaneously: Rule 144A ADRs are offered to QIBs in reliance on Rule 144A (or pursuant to another exemption); and Regulation S DRs are offered offshore outside the issuer's home country in reliance on Regulation S. Unlike a unitary structure, the two classes of DRs are offered pursuant to two separate and distinct DR facilities. The Rule 144A ADRs are issued pursuant to a Rule 144A deposit agreement, while the Regulation S GDRs are issued pursuant to a Regulation S deposit agreement.¹³

Unlike the unitary structure, the bifurcated structure, subject to compliance with the SEC guidelines for side-by-side facilities discussed below, enables Regulation S GDRs to be deposited in a Level One or other registered facility subsequently created and registered on Form F-6, so that the foreign private issuer can retain the option to create an expanded market for its securities. Regulation S GDRs are not subject to the registration requirements of the 1933 Act, and thus are not restricted securities within the meaning of Rule 144. However, they may be subject to temporary restrictions on resale in the United States as provided in Regulation S. To prevent leakage (discussed below) during any such restricted period, the Regulation S GDRs will be made subject to contractually fixed, temporary restrictions on deposit, withdrawal and transfer.

Side-by-side Facilities

“Side-by-side” is the expression used to describe the concurrent existence of a Rule 144A DR facility and a registered Level One DR facility representing the same class of Underlying Shares. The Level One DR facility may be established before or after an issuer makes a U.S. private placement.¹⁴

In either case, the foreign private issuer and the Depositary, together with their advisers, should adopt procedures to maintain the separation between restricted and unrestricted ADR facilities and to protect against leakage.¹⁵

¹³ The bifurcated structure evolved because of concerns that GDRs issued pursuant to a unitary facility in reliance on Regulation S and quoted on the Stock Exchange Automated Quotation (“SEAQ”) system would violate the prohibition of Regulation S against directed selling efforts in the United States. SEAQ quotes are available as electronic quotations on the screens of a number of U.S. broker-dealers. The structure also developed in response to concerns that the availability of SEAQ quotes in the United States might constitute a general solicitation, thereby jeopardizing the registration exemption provided by Rule 144A. However, the SEC has indicated that a SEAQ quote in the Regulation S context does not in and of itself jeopardize the Rule 144A exemption.

¹⁴ However, Rule 144A is not available for resales of securities that, when issued, were of the same class as securities listed on a U.S. national securities exchange. Accordingly, if a foreign private issuer already has ADRs listed on a U.S. securities exchange (*i.e.*, through a Level Two or Level Three facility) representing a particular class of its securities, then it may not make a Rule 144A offering of securities of the same class. This does not preclude subsequent listings of securities of the same class after a Rule 144A transaction has been consummated. The existence of a Level One facility will not preclude the availability of Rule 144A in connection with an offering of Rule 144A ADRs.

¹⁵ For a description of procedures agreed to by the Staff, see the discussion in this chapter below under the heading “—Distinguishing Between Restricted and Unrestricted DRs.”

The SEC has expressed significant concern over the implications of side-by-side facilities. Its concern focuses on preventing DRs or Underlying Shares that are restricted securities from being sold as if they were unrestricted securities or deposited in an unrestricted or registered DR facility. There are three aspects to the SEC's concerns: leakage, automatic fungibility and distinguishing restricted and unrestricted DRs.

Leakage. Leakage refers to the movement of Rule 144A DRs (including DRs initially issued pursuant to a unitary structure in reliance on Regulation S) or securities underlying Rule 144A DRs from a restricted DR facility to an unrestricted DR facility registered on Form F-6 at a time when those securities are restricted securities under Rule 144. The risk of leakage may exist directly (from a Rule 144A DR facility into an unrestricted facility) or indirectly through a pre-arranged transaction that makes it appear as if a valid resale of a security has been made in an offshore transaction in reliance on Rule 904 of Regulation S prior to selling or depositing such security in the United States or in a registered DR facility as if such security were unrestricted.

Automatic Fungibility. This term refers to the position implicit in “bifurcated” DR facilities that, at the end of a designated period (in most cases, upon the later to occur of the termination of a 40-day restricted period and the effectiveness of a registration statement on Form F-6 relating to DRs representing the same class of underlying security), Regulation S DRs should be freely tradable to the same extent as the DRs registered pursuant to Form F-6. The SEC's concern was that established certification procedures would be inadequate to ensure that the Regulation S DRs and the pool of securities underlying the Regulation S DRs would in fact be unrestricted.

Distinguishing Between Restricted and Unrestricted DRs. Related to its concerns about leakage and fungibility, the SEC was emphatic that the market adopt consistent practices to distinguish restricted DRs from unrestricted DRs by the use of distinct Committee on Uniform Securities Identification Procedures (“CUSIP”) and International Security Identification Number (“ISIN”) numbers to enable market participants to comply with any applicable restrictions. The SEC's position is that DRs issued pursuant to a unitary facility are all restricted securities and must be assigned one CUSIP number regardless of whether the DRs were issued (or resold by the underwriters) in a transaction that satisfied the requirements of Rule 144A or Regulation S.

In SEC No-Action Letter Depository Receipts, available April 14, 1993, the SEC issued guidelines with respect to the establishment of concurrent restricted and unrestricted DR facilities. Under these guidelines, the SEC will declare effective a Form F-6 registration statement for a new facility when a restricted DR facility (or facilities, in the case of the bifurcated structure) for the same class of Underlying Shares already exists if each existing restricted DR facility is operated pursuant to the following principles:

- (1) Rule 144A ADRs must be distinguished from Regulation S GDRs or unrestricted GDRs by a different name, a different CUSIP number, and if applicable, a different ISIN number.
- (2) After the initial deposit in connection with the offering, additional deposits of securities into a restricted facility may be made (subject to (4) below) by any person who delivers the appropriate deposit certification and who agrees in writing (by or

on behalf of the beneficial owner of the DRs to be issued) to observe the resale restrictions applicable to the DRs and Underlying Shares.

- (3) Upon withdrawal of Underlying Shares from a restricted DR facility, the Depositary must receive a written certification establishing whether the withdrawn securities will be unrestricted or restricted in the hands of the beneficial owner thereof. In the latter case, such certification must contain a written agreement on behalf of such beneficial owner that, so long as the withdrawn securities are restricted, it will comply with the applicable resale restrictions and will not deposit such securities into an unrestricted DR facility (including a Regulation S GDR facility under which the issuance and sale of additional DRs may be registered with the SEC). As noted above, resales would typically be permitted pursuant to Rule 144A, Regulation S or, if available, Rule 144.
- (4) Until such time as an F-6 registration statement, if any, is effective with respect to a particular DR facility, the Depositary must be satisfied (by means of the certification procedure) that any issuance of additional DRs thereunder will be exempt from, or not be subject to, the registration requirements of the 1933 Act. In the case of a Regulation S GDR facility, prior to effectiveness of an F-6 registration statement, the written certification delivered to the Depositary on behalf of the beneficial owner of the securities to be deposited must establish:
 - such beneficial owner is not an affiliate of the issuer of the Underlying Shares or a person acting on behalf of such an affiliate; and
 - the securities to be deposited are not restricted securities within the meaning of Rule 144(a)(3).
- (5) An F-6 registration statement with respect to a new unrestricted DR facility, or with respect to DRs to be issued pursuant to an existing Regulation S DR facility following effectiveness of the F-6, may not be filed with the SEC until 40 days after consummation of the Regulation S offering.

SPONSORED AND UNSPONSORED ADR PROGRAMS

The primary distinction between a sponsored and unsponsored ADR facility is the participation of the foreign private issuer of the Underlying Shares in the sponsored facility.

Sponsored

In a sponsored facility, the rights and obligations of the issuer are formally and specifically defined in the deposit agreement entered into by the issuer and the Depositary. In addition, the foreign private issuer signs the Form F-6 registration statement. The terms of deposit for sponsored facilities differ from those for unsponsored facilities. In a typical sponsored facility, the Depositary will agree to distribute notices of shareholder meetings and voting instructions (which the issuer is obligated to deliver in a timely manner), enabling ADR holders to exercise voting rights through the Depositary with respect to the Underlying Shares. The Depositary usually also agrees to provide shareholder communications and other

information to the ADR holders at the request of the issuer of the Underlying Shares. The issuer will typically recognize the interests of ADR holders to participate in certain corporate actions, subject to compliance with U.S. laws (particularly the registration requirements under the 1933 Act), by consulting with the Depositary as to how best to structure the action in the holders' interests. Sponsorship itself does not trigger different reporting or registration requirements with the SEC. Otherwise, sponsored ADR facilities function in much the same way as unsponsored facilities. As in unsponsored facilities, a custodian in the issuer's home country usually is appointed to hold the Underlying Shares.

The deposit agreement sets out the rights and responsibilities of the foreign private issuer, the Depositary and the ADR holders. The allocation of responsibility for expenses, fees and charges is a matter of contract among the issuer, the Depositary and the ADR holders and is specified in the deposit agreement. In a sponsored facility, the issuer of the Underlying Shares normally will pay the Depositary for administrative and shareholder-related expenses, such as the costs of mailings to holders of ADRs, although ADR holders continue to bear certain other costs, such as ADR issuance and cancellation fees.

Unsponsored

Unsponsored ADR facilities generally are created in response to a combination of investor, broker-dealer and Depositary interest. Most commonly, a Depositary is the principal initiator of a facility, responding to U.S. investor interest in, for example, a particular non-U.S. security.

The Depositary may request a letter of non-objection from the foreign private issuer of the Underlying Shares, although in an unsponsored facility neither the issuer's consent nor participation is required.

Provided the foreign private issuer is a reporting company under the 1934 Act that is in compliance with the 1934 Act reporting requirements, or is exempt from such reporting requirements pursuant to Rule 12g3-2(b) of the 1934 Act, the Depositary will register the ADRs by filing a 1933 Act registration statement on Form F-6. Unsponsored ADR facilities do not include a deposit agreement and only the form of receipt for the ADRs is filed with the Form F-6. Once the registration statement becomes effective,¹⁶ the Depositary will begin to accept deposits of securities of the issuer of the class to which the ADRs relate and issue ADRs against such deposits. The Depositary normally will appoint a custodian bank in the issuer's home country to hold the Underlying Shares.

¹⁶ Rule 466 under the 1933 Act provides that, if the Depositary has previously filed a Form F-6 in connection with a deposit agreement that is virtually identical to the Form F-6 being filed, the registration may be made effective immediately upon its filing, or at any time thereafter, by designating the date and time of effectiveness on the cover page of the form and including a certification as to compliance with the Rule.

On September 11, 2003, the SEC proposed an amendment to Form F-6 that would preclude the use of Form F-6 to register unsponsored ADRs if the foreign private issuer has separately listed shares on a U.S. national securities exchange. The SEC stated that the proposed amendment is intended to ensure that U.S. investors in a foreign private issuer enjoy a similar level of shareholder rights and to minimize investor confusion.

In an unsponsored ADR program, the holders of the ADRs usually bear all of the costs of the facility. The Depositary normally charges fees upon the deposit and withdrawal of Underlying Shares, the conversion of dividends into U.S. dollars, the disposition of non-cash distributions and other services. In some cases, fees may be waived or reduced, as, for example, in the event of duplication (see below), when two or more competing Depositaries have established facilities for a class of securities of the same issuer.

Although, as noted above, the Depositary in respect of an unsponsored facility must “make available” certain information about the issuer of the Underlying Shares, generally it is not obligated to distribute shareholder communications received from the issuer or to pass through voting rights in respect of the Underlying Shares to holders of the ADRs.

CONTRACTUAL RIGHTS

In addition to triggering rights and obligations under U.S. federal and state securities laws, a sponsored ADR facility creates a contractual relationship among the Depositary, the issuer of the Underlying Shares and the holders of the ADRs, who, by accepting the ADRs, are deemed to have become parties to, and are thereby bound by, such contract. In the case of a sponsored facility, the deposit agreement constitutes that contract. The certificates evidencing sponsored ADRs contain an extensive summary of the terms of the deposit agreement. In the case of an unsponsored facility, the contract is between the Depositary and the holders of ADRs only, as the issuer has no formal involvement in the facility. The ADR certificate for unsponsored ADRs constitutes the full contract and is not just a summary, because there is no deposit agreement. The ADR certificate forms a contract between the Depositary and each holder of ADRs.

OTHER GENERAL CONSIDERATIONS

Duplication

Unsponsored ADR facilities are frequently duplicated. More than one Depositary may establish its own ADR facility for the same class of Underlying Shares of the same issuer. For example, each of four or five Depositaries may have created an ADR facility in respect of the shares of a single foreign private issuer whose shares are widely sought after in the U.S. ADR market. Neither the foreign private issuer of the Underlying Shares nor the Depositary which created the original unsponsored facility is required to approve a duplicate unsponsored ADR facility. All ADRs issued in respect of the same class of underlying security of the same issuer are assigned the same CUSIP number and generally are considered fungible with each other and trade without regard to the identity of the Depositary.

Historically, duplication has been avoided in connection with sponsored programs because of concerns about resulting market confusion or disorder. If a sponsored facility has been established by one Depositary, the SEC has not heretofore permitted another Depositary to

create another facility (whether sponsored or unsponsored) covering the same Underlying Shares.¹⁷ The duplication of a sponsored facility, however, is not categorically prohibited.

Pre-Release Transactions

Depositaries typically engage in “pre-release transactions,” in which an ADR is issued and delivered to a person, typically a broker-dealer, prior to delivery to the custodian bank of the Underlying Shares for deposit or when Underlying Shares are delivered out of the facility prior to receipt and cancellation of the corresponding ADRs. While this practice originated and is still employed in order to bridge gaps in customary settlement periods in different countries, it may now also be utilized by participants in the ADR markets for other purposes. The Depositary’s position with respect to the broker-dealer’s delivery obligations is maintained pursuant to standing agreements between the Depositary and its pre-release customers.

Deposit agreements typically include provisions such as collateral requirements and volume limitations to minimize potential risks associated with pre-release transactions (such as the risk of failure to deliver the Underlying Shares for deposit). The foreign private issuer should consult U.S. counsel with respect to the negotiation of other arrangements to limit its risk and that of the holders of its ADRs arising out of pre-release transactions.¹⁸

BASIC DOCUMENTS

Set forth below is a list of basic transaction documents for a DR transaction. Please refer to Appendix B (*Basic Documents for Securities Offerings in the U.S. Capital Markets*) of this volume, as well as the other volumes of *Accessing the U.S. Capital Markets*, for a further description of these documents.

1. 1933 Act registration statement for the Underlying Shares (if applicable).
2. 1933 Act registration statement on Form F-6.
3. 1934 Act registration statement (if applicable).
4. Underlying Shares of foreign private issuer.
5. Deposit agreement (if applicable).
6. Form of ADR.
7. Pre-release indemnity side letter (if applicable).

¹⁷ If the issuer of the Underlying Shares decided to sponsor a facility after the establishment of one or more unsponsored facilities, the issuer might pressure the Depositaries of the unsponsored facilities to effect a transfer of the Underlying Shares and the related ADR holders to the sponsored facility and terminate their unsponsored facilities.

¹⁸ For a discussion of the U.S. federal tax consequences of pre-release transactions, see Appendix A (*U.S. Tax Considerations for Non-U.S. Issuers Accessing the U.S. Capital Markets*) of this volume.

CHAPTER 3

CONVERTIBLE AND EXCHANGEABLE SECURITIES

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GENERAL

A convertible security is a security that provides the holder with the right to convert the security into the common equity of the issuer of the security. An exchangeable security is a security that provides the holder with the right to exchange the security for the common equity of an issuer other than the issuer of the exchangeable security. In either case, the economic consequences of owning such securities are linked to the market performance of the underlying equity securities.¹

Convertible debt securities have become a significant option available to issuers seeking financing on optimal terms. The embedded conversion feature enables issuers to issue debt securities with an interest rate that is often far lower than the rate of interest that the issuer would otherwise have to pay on a comparable non-convertible debt security. Many innovations have been built into convertible products for tax, accounting and regulatory purposes that further enhance their attractiveness to issuers. For example, many US issuers will issue convertible notes that settle on a net share basis in order to avail themselves of accounting treatment that is more beneficial than traditional convertible notes settled on a physical basis. In such structures, the issuer will be obligated to deliver upon conversion cash equal to the lesser of the principal amount of the notes being converted and the conversion value and, to the extent that the conversion value exceeds the principal amount of the notes converted, a number of shares of common stock having a market value equal to such excess. In such instruments, the conversion value and the number of net shares that the issuer is required to deliver is determined during an “observation period” consisting of a specified number of trading days.

¹ Equity-linked securities are distinguished from securities that provide for pay in kind or other similar arrangements (such as an alternative coupon payment mechanism) in respect of the issuer’s fixed payment obligations under the terms of the instrument. The latter securities use the issuance of equity or other securities as a form of payment currency. As such, the value of the payout on those securities is not linked to the market performance of the underlying security, but rather provides for a variable number of securities to be issued that will yield a market value that corresponds to the issuer’s fixed payment obligation.

Exchangeable securities, which often include terms that are similar to convertible securities, have likewise become a significant factor in the capital markets. Because these securities are exchangeable for the equity of a different issuer, these securities enable an issuer to “monetize” a securities position that it holds in another issuer. In addition, such securities form a staple of the many structured notes programs adopted by various U.S. domestic investment banks and others. Structured notes are offered by investment banks as a means of providing purchasers with exposure to the equity security to which the note is linked when instruments providing the economic terms of the structured note have not been issued by the issuer of the underlying common equity.²

BASIC STRUCTURAL PROVISIONS

Securities that may be converted into, or exchanged for, common equity at the option of the holder are commonly referred to as optional convertible or optional exchangeable securities. Securities that will automatically or at the option of the issuer be converted or exchanged for the underlying equity are commonly referred to as mandatory convertible or mandatory exchangeable securities.

Convertible and exchangeable securities are generally debt securities or preferred stock; they may also take the form of trust preferred or other types of securities issued by special purpose vehicles. Regardless of the form, convertible and exchangeable securities generally provide:

- an income stream (which may be a fixed or floating interest rate and, in the case of zero coupon convertible securities, may have an accreting principal amount);
- anti-dilution protection; and
- takeover protection.

The conversion or exchange feature embedded in a convertible or exchangeable security is, in effect, an option to purchase the underlying equity at the conversion or exchange price of the security (*i.e.*, the number of shares deliverable divided by the principal amount or liquidation value of the security). Since the embedded option has value to the investor, the investor effectively pays the issuer for this option by accepting a lower interest rate than for a comparable, non-convertible security.

Convertible and exchangeable securities generally protect against dilution of the underlying common equity from certain corporate actions or events that affect the underlying common equity. Some of the more standard events include stock splits or combinations, distributions of securities or assets, changes in the rate at which cash dividends are payable on the underlying equity, mergers and issuer tender offers.

² See Chapter 7 (*Structured Notes*) of this volume.

In addition to anti-dilution adjustments, protection is often provided for change of control events, particularly a cash acquisition. Frequently a change of control will enable the holder to put the security to the issuer at its principal amount or liquidation value. However, because convertible securities contain an embedded option, a put right resulting from an event such as a cash acquisition that permanently impairs the value of the embedded option would not necessarily fully compensate the investor for the loss of this value. As a result, it has become standard for convertible securities issued in the U.S. capital markets to include a make-whole payment in connection with a cash acquisition. This make-whole often takes the form of an increase in the conversion rate.

1933 ACT CONSIDERATIONS³

At the time of offer and sale, convertible or exchangeable securities, like any other class of securities, must either be registered under the 1933 Act or offered and sold pursuant to an exemption from registration. The exemption provided by Rule 144A under the 1933 Act is the most common exemption from registration used by issuers in the U.S. capital markets.

Optional Convertible or Exchangeable Securities

Offerings of convertible or exchangeable securities that are immediately convertible or exchangeable are considered to be offers for the purchase of the underlying security as well as the convertible or exchangeable securities. This is because the definition of “offer” in Section 2(a)(3) of the 1933 Act includes a right to convert or exchange a security into another underlying security as an offer of the underlying security unless the conversion or exchange right cannot be exercised until a “future date.” The staff of the SEC (the “Staff”) has defined “future date” as any date that is beyond one year of the date in question. As a result, unless the conversion or exchange cannot occur prior to one year from the date of issue, in addition to the requirement for registration of the convertible or exchangeable security (or for there to be an applicable exemption from those requirements), the underlying equity must also be registered at the time of sale of the convertible or exchangeable security unless an exemption from registration is available. Where convertible or exchangeable securities are not convertible or exchangeable within one year from the date of issue, the issuer may choose not to register the underlying securities at the time of registering the convertible or exchangeable securities, but, in the absence of an available exemption, the underlying equity must be registered no later than the date the securities become convertible or exchangeable.

Securities underlying optional convertible or exchangeable securities are considered to be sold at the time the investors elect to convert or exchange. Therefore, the underlying securities must be registered at the time of conversion or exchange unless an exemption (such as Section 3(a)(9) discussed below) is available. If an exemption from such registration is not available, the issuer of the underlying security will be required to furnish a prospectus in connection with the conversion or exchange and, as a consequence, will be required to employ an “evergreen” shelf registration statement (*i.e.*, a shelf registration statement that will be available at all times during

³ For recently updated interpretive guidance by the Staff on certain 1933 Act considerations, see <http://www.sec.gov/divisions/corpfin/cfguidance.shtml#sas>.

the optional conversion or exchange period). If an evergreen registration statement is not viable, the terms of the security may restrict the periods during which the holder may convert or exchange.⁴

Section 3(a)(9) Exemption for the Conversion or Exchange

Section 3(a)(9) of the 1933 Act provides an exemption for a security that is exchanged by the issuer with its existing securityholders where no commission or other remuneration is paid for soliciting such exchange. Provided the underlying securities are securities of the same issuer as the issuer of the convertible securities, Section 3(a)(9) would be available to exempt the issuance of the underlying equity upon conversion so no evergreen prospectus would need to be delivered upon conversion.

The “same issuer” requirement means that the exemption provided by Section 3(a)(9) of the 1933 Act is generally not available for exchangeable securities. When a trust or other special purpose vehicle issues securities that are exchangeable for securities of its parent, and the parent guarantees the securities of the special purpose vehicle such that the ultimate credit relied upon by investors is that of the parent, SEC no-action letters have permitted reliance upon the Section 3(a)(9) exemption.⁵

Section 4(1) Exemption for the Conversion or Exchange

Where the Section 3(a)(9) exemption is not available for the issuance of the underlying securities upon conversion or exchange, the underlying securities must be registered and a prospectus must be delivered upon conversion or exchange unless another exemption is available (e.g., Rule 144A, Section 4(1), etc.).

- *Exchangeable Securities.* An exemption pursuant to Section 4(1) of the 1933 Act will be available if there is no involvement by the issuer of the underlying security or if no underwriter or dealer is involved. As such, under many circumstances, issuers of an exchangeable security may be able to avail themselves of this exemption from registration.
- *Affiliate Relationships.* If there is a control or affiliate relationship between the issuer of the exchangeable security and the issuer of the underlying security (as would be the case where an issuer issues notes that are exchangeable for the equity of another entity that the issuer controls), the Section 4(1) exemption would not be available because the transaction would be deemed to involve the issuer. In addition, even where the issuer of the exchangeable security is not affiliated with the issuer of the underlying security, the exemption provided by Section 4(1) may nevertheless be

⁴ Some issuers are reluctant to obligate themselves to provide an “evergreen” shelf registration statement given the potential for material corporate developments to arise at any time. Depending on the facts and circumstances, a development of this nature might not be ripe for public disclosure. However, the non-disclosure of a material development would constitute a material omission from the related prospectus.

⁵ See SEC No-Action Letters The Timken Company, available January 20, 1986, and Svenska Cellulosa Aktiebolaget SCA, available December 15, 1988.

deemed to be a distribution of the underlying security by the issuer. For example, if the issuer of the exchangeable security were to enter into a forward agreement or other hedging arrangement in respect of its delivery obligations under the exchangeable security with the issuer of the underlying security or an affiliate of that issuer, the issuance of the exchangeable security would be viewed as a distribution of the underlying securities on behalf of the issuer or affiliate.

- *Disclosure Issues.* Even if Section 4(1) of the 1933 Act provides the issuer of the exchangeable security with an exemption from registration, the issuer of the exchangeable security must also consider whether it has provided adequate disclosure about the underlying security.⁶

Mandatory Convertible or Exchangeable Securities

Where securities are convertible or exchangeable on a mandatory basis, the underlying securities must be registered or exempt at the time the convertible or exchangeable securities are initially sold since the investment decision with respect to the underlying securities is being made at that time, regardless of when the securities actually convert into, or are exchanged for, the underlying securities. That is, by making an investment decision to purchase the mandatorily convertible or exchangeable security, the investor is viewed to be concurrently making an investment decision to own the underlying security. Consequently, in the case of mandatorily convertible or exchangeable securities, there is a current sale of the convertible or exchangeable security and the underlying security. There is no separate sale of the underlying security upon conversion or exchange unless at that time the holder is required to make an additional investment or an investment decision. As such, the mandatory conversion or exchange is not a registrable event and no prospectus need be delivered (or an exemption from such requirements required) in connection with the mandatory conversion or exchange.

Shelf Registration for an Offering of Convertible or Exchangeable Securities

If an issuer has a pre-existing effective shelf registration statement, each of the convertible or exchangeable securities and the underlying securities must have been included in the shelf registration statement at the time of effectiveness (or at such later date as described above if the securities are not immediately convertible). If either class was not included in the shelf registration statement, the issuer must file a new registration statement or, if the issuer is a “WKSI,” file a post-effective amendment to add the securities to the shelf registration statement or proceed with the offering in reliance upon an exemption from registration.

If the issuer is a WKSI, the requirement to file a shelf registration statement or a post-effective amendment to a WKSI shelf to add the convertible or exchangeable securities and underlying securities should not be burdensome. Such registration statements or post-effective amendments automatically become effective upon filing with the SEC. Accordingly, any execution risk caused by the potential for the SEC to review the filing is minimized.

⁶ For further information on disclosure issues, see the discussion in this chapter below under the heading “— Documentation and Liability Issues Relating to Exchangeable Securities.”

Exemptions from Registration for an Offering of Convertible or Exchangeable Securities

Rule 144A

Rule 144A under the 1933 Act is only available for securities that, when issued, are not of the same class as securities listed on a national securities exchange or quoted in a U.S. automated interdealer quotation system.

Optional Convertible or Exchangeable Securities

With respect to convertible or exchangeable securities, Rule 144A specifies that the convertible or exchangeable securities will be deemed to be of the same class as the securities into or for which the exchangeable or convertible securities are convertible or exchangeable unless the convertible or exchangeable securities are issued with an effective conversion premium of at least 10%.

Because of the depth of liquidity for securities issued in reliance upon Rule 144A, Rule 144A has become the dominant exemption used in connection with the issuance of unregistered optional convertible securities.

Mandatory Convertible or Exchangeable Securities

The SEC views the offer and sale of a mandatory convertible or exchangeable security as an immediate sale of the underlying security. Accordingly, the exemption provided by Rule 144A is not available for mandatory convertible or exchangeable securities unless the underlying securities are otherwise unrestricted securities within the meaning of the 1933 Act or otherwise when issued were not of the same class as securities listed on a national securities exchange or quoted in a U.S. automated interdealer quotation system.⁷

- *Mandatory Convertible Securities.* In the absence of registration, the underlying securities, like the convertible securities, are by definition restricted securities within the meaning of the 1933 Act. Accordingly, in the absence of registration under the 1933 Act, mandatory convertible securities must be issued in reliance upon the exemption provided by Section 4(2) of the 1933 Act or another available exemption.
- *Mandatory Exchangeable Securities.* Because the issuer of the exchangeable security is not the issuer of the underlying security, depending on the facts and circumstances and the structure of the particular transaction, the underlying securities may or may not be restricted securities within the meaning of the 1933 Act. Where the underlying securities are themselves eligible for resale in reliance upon Rule 144A (as in the case of founder's shares) or are otherwise unrestricted (as in the case of an issuer of an exchangeable security that has no hedging or other similar arrangements in place with the issuer of the underlying securities and that is not an affiliate of such issuer), the

⁷ See SEC No-Action Letters Shearman & Sterling, available December 21, 1998, and Cravath, Swaine & Moore, available October 25, 1999.

exchangeable security would be eligible for resale in reliance upon Rule 144A provided it otherwise meets the eligibility criteria of Rule 144A.⁸

Regulation S

Pursuant to Rule 405 under the 1933 Act and certain no-action letters issued by the SEC, convertible and exchangeable debt securities are treated as “equity securities” for purposes of Regulation S.

Convertible or Exchangeable Securities in Global Form

Where convertible securities issued in global form in reliance on Regulation S are eligible for resale pursuant to Rule 144A, the SEC will not require the implementation of the stop transfer provisions set forth in Rule 903(b)(3)(iii)(B)(4) of Regulation S provided that the transaction requirements comply with the requirements set forth in the SEC No-Action Letter Cravath, Swaine & Moore, available August 26, 1998.

Listing Issues

The issuer may be required to list the common stock issuable upon conversion of the convertible instruments pursuant to a listing application with the relevant exchange. In addition, if the convertible or exchangeable securities are not being sold pursuant to an effective registration statement, under DTC’s rules, DTC will only accept the convertible or exchangeable debt securities if they are eligible for resale pursuant to Rule 144A and included in an SEC-approved self-regulatory organization (“SRO”) transfer system like NASDAQ’s institutional market called “PORTAL.” PORTAL has become the SRO transfer system of choice for these listings. If a PORTAL listing is required, the lead underwriter for the offering will need to apply for the PORTAL listing on behalf of the issuer and deliver to DTC and the issuer confirmation from PORTAL that the convertible or exchangeable debt securities have been approved for trading on PORTAL.

REGISTRATION RIGHTS

Where convertible or exchangeable securities are issued in reliance upon an exemption from the registration requirements of the 1933 Act, an issuer may enter into a registration rights agreement with the underwriters of the securities for the benefit of the holders of the securities in which the issuer agrees to set up and maintain a resale shelf with the SEC that will allow the holders to sell the securities pursuant to an effective registration statement or, in some cases, to exchange the securities for 1933 Act-registered securities.

The registration rights agreement contains a series of milestones, discussed in further detail below, that, if not achieved, result in the issuer paying liquidated damages (typically in the form of an increase in the interest rate payable on the convertible or exchangeable security) until such requirements are satisfied.

⁸ Id.

Resale Registration

Resale registration rights agreements typically require the issuer to file and to cause to become effective a registration statement and related prospectus relating to the resale of the securities issued in the non-registered offering. Such agreements generally also require the issuer to maintain the effectiveness of the shelf registration statement and usability of the related resale prospectus during the period in which the unregistered securities are ineligible for resale without restriction in the absence of an exemption from registration.

The filing and effectiveness deadlines have varied from deal to deal but typically have been within three to six months, respectively, from the closing. However, amendments to Rule 144 under the 1933 Act adopted by the SEC in December 2007, which liberalized the resale provisions of Rule 144, have resulted in changes to these deadlines and have also called into question the necessity in any event of such agreements. Pursuant to these amendments, holders of securities issued in unregistered offerings that are not affiliates of the issuer may generally resell without restriction after six months from the issue date of the securities if the issuer is subject to the reporting requirements of the 1934 Act. If the issuer has not filed all required reports (other than reports on Form 8-K or 6-K) or if the issuer is not subject to the reporting requirements of the 1934 Act, then holders who are not affiliates may freely sell the securities after one year from the issue date.

Since the period of free tradability under the amended rule commences at the point when a prospectus was historically provided, certain of the historical registration rights provisions are viewed as redundant. Some transactions completed shortly after the adoption of the Rule 144 amendments required the filing of a registration statement only if the unregistered securities were not eligible for resale (for example, where the issuer has failed to file a required document (other than a report on Form 8-K or 6-K) pursuant to the 1934 Act) commencing six months from the issue date. Other transactions executed during this period dispensed with registration rights in their entirety, requiring only the payment of liquidated damages if the unregistered securities were not eligible for resale without limitation by holders who are not affiliates of the issuer following six months from the issue date.⁹

In October 2008, the Securities Industry Financial Markets Association (“SIFMA”) issued guidance concerning resale procedures, covenants and remedies with respect to convertible securities issued in reliance upon Rule 144A in light of the amendments to Rule 144. In general, the guidance provides that an issuer that is subject to the reporting requirements of the 1934 Act should be required to covenant that it will substitute an “unrestricted” CUSIP number for the restricted CUSIP number representing the applicable issue of convertible securities following the one year anniversary of the issuance of the convertible securities.¹⁰ This

⁹ Note that the need to create additional CUSIPs and ISINs for securities that are freely tradable and the corresponding opinion issue has resulted in the continued use of registration rights arrangements.

¹⁰ A change in CUSIP number with respect to the entire issue of convertible securities should not occur prior to the one year anniversary of issue since trading in reliance upon Rule 144 following the six month anniversary of issuance but prior to the one year anniversary of issuance is conditioned upon the issuer being current in its reporting obligations under the 1934 Act.

obligation is subject to certain conditions, such as the fulfillment by the issuer of its covenant to prohibit the resale by its affiliates of convertible instruments purchased in the open market. The guidance then provides two alternative approaches involving circumstances where the securities are not freely transferable in reliance upon Rule 144 when anticipated.

The first approach requires the issuer to enter into a registration rights agreement pursuant to which it is obligated to file a registration statement relating to resales of the convertible securities should the convertible securities not be eligible for resale without restriction in reliance upon Rule 144 following the one year anniversary of issue. This would occur, for example, if the issuer were to “reopen” the issue to issue additional convertible securities that are fungible with the original issue and that are represented by the same CUSIP number. In such event, the holding period for the entire convertible securities issue would be required to begin again as of the date of the reopening. Such registration rights agreements would provide for customary liquidated damages should the issuer default in its obligations to make available a registration statement relating to resales of the convertible instruments.

An alternate approach included in the SIFMA guidance would permit the issuer to forego entry into a registration rights agreement in connection with the transaction. Under this approach, the issuer would be required to pay liquidated damages if the securities are not freely tradable in reliance upon Rule 144 when anticipated.

Exxon Capital Exchange Offers¹¹

Under the Exxon Capital line of no-action letters, an issuer is permitted to exchange registered securities for securities that are substantially similar to the securities investors purchased in a non-registered transaction.¹² Because the securities are registered in the exchange offer rather than upon resale by the investor, selling securityholders need not be named in a resale prospectus and therefore avoid potential underwriter liability. In addition, since the exchange offer is consummated in a single transaction, the issuer can avoid the inconvenience associated with maintaining a resale shelf registration statement (*i.e.*, the issuer is not required to keep a continually updated resale prospectus available for extended periods of time).

Limitations on Exxon Capital for U.S. Issuers

While the Exxon Capital line of no-action letters is available for U.S. issuers in relation to debt securities, trust preferred securities or preferred stock, the line of no-action letters is not available for U.S. issuers of common stock or securities convertible into or exchangeable for common stock.

¹¹ See also the discussion in this chapter above under the heading “Registration Rights—Resale Registration.”

¹² For further discussion of non-registered transactions and securities, see Chapter 8 (*1933 Act-Exempt Offerings and Securities*) of the other volumes of *Accessing the U.S. Capital Markets*.

Exxon Capital Limitation Not Applicable to Foreign Private Issuers

While U.S. issuers are restricted from availing themselves of the Exxon Capital line of no-action letters with respect to securities that are convertible into common equity, foreign private issuers are not subject to such restrictions and may avail themselves of the registration procedures provided by the Exxon Capital line of no-action letters.¹³

TENDER OFFER RULES

Many convertible securities provide investors with certain put rights on fixed dates or which result from certain events, such as, for example, a change of control. In general, the exercise of a put right afforded by the terms of the securities themselves should be exempt from the tender offer rules. Nevertheless, most convertible securities that afford holders put rights provide for a minimum of 20 business days during which the put right may be exercised and further provide that, if necessary, the issuer will comply with applicable tender offer rules in connection with the put rights provided by the securities.

CONCURRENT TRANSACTIONS

In connection with the issuance of convertible securities, it is not uncommon for an issuer to use a portion of the proceeds of the offering to engage in certain transactions relating to its common stock. One such category of transactions involves the repurchase of shares of common stock by the issuer with a portion of the proceeds of the offering. Often times, the issuer will purchase the shares from purchasers of the convertible securities who are interested in hedging their position in the convertible securities that they are purchasing in the offering. Transactions of this nature are generally restricted to offerings of convertible securities being made in reliance upon Rule 144A under the 1933 Act in light of the exemption provided by Regulation M in relation to offerings conducted in reliance upon Rule 144A.

Another common transaction involves the concurrent purchase and sale by the issuer of options and warrants on its common stock where the net cost of these transactions is funded with a portion of the proceeds of the convertible securities issuance. In such transactions, the issuer will purchase from one or more dealers (who are frequently affiliates of the underwriters of the convertible securities) options exercisable by the issuer for shares of its common stock upon substantially the same economic terms as provided by the convertible securities. The issuer thereby hedges its common stock delivery obligation in respect of the convertible securities. Concurrently, the issuer will sell to the same dealers warrants for the purchase of common stock that are exercisable by the dealers at a strike price that is above the conversion price of the notes and the exercise price of the options purchased by the issuer from the dealers in order to offset in part the cost of the purchased options. The purpose of these transactions is to mitigate the potential dilutive impact of the convertible securities issuance by synthetically increasing the conversion price of the convertible securities being issued to the strike price of the warrants purchased by the dealers from the issuer. Issuers find these transactions appealing because the combined economic terms of such convertible securities issuances and related derivative

¹³ See SEC No-Action Letter [Grupo Financiero InverMexico, S.A.](#), available April 4, 1995.

transactions tend to be more attractive than the terms upon which an issuer would be able to issue convertible securities having a conversion price that is equal to the higher strike price of the warrants sold to the dealers.

The foregoing transactions involve a significant number of complicated legal issues that are not discussed here in detail. These issues require full resolution prior to the commencement of an offering that contemplates such a concurrent transaction.

DOCUMENTATION AND LIABILITY ISSUES RELATING TO EXCHANGEABLE SECURITIES

Because exchangeable securities involve an issuance by an issuer of securities that are exchangeable for the securities of another issuer, disclosure and liability issues arise that differ from traditional convertible securities involving a single issuer of both the exchangeable securities and the underlying securities. Unless the issuer of the underlying securities or an entity that controls it is a party to the transaction involving the issuance of the exchangeable securities, the issuer of the exchangeable securities may not have access to the issuer of the underlying securities or be able to obtain its participation or cooperation. As a result, questions arise as to the appropriate level of disclosure regarding the underlying securities and the issuer thereof as well as the steps that should be taken to minimize liability relating to such information.

Documentation Where the Underlying Security Need Not Be Registered

SEC Registered Securities

Where an exchangeable security is SEC registered by the issuer but the underlying securities are not required to be registered because the exemption provided by Section 4(1) of the 1933 Act is available, questions arise as to the appropriate level of disclosure in the prospectus relating to the issuer of the underlying security, the potential liability of the issuer of the exchangeable security and the underwriters for such information, and underwriting agreement protection underwriters should seek from the issuer of the exchangeable security.

Disclosure Issues

Because the exchangeable security is exchangeable for the underlying security, the purchaser of the exchangeable security is making an investment decision with respect to both securities. As a result, the investor will require significant information, or access to such information, concerning the issuer of the underlying security.

The Staff has given some relief in this respect. See No-Action Letter Morgan Stanley (available June 24, 1996) which generally provides:

- the issuer of the underlying security must be an unaffiliated 1934 Act reporting company that:
 - is S-3 (or F-3) eligible for a primary offering of non-investment grade securities;
 - or

- meets the exchange listing criteria for equity-linked derivative securities to be listed on a national stock exchange; and
- the prospectus must provide a brief description of the business (usually one or two paragraphs) and include the price range of the common stock and dividend policy and reference the availability to investors of the public SEC filings of the issuer of the underlying security.

Liability Issues

Underwriters may have Section 12(a)(2) liability for statements made to purchasers of the securities, whether such statements relate to the issuer of the exchangeable security or to the issuer of the underlying security. Any use of research, SEC filings or other material relating to the issuer of the underlying security will increase an underwriter's risk exposure.

Underwriting Agreement Provisions

To the extent that there is no control relationship between the issuer of the exchangeable security and the issuer of the underlying security, there generally is no ability to require the issuer of the underlying security to participate in the drafting of the disclosure concerning the exchangeable security or to require the issuer of the underlying security to enter into any agreements relating to the offering that would provide representations, indemnification or comfort on the information concerning the underlying security and the issuer thereof. Accordingly, underwriting agreements relating to exchangeable securities will frequently only be entered into with the issuer of the exchangeable securities and no opinions, comfort or indemnity will come from or relate to the issuer of the underlying securities.

Documentation Where the Underlying Security Must Be Registered

Under certain circumstances, both the exchangeable security and the underlying security will be required to be SEC registered. This circumstance will arise where there is an affiliation between the issuer of the exchangeable security and the issuer of the underlying security or where the issuer of the exchangeable security enters into a hedging arrangement or other share delivery agreement with the issuer of the underlying security or an affiliate thereof. Under these circumstances, two separate registration statements are filed and become effective and the prospectus relating to the underlying securities is generally attached to the prospectus for the exchangeable securities.

Liability Issues

To the extent that an underwriter delivers prospectuses relating to the exchangeable securities and underlying securities, the underwriter is subject to potential underwriter's liability on both documents. Therefore, it is typical to have a standard underwriting agreement with the issuer of the exchangeable security, and an underwriting or registration agreement with the issuer of the underlying security, both of which contain standard representations and covenants. Both issuers typically indemnify the underwriter. The agreements typically include disclosure based indemnity of the issuer of the exchangeable security by the issuer of the underlying security. While each issuer has Section 11 liability only on its own prospectus, the issuer of the

exchangeable security will have potential liability under Section 12(a)(2) of the 1933 Act for the combined prospectuses.

MONETIZATION TRANSACTIONS

Exchangeable securities are frequently used as a method to monetize a large security holding. In the typical monetization transaction, a client of an investment bank (either a corporation or natural person) holds a large securities position in an unaffiliated issuer. In the transaction, the investment bank “lends” its balance sheet and credit rating to the client by issuing debt securities that are mandatorily exchangeable for the class of security held by the client.

When exchangeable securities are issued pursuant to a monetization transaction involving common stock, the exchangeable security is offered and sold by the investment bank as an obligation of the investment bank. The issue price of each exchangeable security is fixed at pricing to equal the market price or other offering price at the time of pricing of one underlying share of common stock. The exchangeable securities will bear interest at a fixed rate that would correspond to a premium over the dividend rate on the underlying common stock. At maturity (generally up to three years from the date of issue), the holder of the exchangeable security is entitled to receive, at the option of the investment bank (but acting at the direction of the client), underlying shares of common stock or the cash equivalent of the market value of the underlying shares at maturity.

In order to hedge its obligation to deliver the underlying shares of common stock on the date of mandatory conversion (or the cash value thereof), the investment bank enters into a forward contract (typically prepaid) with the client holding the underlying shares of common stock. This forward contract typically mirrors the investment bank’s rights and obligations under the exchangeable securities. Frequently, the maximum number of shares deliverable on the exchangeable securities would be pledged by the investment bank’s client as collateral to eliminate any credit risk to the investment bank resulting from the failure of the client to deliver the underlying shares of common stock.

Monetization transactions are attractive to issuers and selling securityholders for a variety of reasons. Historically, the structure would enable clients with securities holdings to effectively sell the position without incurring a tax event until settlement of the related forward contract. Monetization transactions also enable clients to effectively sell securities positions in a manner that may be more orderly than the outright sale of the position itself where the issuance of an exchangeable security by the client would yield unfavorable economic terms or be unduly burdensome or otherwise not possible. Circumstances such as these would arise where the client is a natural person. In addition, even where the client is a corporation, the investment bank may have a better credit rating than the client which would result in more favorable economic terms for the exchangeable security. Further, where the client is not subject to the reporting requirements of the 1934 Act, the issuance by it of a mandatory exchangeable security would require the preparation of a prospectus and would result in the entity being subject to the reporting requirements of the 1934 Act. Finally, while the entity wishing to monetize its securities holdings receives the cash proceeds from the prepaid forward contract at the inception

of the monetization transaction, the forward transactions with the investment bank frequently enable the client to retain voting and dividend rights on underlying shares.

Trust As Monetization Vehicle

Trust monetizing securities are a variation of the monetizing structure described above and are issued by a trust registered as an investment company under the Investment Company Act. Under this variation, the trust, instead of an investment bank, issues securities that are mandatorily exchangeable for the underlying securities. Because the trust issues the exchangeable security, the balance sheet of the investment bank is not impacted by the structure. In addition, investors do not expose themselves to the credit profile of the investment bank.

Trust monetizing securities are effectively synthetic mandatory exchangeable bonds. The structure typically provides for the purchase by the trust of zero coupon Separate Trading of Registered Interest and Principal of Securities (“STRIPS”) issued by the U.S. Department of the Treasury (the “U.S. Treasury”) to provide periodic interest payments on the trust monetizing securities. The trust also enters into a prepaid forward purchase contract with the client holding the underlying shares of common stock to provide the equity securities due to purchasers of the trust monetizing securities at maturity. The maximum number of shares deliverable at maturity are pledged by the client as collateral for its delivery obligations under the forward purchase contract in order to remove any credit risk to the trust from the client's failure to deliver shares under the forward contract. The trust holds the STRIPS and the forward purchase contract as a tax free vehicle and distributes cash and shares of common stock in accordance with the terms of the instrument.

Monetizing trusts are subject to significant regulatory issues. Typically the trust is an “investment company” within the meaning of the 1940 Act. As a result the trust is required to comply with the provisions of the 1940 Act applicable to investment companies, subject to certain exemptions typically granted by the Staff.

BASIC DOCUMENTS

Set forth below is a list of basic transaction documents for an offering of convertible or exchangeable securities in the U.S. capital markets. Please refer to Appendix B (*Basic Documents for Securities Offerings in the U.S. Capital Markets*) of this volume, as well as the other volumes of *Accessing the U.S. Capital Markets*, for a further description of these documents.

1. Due diligence lists and questionnaires.
2. 1933 Act registration statement (if applicable).
3. Press release.¹⁴

¹⁴ It is universal practice to announce an offering of convertible securities via a press release immediately prior to the commencement of marketing efforts. The fact that an issuer is offering convertible securities is considered (continued)

4. Offering documents, including the following:
 - a preliminary, or “red herring,” offering document;
 - a free writing prospectus/term sheet;
 - a final offering document; and
 - any non-U.S. supplements or “wrappers.”
5. Resale registration statement (if applicable).
6. FINRA filings.
7. State securities law, or “blue sky,” filings.
8. Registration rights agreement (if applicable).
9. Underwriting or purchase agreement.
10. Road show materials.
11. Corporate documents including the following:
 - amended and restated charter and bylaws, constitution and similar organization documents; and
 - board and committee resolutions.
12. Indenture, charter document or other issuance, registrar, paying agent, conversion or exchange agent and transfer agent documentation.¹⁵

to be material information with respect to the issuer. If the offering is exempt from registration, the press release must be made in reliance upon Rule 135c under the 1933 Act. Where a press release is not issued in advance of marketing efforts (as in the case of negotiated issuances between an issuer and a limited number of investors), the issuer will require potential investors who have been approached with the offering to execute documentation prohibiting them from trading shares of the issuer’s common stock until the public announcement by the issuer.

¹⁵ For convertible debt securities, the indenture is generally a closed-end indenture that relates to the convertible securities that are being offered. However, it is not uncommon for convertible securities to be offered pursuant to a supplemental indenture to an open-ended indenture. Exchangeable securities are frequently issued pursuant to open-ended indentures.

If the convertible instrument is preferred stock, a certificate of designations or other similar document that becomes part of the issuer’s charter will set forth the terms of the preferred stock. As is the case with an indenture, underwriters’ or purchasers’ counsel will normally draft the certificate of designations. The certificate of designations or other similar charter document will be governed by the laws of the jurisdiction in which the issuer is incorporated.

13. Forms of exchangeable securities and underlying securities.
14. Deposit agreements and form of ADR.¹⁶
15. DTC letter of representations.
16. Listing documents (if applicable).
17. 1934 Act registration statement (if applicable).
18. Legal opinions and 10b-5 statements.
19. Auditor's comfort letter(s) and related documentation.
20. Other closing documents.

¹⁶ A deposit agreement and ADRs will be required if the offered securities are convertible into or exchangeable for shares issued by a foreign private issuer that are to may be represented by ADRs. For a further discussion, see Chapter 2 (*Depository Receipts (ADRs and GDRs)*) of this volume.

CHAPTER 4

HYBRID CAPITAL SECURITIES

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GENERAL

Tier 1 and other hybrid capital products include tax-deductible non-operating subsidiary preferred securities (“trust preferred securities”) and a wide variety of other securities designed to conform to the regulatory capital adequacy guidelines established for U.S. and non-U.S. banks and insurance companies. These products also include similar instruments issued by insurance and other financial services companies as well as non-financial companies seeking enhanced equity credit from the rating agencies for their securities.¹

The Basel Accord divided bank capital for the first time into Tier 1 or core capital and Tier 2 or supplementary capital. In October 1998, the Basel Committee on Banking Supervision announced (via what is commonly known as the “Sydney Press Release”) that it would consider it acceptable for banks to issue “innovative capital instruments” such as trust preferred securities for up to 15% of a bank’s Tier 1 capital. The Sydney Press Release has since been replaced by a new framework referred to as “Basel II.” However, Basel II does not change the definition of “capital” and what it is supposed to constitute. Though the Sydney Press Release is still relevant, at least at the level of the Basel Committee, the European Union (the “EU”) has taken some further steps, as discussed below. In 1996, the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”) approved the use by U.S. bank holding companies of trust preferred securities as a means of adding to Tier 1 capital, subject to certain conditions. In May 2005, the Federal Reserve Board issued a final rule revising its treatment of trust preferred securities, including certain of the requirements for trust preferred securities to qualify as Tier 1 capital. Under the final rule, trust preferred securities and other “restricted core capital elements” may not exceed 25% (15% in the case of “internationally active” banking organizations) of a bank holding company’s core capital elements, net of goodwill less any associated deferred tax liability.

In the EU, the principles established by the Basel Accord and, subsequently, Basel II, are contained in the Banking Consolidation Directive (for banks) and the Capital Adequacy Directive (for investment firms, as well as banks). These two directives were “recast” in 2006 as

¹ For a more extensive discussion of hybrid capital securities, see Sidley’s *Hybrid Capital Product Development* publication, available at <http://www.sidley.com/hybridcapitalproductdevelopment>.

a result of Basel II and are commonly referred to as the “Capital Requirements Directive.” In May 2009, the European Parliament approved a series of amendments to the Capital Requirements Directive, including, for the first time, the explicit recognition throughout the EU of hybrid capital instruments as Tier 1 capital. These amendments to the Capital Requirements Directive are to become effective on December 31, 2010. The European Commission has been working since 2005 to achieve convergence among the EU member states on what could constitute hybrid capital. Among other things, the amendments to the Capital Requirements Directive provide that dated instruments (with 30 year minimum maturity) can qualify as Tier 1 capital (with a limit of 15% of Tier 1 capital). In addition, non-cumulative perpetual preference shares can qualify for core Tier 1 capital so long as they are fully loss-absorbing on a going concern basis, and rank *pari passu* with ordinary shares.

There are many varieties of hybrid capital products, all of which seek to lower an issuer’s cost of capital by balancing the product’s loss-bearing attributes against the issuer’s tax saving and other objectives. Specifically, the products are treated for regulatory and rating purposes as the equivalent or near-equivalent of equity securities while the issuer hopes to achieve a tax deduction or other tax benefit for payments on the securities (a result that is not possible in the case of dividend payments on equity securities).

For U.S. issuers, trust preferred securities have become the most common hybrid capital product. A common form of the trust preferred security structure involves the issuance by a company of a junior subordinated debt security to a grantor trust. The trust, the only asset of which is the company’s debt security, issues its preferred securities to investors. The bank holding company guarantees the trust preferred securities to the extent of the amounts that it pays on the debt obligation issued to the trust. The debt typically has a maturity of 20 to 45 years, and interest on the debt security is deferrable for up to five years. The distributions on the preferred securities are cumulative and non-discretionary, but are payable only to the extent of income received by the trust on the company’s debt security.

In February 2005, Moody’s Investors Service (“Moody’s”) decided for rating purposes to give “equity credit” of up to 75% for certain hybrid capital products, whether or not issued by bank holding companies and insurance companies. In January 2006, Moody’s explained that its decision was motivated not only by consideration of the extent to which a hybrid “mirrors the features of common equity,” but also by the assignment of greater recognition to “the support that a hybrid may provide for more senior creditors as well as the positive impact of a hybrid on an issuer’s probability of default.” The other major rating agencies also issued revised guidance, albeit not in the same form as Moody’s.

Moody’s action was quickly followed by efforts to develop “enhanced” hybrid capital products that would qualify for maximum equity credit. Some structures used by issuers have involved a longer maturity for the debt portion of the transaction (up to 60 years), a longer interest deferral period (up to 12 years, with a commitment to fund unpaid interest after five to seven years with the proceeds of a qualifying equity issuance), a mandatory deferral of interest in the event of non-compliance with certain financial covenants and a “replacement covenant” that requires any redemption to be preceded by a qualifying equity issuance. Structures used by bank holding companies must comply with the Federal Reserve Board’s policy that limits mandatory interest deferrals and interest rate “step-ups” coupled with call options. In the case of

“internationally active” bank holding companies, Federal Reserve Board guidelines generally limit to 15% the amount of trust preferred securities and other restricted core capital elements that can be treated as Tier 1 capital; however, in early 2006 the Federal Reserve Board issued a letter to Wachovia Corporation that concluded that that company’s “Wachovia income trust securities” (“WITS”) were subject to the 25% Tier 1 capital limitation applicable to certain mandatory convertible securities. The WITS provided for a remarketing of the underlying junior subordinated debentures after five years to fund the purchase of non-cumulative perpetual preferred stock. Some market participants viewed the WITS as containing an implicit interest rate step-up because of the fact that the dividend on the preferred stock would not be deductible for federal income tax purposes. The Federal Reserve Board continues to consider whether to issue further guidance on WITS-type structures.

A potential obstacle to the use of “enhanced” hybrid capital products arose in March 2006 when the National Association of Insurance Commissioners (“NAIC”), through its Securities Valuation Office, examined a Lehman Brothers product at the request of the New York State Insurance Department. The Securities Valuation Office, which provides guidance regarding the reporting of securities held by regulated insurance companies, concluded that the product should be classified as common equity rather than preferred equity, which would require insurance company investors to reserve more equity against such securities than would be required in the case of other types of hybrid capital products. At least one rating agency publicly disagreed with the Securities Valuation Office’s conclusion, which the Securities Valuation Office was quickly asked to re-examine. The NAIC formed a Hybrid Risk Board Capital Working Group to address the issue. The Hybrid RBC Working Group in turn requested the American Academy of Actuaries (“AAA”) to review the issue, and adopted the AAA report, which stated that the product should be treated as it had been prior to the Securities Valuation Office’s conclusion.

1933 ACT CONSIDERATIONS

Registered Securities

In a 1933 Act-registered transaction, the parent company files a registration statement that covers the trust preferred securities together with the related parent company debt securities and guarantees. The trust or trusts (if multiple offerings are being registered) that will issue the trust preferred securities (collectively, the “Trust”) and the parent company will sign the registration statement as co-registrants. Form S-3 or F-3 is typically used and is available if the parent company is eligible to use that form, as the Trust is considered a majority-owned subsidiary of the parent company and the parent company’s obligations under its junior subordinated debt obligation and its guarantee of the trust preferred securities, taken together, are considered a full and unconditional guarantee of the trust preferred securities. Separate financial statements for the Trust are not necessary in reliance on Rule 3-10(b) of Regulation S-X.

Private Offerings

Trust preferred securities are frequently offered to QIBs pursuant to Rule 144A as well as to offshore investors in reliance on the safe harbor afforded by Regulation S. The question arises under Regulation S as to the “category” in which the offering belongs for purposes of

determining the duration of the required “offering restrictions.” If the trust preferred securities were regarded as equity securities of a non-reporting U.S. company (namely, the Trust) they would be Category 3 securities subject to a one-year restricted period and other conditions. This is an undesirable result, particularly as the underlying debt securities would themselves be Category 2 securities subject to only a 40-day restricted period. Rule 903(b)(3) would permit non-participating preferred stock to be treated for this purpose as debt securities subject to Category 3, but this would still require compliance with some onerous conditions. A more promising solution, and one typically taken, is afforded by Rule 903(b)(4), which permits reliance on a parent company’s guarantee of an issuer’s “debt securities” to determine the appropriate category.

Analysis — Private vs. Registered Trust Preferred Securities

Apart from the transfer restrictions associated with a private trust preferred securities issuance and the exclusion of retail investors in the United States, the characteristics of registered and private trust preferred securities are largely the same to an investor. Since the market for trust preferred securities is largely composed of institutional investors that are eligible to acquire privately placed trust preferred securities, a registered offering of trust preferred securities will not necessarily result in a cost of funds that is significantly lower than the cost of funds of privately placed trust preferred securities.

One obvious advantage of a private trust preferred securities issuance is that the sponsoring company and the Trust avoid having to go through the SEC registration process. In that regard, it should be noted:

- (1) For many foreign private issuers, registering a trust preferred securities issuance would not require operating segment disclosure in accordance with U.S. Statement of Financial Accounting Standards No. 131 (“SFAS 131”).
- (2) The disclosure in a private placement memorandum for a private trust preferred securities issuance does not have to include all the disclosure that would be required in a 1933 Act registered offering.
- (3) A private trust preferred securities issuance does not require that the declaration of trust, the indenture or the guarantee be qualified under the Trust Indenture Act of 1939 (the “1939 Act”). Given the standardization of these documents for trust preferred securities, however, this may not represent significant savings.

Private trust preferred securities do have some drawbacks, including the following:

- (1) Private trust preferred securities are subject to resale and other transfer restrictions. These restrictions may present liquidity considerations that could affect the amount of interest paid by the parent company (and distributions paid by the Trust).
- (2) If Rule 144A eligibility is desired, the parent company will have to provide secondary market purchasers of the trust preferred securities with the information required under Rule 144A(d)(4) unless it is a reporting company under the 1934

Act or, if a foreign private issuer, satisfies the information requirements of Rule 12g3-2(b).

1934 ACT CONSIDERATIONS

The Trust does not have ongoing reporting and disclosure obligations under the 1934 Act in reliance on Rule 3-10(b) of Regulation S-X and Rule 12h-5 under the 1934 Act and the deemed equivalence of the parent company's obligations to a full and unconditional guarantee of the trust preferred securities.

Moreover, the Trust will not be viewed as subject to the 48-hour prospectus delivery obligation imposed by Rule 15c2-8(b) on underwriters of SEC-registered securities of non-reporting companies. Again, the basis for this conclusion is the fact that investors are relying on the parent company's obligations and that the parent company is itself a reporting company.

1939 ACT CONSIDERATIONS

In an SEC-registered transaction, all of the following will be qualified as indentures under the 1939 Act: (a) the Trust's declaration of trust, pursuant to which the trust preferred securities are issued, (b) the indenture pursuant to which the sponsoring company's debt securities are issued and (c) the sponsoring company's guarantee.

1940 ACT CONSIDERATIONS

The Trust will be exempt from the requirements of the 1940 Act in reliance on Rule 3a-5, a rule normally applied for the purpose of exempting finance subsidiaries. Under Rule 3a-5, as interpreted by the Staff, the Trust is considered a "corporation" and the trust preferred securities are considered non-voting preferred stock issued by a "finance subsidiary."

EFFECTS OF DECONSOLIDATION

According to public remarks by members of the SEC staff, the conclusions described above regarding omission of the Trust's financial statements from the registration statement, its continuing 1934 Act reporting obligations and its ability to rely on Rule 3a-5 under the 1940 Act continue despite the Trust's deconsolidation as a result of Financial Accounting Standards Board Interpretation No. 46 ("FIN 46R").

BASIC DOCUMENTS

Set forth below is a list of basic transaction documents for an offering of hybrid capital securities in the U.S. capital markets. Please refer to Appendix B (*Basic Documents for Securities Offerings in the U.S. Capital Markets*) of this volume, as well as the other volumes of *Accessing the U.S. Capital Markets* and Sidley's *Hybrid Capital Product Development* publication, for a further description of these documents.

1. Due diligence lists and questionnaires.
2. 1933 Act registration statement (if applicable).

3. Offering documents, including the following:
 - a preliminary, or “red herring,” prospectus;
 - a free writing prospectus/term sheet;
 - a final prospectus; and
 - any non-U.S. supplements or “wrappers.”
4. FINRA filings.
5. State securities law, or “blue sky,” filings.
6. Trust formation documents.²
7. Underwriting or purchase agreement.
8. Road show materials.
9. Indenture or issuing and paying agency agreement for the debt securities.
10. Trust preferred securities, debt securities and guarantee agreement.
11. DTC letter of representations.
12. Listing documents (if applicable).
13. 1934 Act registration statement (if applicable).
14. Legal opinions and 10b-5 statements.
15. Auditor’s comfort letter(s) and related documents.
16. Interest calculation agreement (if applicable).
17. Other closing documents.

² The trust formation documents, including the declaration of trust or trust agreement, will, among other things, constitute the governing instruments of the trust, designate the trustees of the trust (as well as the trustees’ policies and duties) and provide for the issuance of the trust preferred securities.

CHAPTER 5

HIGH YIELD DEBT SECURITIES

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GENERAL

High yield debt securities are debt securities that are rated less than investment grade by the rating agencies.¹ Typical high yield debt securities are senior debt instruments with an extensive covenant package that bear interest at a fixed rate, mature in ten years or less, have an equity funded partial call provision and premium call features that are designed for the issuer's particular circumstances, and have investor put features for change of control and certain asset sales. High yield debt securities may be guaranteed by the issuer's subsidiaries, occasionally are guaranteed by the issuer's parent, if there is one,² and may be secured by the assets of the issuer and any guarantors. Issuers occasionally issue subordinated high yield debt securities. High yield debt securities can but so far have not been "complex financial products," *i.e.*, there are very few, if any, hybrid, equity-linked or even floating rate high yield debt securities.³

Types of high yield issuers include:

- new issuers that have traditionally relied on bank financing;
- private companies that are issuing debt securities in anticipation of or simultaneously with an IPO;
- issuers located or whose businesses are concentrated in countries where the sovereign is not investment grade rated; and

¹ Some issuers with split-rated debt securities (*i.e.*, securities that are rated investment grade by some rating agencies and not investment grade by other rating agencies) are also required to model their covenant packages on those typically used for high yield debt securities, particularly issuers in cyclical businesses and volatile markets and issuers whose debt securities traditionally have not been rated investment grade.

² Where a parent guarantees its issuer subsidiary's high yield debt securities, Regulation S-X 3-10 would require full financial disclosure by the parent and the subsidiary.

³ The covenant package for subordinated debt securities and other non-senior debt instruments, such as hybrid capital securities, may not be as extensive as the covenant package for the senior high yield debt securities of the same issuer, though they may have some features that are often found in high yield debt securities, such as a change of control put.

- “fallen angels” - issuers that have been in the investment grade debt markets but whose debt securities rating has fallen below investment grade.

While high yield debt securities can be and are sold in 1933 Act-registered offerings, the clear majority of high yield debt securities offerings in the U.S. capital markets have been made pursuant to Rule 144A and Regulation S under the 1933 Act. High yield debt securities are also privately placed directly to investors pursuant to Section 4(2) of the 1933 Act (which may include resale rights pursuant to Rule 144A and Regulation S), such as sales to mezzanine investors pending an issuer’s IPO. An issuer in the Rule 144A and Regulation S markets may give holders registration rights that will provide them with freely tradable, 1933 Act-registered securities in exchange for their unregistered securities if the issuer can achieve a lower cost of funds or registration rights are required by investors.

The primary advantage of not registering an offering under the 1933 Act is that, for an issuer that does not qualify as a WKSI and is not eligible to use Form F-3 or S-3 for automatic shelf offerings, it enables the issuer to offer and sell its high yield debt securities without having to go through the SEC’s registration statement review process. Issuers that qualify as WKSI and qualify to use Form F-3 or S-3 for automatic shelf offerings are able to automatically register their high yield debt securities with the SEC and thereby avoid the SEC’s review process. See “1933 Act Considerations” below.

COVENANT PACKAGE

The primary feature that distinguishes high yield debt securities from medium- and long-term investment grade debt securities is the extensive covenant package. Covenant packages for most medium- and long-term debt securities include affirmative covenants and negative covenants. Affirmative covenants impose obligations on the obligor to take specified actions, while negative covenants prohibit the obligor from taking specified actions unless specified conditions are met.

High yield covenant packages typically cover not only the issuer but also all subsidiaries of the issuer other than those that are specifically excluded or are excludable in the future (“restricted subsidiaries”) and, with certain important exceptions, treat the issuer and its restricted subsidiaries together as a single entity. Unrestricted subsidiaries are subsidiaries that are excluded or excludable from the covenant package, though it is unusual for a covenant package to permit any material subsidiary to be classified as an unrestricted subsidiary unless the omission would not have a material adverse impact on the issuer’s ability to pay the debt service on its high yield debt securities.⁴ If securities are guaranteed by subsidiaries of an issuer, typically all the subsidiary guarantors would be restricted subsidiaries. If the issuer is controlled by another company and the parent guarantees the high yield debt securities, the covenant package that applies to the parent may be different from the covenant package that applies to the issuer and its restricted subsidiaries.

⁴ See also the discussion in this chapter below under the heading “—Subsidiaries.”

The financial covenants included in the covenant package are typically based on the issuer's GAAP. For example, if an issuer prepares its financial statements and operates its business in accordance with U.S. GAAP, the financial covenants will be based on U.S. GAAP. In unusual circumstances, such as an issuer based in an emerging market with GAAP that is poorly defined, an issuer may have to agree to report and operate its business under and cause its financial covenants to be determined by reference to another GAAP, such as U.S. GAAP or IFRS.

The covenant package must address the interests of both the issuer and the investors. Neither the issuer nor any underwriter or investor wants the issuer and its restricted subsidiaries and guarantors to be bound by a covenant package that is adverse to their current businesses, financial condition and business plans and therefore to the interests of investors. Furthermore, any material modification of a covenant package requires the consent of the securityholders, which can be a difficult, expensive and time consuming process. As a result, the process of drafting the covenant package should be a cooperative effort by the issuer, the underwriters and their respective counsel.

Set forth below is a general discussion of typical high yield covenants and how they vary from typical investment grade covenants. Although there are a number of model terms in the market for high yield debt securities, each covenant package will be different as each must be tailored for, among other things, the businesses and markets in which the issuer and its restricted subsidiaries operate, the country or countries in which the issuer and its restricted subsidiaries are established and the needs of the markets into which the high yield debt securities are offered and sold.

Affirmative Covenant Package

The affirmative covenant package for high yield debt securities issued by a corporate issuer typically includes covenants by the issuer and any guarantor to:

- make payments as and when due on the securities;
- maintain an office or agency in a particular jurisdiction (typically New York, NY for a U.S. capital markets transaction) to make payments on and exchange and transfer securities;
- if they act as their own paying agent, hold payments in trust until such time as they are received by investors;
- in the case of securities that are issued outside the issuer's jurisdiction (*e.g.*, securities offered by a foreign private issuer in the U.S. capital markets or by a U.S. issuer in the European capital markets), pay additional amounts to compensate for withholding taxes on payments under the securities imposed by the issuer's jurisdiction or, in

some cases, other jurisdictions from which a payment in respect of the securities is made;⁵

- maintain the corporate existence and franchises of the issuer and, in some cases (*e.g.*, if the issuer is a holding company), the issuer's subsidiaries; and
- provide the trustee and/or securityholders with annual statements of covenant compliance and notices of defaults.

The foregoing high yield debt securities covenants are similar to the affirmative covenants that also apply to many medium- and long-term investment grade debt securities. In addition to the foregoing, the affirmative covenant package for high yield debt securities issued by a corporate issuer typically include the following covenants, both of which appear less frequently in investment grade debt securities covenant packages:

- file with the SEC or provide to the trustee and/or securityholders (A) all such reports and other information as it would be required to file if it were subject to Section 13(a) or 15(d) of the 1934 Act and (B) if and so long as the issuer has unrestricted subsidiaries, separate presentations that cover the unrestricted subsidiaries on the one hand and the issuer and the restricted subsidiaries on the other hand; and
- pay and cause its subsidiaries to pay all taxes when due other than those being contested in good faith or where the failure to pay is not adverse to securityholders.

Negative Covenant Package

Negative covenant packages for high yield debt securities are often compared to the negative covenant packages found in credit agreements. However, negative covenants in credit agreements require borrowers to achieve and maintain various financial and other targets and regulate the actions of borrowers by imposing hurdles and other restrictions, which can be waived or renegotiated with the lender group, while high yield debt securities covenants are limited to regulating the actions of issuers through restrictive covenants and are much more difficult to amend or waive.

Negative covenants in investment grade debt security covenant packages, which are negotiated with the underwriters, generally include:

- a Limitation on Liens covenant that restricts the ability of the issuer and any guarantor to grant liens, other than specified permitted liens, unless the issuer or the

⁵ Normally this is accompanied by a provision that gives the issuer the right to redeem the securities in full if additional amounts are payable by the issuer on any securities as a result of a change in law. While it is debatable whether this call right should apply if there is a change in law that only imposes an obligation on a guarantor to pay additional amounts (investors typically expect payment from the issuer and may not expect to lose their securities if the change in law only applies to the guarantor), there are securities in the market where this is the case.

guarantor, as the case may be, grants an equal and ratable lien to the holders of the debt securities;

- a Limitation on Sale and Leaseback Transactions covenant that restricts the ability of the issuer and any guarantor to enter into sale and leaseback transactions with respect to its assets, other than specified permitted transactions; and
- a Merger and Consolidation covenant pursuant to which the issuer and any guarantor must satisfy certain conditions designed to protect holders of the debt securities in order to merge or convert into, consolidate with or transfer or lease substantially all of its property to, a third party.

In addition to the foregoing, the negative covenant package for high yield debt securities typically includes covenants that regulate:

- the incurrence of indebtedness by the issuer and its restricted subsidiaries, known as the “Limitation on Indebtedness” covenant;
- the payment of dividends and certain other payments to third parties (typically called “restricted payments”) by the issuer and its restricted subsidiaries, known as the “Limitation on Restricted Payments” covenant;
- the issuance of guarantees by restricted subsidiaries (particularly where the restricted subsidiaries do not guarantee the issuer’s high yield debt securities), known as the “Limitation on Subsidiary Guarantees” covenant;
- the restrictions on the ability of restricted subsidiaries to pay dividends and make other payments and transfers to the issuer, known as the “Limitation on Subsidiary Payment Restrictions” covenant;
- the use of proceeds from asset sales, known as the “Limitation on Asset Sales” covenant; and
- transactions with affiliates of the issuer (other than restricted subsidiaries), known as the “Limitation on Affiliate Transactions” covenant.

Some covenant packages may not include the Limitation on Liens covenant if it is covered by the other covenants (particularly the Limitation on Restricted Payments and Limitation on Subsidiary Payment Restrictions covenants) or the securities are already secured. Also, some covenant packages will include other covenants, such as a covenant that the issuer and its subsidiaries will only engage in permitted businesses.

Covenant packages may provide that, if the high yield debt securities become and so long as they remain investment grade rated, only specified negative covenants — at a minimum those that would apply to investment grade issuers and their guarantors — will apply to the issuer and its restricted subsidiaries. These “fall away” provisions are less likely to be found in covenant

packages for issuers in cyclical businesses and markets and more likely to be found in covenant packages for fallen angels and new issuers in more stable, less volatile markets.

Limitation on Indebtedness

The primary purpose of the Limitation on Indebtedness covenant is to limit the indebtedness of the issuer and its restricted subsidiaries to a level that will support the needs and business plans of the issuer while not putting stress on the ability of the issuer to service its indebtedness or putting downward pressure on the issuer's credit ratings. The term "indebtedness" is typically defined broadly to include such categories as indebtedness for borrowed money, guarantees of indebtedness, certain hedging obligations, indebtedness secured by property of the issuer or its restricted subsidiaries and certain fixed maturity and redeemable preferred stock or similar instruments.

The covenant typically gives the issuer two ways to incur debt — it can either satisfy the "interest coverage ratio" test or it can incur "permitted indebtedness."

Interest Coverage Ratio. The interest coverage ratio is typically expressed as the ratio of consolidated earnings before interest, taxes, depreciation and amortization ("EBITDA") of the issuer and its restricted subsidiaries for the most recent four fiscal quarters prior to the transaction date to their consolidated interest expense for that period. The interest coverage ratio typically is around 2.0 to 1.0, but may be higher or lower, or step up or step down upon the occurrence of certain events or the passage of time, depending on the circumstances of the issuer and its restricted subsidiaries. The appropriate interest coverage ratio is that which takes into account, among other things:

- the issuer's current and anticipated income, cash flow and debt service requirements;
- the volatility of the businesses of the issuer and its restricted subsidiaries and the interest rate environment;
- the extra leveraging that may result from permitted indebtedness;
- the business plans of the issuer and its restricted subsidiaries; and
- credit and rating agency implications.

The interest coverage ratio normally is adjusted for such items as indebtedness incurred or repaid and asset dispositions and acquisitions during the most recent four quarters prior to the transaction date.

In order to determine whether an issuer would satisfy the interest coverage ratio test if it were to incur new indebtedness, the issuer must apply the test assuming the new indebtedness had been incurred at the beginning of the most recent four fiscal quarters prior to the transaction date. The issuer must also satisfy any other conditions that may be imposed (such as secured indebtedness limits if the new indebtedness is secured).

Permitted Indebtedness. Over the long term, investors expect that the issuer's business will grow and its leverage will improve such that it will never have a problem satisfying the interest coverage ratio test to incur additional indebtedness. However, investors also recognize that, particularly during the period immediately following the issue of high yield debt securities, issuers may need additional flexibility in case they do not meet the interest coverage ratio test. As a result, investors typically are prepared to provide some flexibility so long as it is consistent with their understanding of the issuer's business plan and does not present an excessive risk to the issuer's ability to make payments on the debt securities.

Permitted indebtedness can be divided into three categories:

- additional indebtednesses that the investors would expect the issuer to need as part of its business, such as indebtedness and the unused amount of credit facilities existing at the time the high yield debt securities are issued and any refinancing thereof;
- items that are technically indebtedness but would not be likely to impact the issuer's cash flow or credit, such as securitization and warehouse credit facilities, issuer guarantees of restricted subsidiaries' indebtedness, certain income tax liabilities, certain hedging liabilities and certain trade liabilities; and
- one or more dollar baskets, which may be one time baskets or any time outstanding baskets, may be targeted at specific events or projects and, in the case of a general basket or the general component of a single basket, is usually sized to provide a reasonable cushion for unexpected financing needs.

It should be noted that, while permitted indebtedness may be incurred even if the interest coverage ratio test is not met, the interest expense for all the indebtedness of an issuer and its subsidiaries, including the interest expense for permitted indebtedness, is included in the calculation of the interest coverage ratio.

Limitation on Restricted Payments

The purpose of the Limitation on Restricted Payments covenant is to restrict the flow of money outside the issuer and its restricted subsidiaries and thereby encourage growth in the issuer's consolidated equity, while taking into account the needs of the issuer and its consolidated subsidiaries to ensure and foster that growth. The term "restricted payments" typically includes:

- cash dividends and dividends payable in the form of certain fixed maturity and redeemable preferred stock or similar instruments made to third parties other than pro rata dividends to holders of minority interests in restricted subsidiaries;
- redemptions and repurchases of equity interests of the issuer or its restricted subsidiaries held by third parties;

- redemptions and repurchases of and other principal payments on debt instruments that are subordinated to the high yield debt securities being offered other than payments due at final maturity; and
- investments in third parties other than permitted investments.

The covenant typically gives the issuer two ways to make restricted payments — it can either make them out of the “equity basket” set forth in the covenant or make them pursuant to a list of “permitted payments” and “permitted investments” that are negotiated prior to the offering in light of the issuer’s current business, financial condition and business plans and the needs of investors.

Equity Basket. The equity basket is intended to give the issuer the benefit of a portion of the growth in its equity to enable it to grow its business. In order to make a payment using the equity growth basket, typically, at the time of payment (1) no event of default or default which with the passage of time would become an event of default can exist and (2) the issuer must be able to incur indebtedness under the Limitation on Indebtedness covenant.

The equity basket typically includes the unused portion of the following items calculated for the period that begins on the first day of the issuer’s first fiscal quarter to occur after the issue date for the high yield debt securities and ends on the last day of the issuer’s last fiscal quarter to occur prior to the transaction date:

- a certain percentage (typically 50%) of the issuer’s consolidated net income;
- the aggregate net proceeds from the sale of equity interests (other than certain fixed maturity and redeemable preferred stock or similar instruments) and certain warrants and options to purchase those equity interests; and
- the aggregate amount of net reductions in investments (other than permitted investments).

The term “investments” typically includes loans, advances and other extensions of credit to third parties (including guarantees but excluding accounts receivable), capital contributions to third parties, investments in debt or equity securities issued by third parties and other items that would be counted as investments in accordance with the generally accepted accounting principals applicable to the covenant package.

Permitted Payments. Permitted payments include items that are regarded as essentially neutral to the interests of high yield debts securities holders, such as dividends that have been declared where the payment was permitted at the time of declaration, redemption of indebtedness that is subordinate to the high yield debt securities with the proceeds from the issuance of equity interests (other than certain fixed maturity and redeemable preferred stock or similar instruments) or subordinated indebtedness that matures after the high yield debt securities, and redemption of equity interests with the proceeds from the sale of other equity interests (other than certain fixed maturity and redeemable preferred stock or similar instruments).

Permitted payments also include payments pursuant to existing instruments that the investors have taken into account in assessing the issuer's capital structure, such as dividends on outstanding preferred equity and mandatory payments on outstanding instruments such as the mandatory repurchase price of outstanding subordinated debt securities.

Permitted payments also include payments required by special circumstances, such as distributions required for an issuer to maintain REIT status for U.S. federal tax purposes and *de minimis* payments required in connection with securitization vehicles. There is also usually a dollar basket that the issuer can use for any reason and is sized based on a "safety" factor and any payments anticipated at the time of the offering that may not otherwise be permitted by the covenant.

Permitted Investments. Investments existing at the time the high yield debt securities are issued and items that are generally considered investments are usually permitted investments where they do not represent a material risk of mandatory payments to third parties, such as temporary cash investments, investments in the ordinary course of business, investments made with the proceeds of an offering of equity interests (other than certain fixed maturity and redeemable preferred stock or similar instruments), hedging agreements, a small amount of loans or advances to officers⁶ and investments resulting from standard transaction documentation.

Permitted investments also usually include a dollar basket as a safety factor and, for specific investments or investment categories contemplated at the time of the offering that may not otherwise be permitted by the covenant, may include one or more additional dollar baskets that are limited to those specific investments or investment categories.

Limitation on Subsidiary Guarantees

The Limitation on Subsidiary Guarantees covenant provides that, if a restricted subsidiary guarantees the indebtedness of another party (particularly the indebtedness of the issuer or another restricted subsidiary to a third party), that restricted subsidiary will also guarantee the high yield debt securities. The issuance of guarantees to third parties is also regulated by the Limitation on Indebtedness and Limitation on Restricted Payments covenants. Accordingly, the Limitation on Subsidiary Guarantees covenant, which functions more like the Limitations on Liens covenant, is typically only included in a covenant package if the high yield debt securities are not, at the time of issuance, guaranteed by the issuer's restricted subsidiaries.

Limitation on Subsidiary Payment Restrictions

The purpose of the Limitation on Subsidiary Payment Restrictions covenant is to minimize impediments to the issuer's ability to access the income and assets of its restricted subsidiaries, thereby minimizing the structural subordination impact to investors in the issuer's high yield debt securities and giving the issuer optimal flexibility to ensure that the resources of its restricted subsidiaries are available to pay the issuer's expenses and other financial

⁶ Sarbanes-Oxley has limited the need for this exemption for 1934 Act reporting issuers.

obligations, including its interest, principal and premium payment obligations under its high yield debt securities.

The Limitation on Subsidiary Payment Restrictions covenant typically prohibits the issuer and any restricted subsidiary from creating or permitting any consensual encumbrance or restriction on the ability of any restricted subsidiary to:

- pay dividends or other distributions on equity instruments or interest on indebtedness to the issuer or another restricted subsidiary;
- repay indebtedness owned to the issuer or any restricted subsidiary;
- make loans or advances to the issuer or any restricted subsidiary; or
- transfer its property or assets to the issuer or any restricted subsidiary.

The covenant typically permits encumbrances and restrictions that either explicitly or by virtue of the encumbrance or restriction will not have a material adverse impact on the issuer's ability to make payments on the high yield debt securities, including those relating to:

- instruments that exist on the date the high yield debt securities are issued or when restricted subsidiaries or assets are acquired and, in many cases, refunded therefor;
- restrictions that exist by operation of law;
- restrictions arising in connection with specified transactions that may be permitted by other covenants (*e.g.*, incurring indebtedness, assets sales, sales of restricted subsidiaries, and securitization and warehousing transactions); and
- certain customary, usually non-material restrictions that arise in the ordinary course of the business of the issuer and its restricted subsidiaries.

Limitation on Asset Sales

The primary purpose of the Limitation on Assets Sales covenant is to ensure that the issuer and its restricted subsidiaries receive fair market value for asset sales and use the cash proceeds from asset sales to (i) reinvest in the businesses of the issuer and its restricted subsidiaries, (ii) repay indebtedness that is senior to the high yield debt securities (in ranking, by virtue of it being secured or by virtue of it being issued by a restricted subsidiary) or (iii) repurchase the high yield debt securities. The covenant often requires that most (often 75%) of the consideration for an asset sale be in the form of cash or cash equivalents. The use of proceeds portion of the covenant is only triggered if the aggregate asset sales proceed during any specified period (typically 12 months) exceeds a specified threshold (such as 5% of adjusted consolidated net tangible assets). The issuer's obligation to offer to repurchase the high yield debt securities typically only arises if the issuer and its restricted subsidiaries have not otherwise

used the proceeds in accordance with the covenant within a specified period of time (typically 12 months) after they are received.⁷

The definition of “asset sales” typically excludes ordinary course of business sales (*e.g.*, sales of inventory, receivables and other current assets), *de minimis* sales (*e.g.*, sales of less than a specified dollar amount in any one transaction or series of transactions) and sales permitted by other specified covenants, particularly the Limitation on Liens and Limitation on Restricted Payments covenants.

Limitation on Affiliate Transactions

The primary purpose of the Limitation on Affiliate Transactions covenant is to ensure that when the issuer and its restricted subsidiaries deal with their other affiliates, they do so on an arms’ length basis and thereby avoid any negative impact on the business and financial condition of the issuer and its restricted subsidiaries that may result from favorable arrangements with affiliates. This covenant is particularly important where the issuer has sister companies or has investors with substantial equity holdings (*e.g.*, 10% or more of an issuer’s capital stock).

The Limitation on Affiliate Transactions covenant typically requires all transactions with affiliates to be on fair and reasonable terms that are no less favorable than those the issuer or restricted subsidiary could obtain from non-affiliates. The definition of affiliate is usually similar to the 1933 Act and 1934 Act definitions — with respect to any person, any other person directly or indirectly controlling, controlled by, or under direct or indirect common control with, that person. The covenant also requires the issuer to follow certain procedures if an affiliate transaction exceeds specified dollar amounts, *e.g.*, a board resolution and a resolution of a majority of disinterested directors if the transaction exceeds a lower specified amount and the same plus an independent evaluation if the transaction exceeds a higher specified amount. These thresholds will vary depending on the particular issuer.

The covenant may exclude transactions that are *de minimis*, continuance of existing arrangements on similar terms, ordinary course of business transactions on customary terms, transactions that are otherwise permitted by the covenant package (*e.g.*, transactions with securitization and warehousing affiliates) and the acquisition of equity interests in the issuer (other than certain fixed maturity and redeemable preferred stock or similar instruments).

Repurchase of Notes upon a Change of Control

This is a typical provision in a high yield debt security. For investors in high yield debt securities, the business plan and the issuer’s management of that business plan is very important. Any change of control, whether it be one investor group for another or the acquisition of a widely held issuer through a leveraged buyout or by another widely held company, or otherwise, means that the investors would be subject to management risk that is not protected by the Merger

⁷ It may be the case that senior instruments, such as credit facilities, will prohibit the issuer from repurchasing the high yield debt securities in accordance with the Limitation on Asset Sales covenant. In such case, that fact needs to be disclosed in the offering document and the issuer needs to agree to seek the consent of senior creditors to make the repurchase if and when otherwise required by the terms of the high yield debt securities.

and Acquisition covenant. Accordingly, the obligation of an issuer to offer to repurchase its high yield debt upon the occurrence of a change in control gives investors the opportunity to liquidate their investment if they are not prepared to accept the risks associated with the new control situation.

The term change of control is often tailored to the circumstances of a particular issuer and can include a change in the percentage of voting equity ownership, or one holder or group acquiring a certain percentage (*e.g.*, 35%) of an issuer's outstanding voting equity, a change in the composition of the board of directors and other changes.

Other Redemption and Repurchase Provisions

High yield debt securities typically have two redemption provisions:

- a typical premium call provision that gives the issuer the right to call the securities in whole or in part after a no-call period (*e.g.*, 5 years) at a declining premium for a period of time (*e.g.*, from years 5 to 7) and then at par until maturity; and
- an equity funded provision that permits the issuer to redeem up to a specified percentage (typically 35%) of the principal amount of an issue of high yield debt securities at any time at a premium with the net cash proceeds from one or more qualifying equity offerings.

The circumstances of the issuer may result in the high yield debt securities having additional redemption provisions. For example, securities issued in advance of an acquisition may require the securities to be redeemed if the acquisition is not completed. Usually this involves a premium or make-whole call price and may require the issuer to sequester the proceeds pending completion of the acquisition for the benefit of the securityholders. Securities issued in advance of an initial public offering or other equity offering may have certain redemption or repurchase provisions that require the issuer to redeem or offer to repurchase all or a certain percentage of the securities with the proceeds of that offering, which may also involve a premium.

High yield debt securities normally do not contain provisions that prevent the issuer from making open market repurchases of the securities so long as the other high yield debt securities covenants do not prevent those repurchases.

Payments for Consent

To prevent the issuer from having the ability to “buy the vote,” the issuers of some high yield debt securities are frequently required to covenant that the issuer and its restricted subsidiaries will not pay a fee to induce holders to consent, waive or amend any term or provision of the high yield debt securities or the underlying indenture.

No Personal Liability

The terms of some high yield debt securities provide that none of the issuer's shareholders, directors or employees shall have personal liability for payments on the securities.

This provision is especially important with closely held issuers to avoid any concerns that investors might have the ability to pierce the issuer's corporate veil.

Events of Default

The events of default and remedies provisions are typical of most debt securities transactions. Failure to make principal or premium payment immediately or interest payments within a certain grace period, covenant defaults after notice and a cure period, and various events of or in anticipation of bankruptcy are all events of default. In addition, defaults in the performance by the issuer and its restricted subsidiaries under the Merger and Acquisitions and Limitation on Asset Sales covenants and the issuer's obligation to repurchase the securities upon a change in control are events of default and do not usually contain notice or cure provisions.

Defeasance

High yield debt securities usually are subject to both legal and covenant defeasance, though these provisions are rarely implemented. Covenant defeasance, however, is sometimes an option to consider if the issuer is trying to restructure the covenants on its outstanding securities and is unable to obtain the consent of the holders of a particular issue of securities.

Subsidiaries

The obligations of the subsidiaries of an issuer in the covenant package require special attention. These covenants involve special issues and are an important area on which to focus when constructing the covenant package for an issue of high yield debt securities.⁸ The typical covenant package defines "subsidiary" to include any entity in which the issuer holds more than 50% of the voting power and whose financial statements would be consolidated with the issuer's pursuant to the issuer's GAAP.

Unrestricted Subsidiaries and Special Subsidiaries

One of the first issues that issuers and underwriters consider is whether all subsidiaries should be restricted subsidiaries and therefore subject to the covenant package. The answer is typically yes unless the subsidiary is not material or the omission of such subsidiary as a restricted subsidiary would not have a material impact on investors, in which case they would be treated as "unrestricted subsidiaries" and therefore third parties to the issuer and its restricted subsidiaries for purposes of the covenant package. Subsidiaries of unrestricted subsidiaries are typically also treated as unrestricted subsidiaries. In some cases, a particular subsidiary is so important to investors that there is a prohibition on that subsidiary being designated as an unrestricted subsidiary. In most cases, however, the issuer's board of directors can designate any subsidiary as an unrestricted subsidiary if it satisfies certain conditions at the time of designation.

⁸ Typically subsidiaries are not parties to the indenture unless they are also guarantors and the issuer agrees to ensure that its restricted subsidiaries comply with the covenants. In some jurisdictions, the issuer's ability to ensure compliance by its subsidiary raises enforceability issues.

A typical covenant package permits the issuer's board of directors to designate a subsidiary as an unrestricted subsidiary if, at time of designation:

- the subsidiary does not own shares in or have any rights over property of the issuer or any restricted subsidiaries;
- assuming any guarantee by the issuer or a restricted subsidiary of indebtedness of the subsidiary is both an incurrence of indebtedness and an investment by the issuer or that restricted subsidiary at the time of designation, each such guarantee could be entered into at the time of designation by the issuer or its restricted subsidiary in compliance with the Limitation on Indebtedness and Limitation on Restricted Payments covenants; and
- the subsidiary to be so designated has *de minimis* assets (e.g., U.S.\$1,000 or less) or, assuming the assets of the subsidiary were treated as an investment by the issuer at the time of designation, the investment would be permitted under the Limitation on Restricted Payments covenant.

If a covenant package does not include one or more of an issuer's subsidiaries but those subsidiaries are included in the consolidated financial statements that the issuer normally publishes, then the issuer would typically have to prepare and deliver to or for the benefit of investors in the high yield debt securities consolidated financial statements that exclude those subsidiaries.

Other issues involving subsidiaries that need to be considered in drafting a covenant package include substantial minority interests and special entities such as warehouse subsidiaries and securitization subsidiaries. Furthermore, in some cases, such as where a substantial portion of an issuer's assets consists of shares in one or more 50% or less-owned entity or entities, as the case may be, the covenant package may include restrictions on entities that would not meet the typical definition of subsidiary.

Subsidiary Guarantors

The issuer and the underwriters may determine that an issuer's subsidiaries should not only be restricted subsidiaries but should also guarantee the issuer's high yield debt securities. This may be the case if the issuer is a non-operating holding company or the guarantees would result in better pricing in the market. Subsidiary guarantees are typically full, unconditional and joint and several obligations (*i.e.*, each subsidiary guarantor would guarantee payment on all of the issuer's high yield debt securities). Subsidiary guarantees enable investors to avoid the structural subordination they would otherwise be subject to with respect to the assets of the issuer's subsidiaries, but raise disclosure, 1934 Act registration and reporting and, in the case of U.S. issuers, U.S. federal tax issues, particularly in the case of non-U.S. subsidiary guarantors (see the discussion of securing subsidiary obligations below).

Unless exempt, guarantors must provide the financial disclosure required by Regulation S-X 3-10. Under Regulation S-X 3-10, factors such as whether the issuer has any independent operations, whether the subsidiary guarantors are 100% owned by the issuer and whether all of

the subsidiaries are guaranteeing the high yield debt securities will determine whether any additional financial information, condensed consolidating information in a footnote or separate financial disclosure for each guarantor is required. If the issuer is or, as a result of the high yield debt securities offering, will become a 1934 Act reporting company, in accordance with Rule 12h-5 under the 1934 Act, (a) if full financial statements of the subsidiary guarantors are required by Regulation S-X 3-10, the guarantors generally will have to register and separately report under the 1934 Act and (b) if full financial statements of the guarantors are not so required, the guarantors will not have to register or report under the 1934 Act but the issuer will need to include any condensed consolidating information about the subsidiary guarantors that is required by Regulation S-X 3-10.

Non-U.S. Subsidiary Guarantors

If the issuer is a U.S. income tax payer and has non-U.S. subsidiaries, it is unlikely that the issuer will want the non-U.S. subsidiaries to guarantee the issuer's obligations under the high yield debt securities. For U.S. federal income tax purposes, if a foreign subsidiary guarantees its U.S. parent's debt securities, then a guarantee by that subsidiary may cause some or all of its income, whether or not dividended to its U.S. parent, to be treated as part of the parent's income for U.S. federal income tax purposes.

Due to the adverse U.S. federal income tax consequences described above, if the credit of a non-U.S. subsidiary is beneficial to an issuer of high yield debt securities that is a U.S. income tax payer, the issuer may consider pledging the shares and other securities it holds in the non-U.S. subsidiary for the benefit of the holders of the high yield debt securities in lieu of a subsidiary guarantee. However, for U.S. federal income tax purposes, such an issuer's pledge of shares of stock in a non-U.S. subsidiary for the benefit of the holders of the high yield debt securities generally will be treated in the same manner as a guarantee by the non-U.S. subsidiary (as discussed in the preceding paragraph)⁹ if (i) at least 66⅔% of the total combined voting power of all classes of the non-U.S. subsidiary's stock entitled to vote is pledged and (ii) the pledge of stock is accompanied by one or more negative covenants or similar restrictions on the shareholder effectively limiting the non-U.S. subsidiary's discretion with respect to the disposition of assets and the incurrence of liabilities other than in the ordinary course of business. In addition, it is important to bear in mind Regulation S-X 3-16, which provides among other things that, if the aggregate book value of the shares and other securities the issuer pledges in a non-U.S. subsidiary is equal to or greater than 20% of the principal amount of high yield debt securities being offered by the issuer, with certain limited exceptions, separate financial statements for the non-U.S. subsidiary will be required.

REGISTRATION RIGHTS

If the high yield debt securities are sold pursuant to Rule 144A or Regulation S with registration rights, the issuer enters into a registration rights agreement for the benefit of the

⁹ As previously discussed, if the pledge of the non-U.S. subsidiary's stock is treated as a guarantee by the non-U.S. subsidiary of the U.S. parent's obligations under the high yield debt securities, the pledge would risk causing some or all of the non-U.S. subsidiary's income, whether or not dividended to its U.S. parent, to be treated as part of the U.S. parent's income for U.S. federal income tax purposes.

holders of the high yield debt securities and agrees to either exchange the securities for 1933 Act-registered securities or, in some cases, to set up a resale shelf with the SEC that will allow the holders to sell the securities pursuant to an effective registration statement. The registration rights agreement contains a series of milestones that, if not achieved, result in the issuer paying additional interest (sometimes referred to as liquidated damages) on the high yield debt securities until they are achieved. These milestones typically include the time of filing the registration statement, the time the registration statement is declared effective by the SEC and, in the case of an exchange offer, the times the exchange offer is commenced by the issuer and consummated.¹⁰

1933 ACT CONSIDERATIONS

1933 Act-Registered Offerings

Issuers that sell their high yield debt securities in the U.S. capital markets in a 1933 Act-registered offering may do so on Form S-1 or, if a foreign private issuer, Form F-1 or, if eligible, Form S-3 or, if a foreign private issuer, Form F-3. Additional 1933 Act registration statement forms are available for Canadian issuers, investment companies, unit trusts, real estate companies and small business issuers.

Typically, an issuer of high yield debt securities that is not a WKSII or, if it is a WKSII, is not eligible to use Form S-3 or F-3 for automatic shelf offerings, will prefer to offer its securities pursuant to Rule 144A and/or Regulation S in order to avoid the potential delays of the 1933 Act registration process. If an issuer is a WKSII that is eligible to use Form S-3 or F-3 for automatic shelf offerings, its registration will be declared effective immediately upon filing with the SEC without any SEC review.

To be eligible to use Form S-3 or F-3 for an automatic shelf offering of non-convertible high yield debt securities, the issuer must be a WKSII that is otherwise eligible to use Form S-3 or F-3 and that, within 60 days of the time of filing the registration statement:

- has a worldwide market value of its outstanding voting and non-voting common equity held by non-affiliates of U.S.\$700 million or more;
- (i) has issued in the preceding three years at least U.S. \$1 billion principle amount of non-convertible debt securities for cash, not exchange, registered under the 1933 Act and (ii) the aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant is \$75 million or more; or
- (ii) the issuer is a majority-owned subsidiary of a parent that is a WKSII and satisfies either of the foregoing requirements and (ii) the issuer's high yield debt securities are fully and unconditionally guaranteed by that parent.

¹⁰ For a discussion of the impact that the reduced restricted periods under Rule 144 has had on registration rights agreements, see the discussion under the heading "Registration Rights—Resale Registration" in Chapter 3 (*Convertible and Exchangeable Securities*) of this volume.

Rule 144A/Regulation S Offerings

Issuers that sell their high yield debt securities in the U.S. capital markets in an unregistered offering typically sell their securities to underwriters and investors pursuant to Section 4(2) of, and Rule 144A under, the 1933 Act and establish procedures that enable the securities to be resold pursuant to Rule 144A and Regulation S under the 1933 Act.

Registration Rights

As previously discussed, issuers that sell high yield debt securities in an unregistered offering pursuant to Rule 144A and/or Regulation S may offer investors the right to exchange their securities for 1933 Act-registered securities. The availability of these registration rights was confirmed by the Staff in the Exxon Capital No-Action Letter¹¹ and subsequent related SEC no action letters. The exchange offer is registered on Form S-4 or, if a foreign private issuer, Form F-4 and the 1933 Act-registered securities have the same terms as the unregistered securities being delivered in exchange.

The conditions imposed by the Staff on the holders of unregistered securities in “Exxon Capital” exchange offers include:

- the holder may not be an affiliate of the issuer;
- the holder must have acquired the securities in the ordinary course of its business;
- the holder must have no arrangement or understanding with any person to participate in a distribution of the 1933 Act-registered securities to be acquired in exchange for the unregistered securities; and
- the holder must not have purchased the unregistered securities directly from the issuer in order to resell them pursuant to Rule 144A or any other available exemption under the 1933 Act (this condition is targeted at underwriters that may hold unsold allotments).

Before the effectiveness of the Form S-4 or F-4 registration statement, the issuer must provide the Staff with a letter that states the exchange offer is being registered in reliance on the staff position set forth in the Exxon Capital No-Action Letter and subsequent related SEC no-action letters. The letter must also contain representations that the staff requires, including the absence of any arrangements for the distribution of the 1933 Act-registered securities to be issued in the exchange offer.

1934 ACT CONSIDERATIONS

Issuers of high yield debt securities in 1933-Act registered offerings, either for cash or in exchange (such as an Exxon Capital offering), pursuant to Section 15(d) of the 1934 Act and the

¹¹ Exxon Capital Holdings Corp. (May 13, 1988). See also the discussion under the heading “Registration Rights — Exxon-Capital Exchange Offers” in Chapter 3 (*Convertible and Exchangeable Securities*) of this volume.

requirements of the applicable 1933 Act registration statement, must file at least one annual report on Form 10-K or 20-F (as applicable) with the SEC for the fiscal year in which the registration statement became effective. Thereafter, unless it otherwise covenants in the indenture (see the discussion above under “Covenants—Affirmative Covenants”), the issuer may de-register if the number of its equity holders (U.S. holders if it is a foreign private issuer) is less than 300 or it otherwise satisfies the SEC’s de-registration requirements.

Issuers of high yield debt securities in an unregistered offering in the U.S. capital markets will not, by virtue of that offering, be required to file any reports with the SEC under the 1934 Act. Many issuers of unregistered securities that are eligible for resale pursuant to Rule 144A satisfy the reporting requirements of Rule 12g3-2(b) under the 1934 Act with their home country filings in order to satisfy the information requirements of Rule 144A, though there are other ways to satisfy the Rule 144A information requirements.

1940 ACT CONSIDERATIONS

An issuer should ensure that, before and after the high yield debt securities are issued, it is not required to register and qualify as an investment company under the 1940 Act.¹²

BASIC DOCUMENTS

Set forth below is a list of basic transaction documents for an offering of high yield debt securities in the U.S. capital markets. Please refer to Appendix B (*Basic Documents for Securities Offerings in the U.S. Capital Markets*) of this volume, as well as the other volumes of *Accessing the U.S. Capital Markets*, for a further description of these documents.

1. Description of Notes included in the offering documents.¹³
2. 1933 Act registration statement (if applicable).
3. Offering documents, including the following:
 - a preliminary, or “red herring,” prospectus;
 - a free writing prospectus;
 - a final prospectus; and

¹² For a further discussion of the 1940 Act, see Appendix A (*Determining Whether an Issuer is a Prima Facie Investment Company or Exempt Pursuant to Rule 3a-1 under the Investment Company Act of 1940*) of the other volumes of *Accessing the U.S. Capital Markets*.

¹³ The terms of the high yield debt securities and any registration rights are typically prepared by counsel to the underwriters or initial purchasers, although repeat issuers that have outstanding high yield debt securities may persuade the underwriters or initial purchasers that issuer’s counsel should perform this role. The terms that apply to the high yield debt securities and the registration rights are usually settled by negotiating the description of the high yield debt securities in the offering document (often contained in the offering document under the heading “Description of Notes” and referred to as the “DoN”). As a result, the terms of the high yield debt securities (and, in particular, the covenant package), and any related registration rights that are contained in the operative documents, typically are almost identical to the descriptions thereof contained in the DoN.

- any non-U.S. supplements or “wrappers.”
4. Indenture.
 5. Form of high yield debt security.
 6. Guarantee(s).
 7. Security documents (if applicable).
 8. Underwriting or purchase agreement.
 9. Registration rights agreement (if applicable).
 10. DTC letter of representations.
 11. Listing applications (if applicable).
 12. Legal opinions and 10b-5 statements.
 13. Auditor’s comfort letter(s) and related documents.
 14. Other closing documents.
 15. Exchange Offer Registration Statement on Form S-4 or F-4 (if applicable).¹⁴

¹⁴ If an Exxon Capital exchange offer is to be conducted after the closing.

CHAPTER 6

MEDIUM-TERM NOTES

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GENERAL

Medium-term note programs are facilities for the continuous offering of debt securities of varying maturities. The term “medium-term notes” is no longer really descriptive of these securities. When these programs were first created, they were designed to fill the gap between commercial paper, with its maximum maturity of nine months, and the minimum practicable maturity of underwritten debt securities (which at the time was considered to be in the area of three to five years). The medium-term notes were issued pursuant to what were then newly developed, “continuous” offering procedures, and the term “medium-term notes” came to refer to notes issued pursuant to these procedures, regardless of maturity.

Medium-term notes are distinguished from other term debt securities, such as traditional Yankee bonds, by the way in which they are marketed and sold. Many of the marketing and settlement procedures for medium-term notes were borrowed from the U.S. commercial paper market. Medium-term notes are generally sold on a principal or agency basis from a dealer’s trading desk with three business-day settlement in same day funds. Book-entry only medium-term note programs, with payments made in same day funds through DTC, have become standard.

While the traditional medium-term note was a fixed rate, non-redeemable senior debt security, almost all programs now provide the flexibility to issue various other types of debt securities (*e.g.*, floating rate, zero coupon, amortizing, foreign currency denominated, indexed or equity-, interest rate- or commodity-linked securities). Many programs now offer the flexibility to issue subordinated medium-term notes. For floating rate medium-term notes, the most common interest rate indices include the London interbank offered rate (“LIBOR”), bank prime rates, commercial paper composite rates, certificate of deposit composite rates, U.S. federal funds rates and U.S. Treasury bill rates.¹ Many medium-term note programs now provide for minimum denominations as low as U.S.\$1,000.² Most medium-term note programs are rated investment grade by at least one U.S. nationally recognized rating agency.

¹ Since floating rate medium-term notes are often issued in conjunction with interest rate swaps or with interest rate risk insurance strategies, the interest rate indices for floating rate medium-term notes generally follow the definitional conventions of the International Swap Dealers Association, Inc.

² Consideration should be given, however, to the European Prospectus Directive as to the minimum denominations for medium-term notes to be offered outside the United States.

While finance companies initially were the predominant users of medium-term note programs, such programs are now acknowledged to provide an easy means for many other types of issuers to access the U.S. capital markets. For example, medium-term note programs have been developed to securitize mortgage loans (both fixed and floating rate) and other financial assets. U.S. banks and federal or state branches and agencies of non-U.S. banks, as well as other financial institutions and corporations, have established medium-term note programs and other similar programs.

Medium-term note programs have increasingly been used to effect global offerings of securities. In the case of SEC registered medium-term note programs, this may involve, in addition to an offering of the medium-term notes in the United States, an offering outside the United States that is listed on a non-U.S. securities exchange such as the London Stock Exchange or the Luxembourg Stock Exchange. Global offerings may also be effected under private medium-term note programs, through reliance upon Regulation S outside the United States and Rule 144A and Section 4(2) of the 1933 Act within the United States.

Once established, a medium-term note program allows the issuer to issue a wide range of debt securities, in varying amounts and maturities, without the need to go through the registration process for each issuance. Each sale requires only that (1) the terms of the sale be agreed upon at pricing (this is frequently done orally with written confirmation) and, in the case of certain principal take-downs, an update of the most recently delivered comfort letter, legal opinions and officers' certificate be provided, (2) a copy of the offering documents, described in this chapter below under "Basic Documents," be made available to the purchaser, (3) a medium-term note, either in global or physical, certificated form, be completed by the trustee or issuing and paying agent, as the case may be, upon the issuer's instructions, and (4) in the case of SEC registered medium-term note programs, a copy of the pricing supplement be filed with the SEC.

1933 ACT CONSIDERATIONS

An issuer that proposes to sell medium-term notes in the U.S. capital markets must register their offer and sale under the 1933 Act unless an exemption from registration is available. This section on 1933 Act considerations is directed primarily at issuers that must choose whether to register a medium-term note program under the 1933 Act pursuant to Rule 415 or to privately place medium-term notes pursuant to Section 4(2) of the 1933 Act, although other exemptions (such as the exemption provided by Section 3(a)(2) of the 1933 Act for securities issued by certain banks) may be available.³

Registered Medium-Term Notes

An issuer that is able to satisfy the requirements of Rule 415 under the 1933 Act is allowed to file a shelf registration statement that enables it to sell securities in a number of tranches over a period of time or on a continuous basis. There are two provisions of Rule 415 that are available to an issuer that seeks to register a medium-term note program with the SEC.

³ Some issuers have obtained the Section 3(a)(2) exemption by supporting their medium-term notes with letters of credit issued by banks.

Clause (ix)

Clause (ix) of Rule 415(a)(1) permits an issuer to register medium-term notes, regardless of whether the notes are registered on Form S-1 or S-3 (or Form F-1 or F-3), provided the offering is commenced promptly, is to be made on a continuous basis and may continue for a period in excess of 30 days of initial effectiveness.

Clause (x)

Clause (x) of Rule 415(a)(1) permits an issuer to register medium-term notes if it registers (or is eligible to register) the securities on Form S-3 or F-3 for offering on a continuous or delayed basis.

Analysis — Clause (ix) vs. Clause (x)

Registering medium-term notes under clause (x) is preferable to registering under clause (ix) for a number of reasons:

- (1) Clause (ix) requires that the notes be offered on a continuous basis, while clause (x) allows the notes to be offered on either a continuous or delayed basis.
- (2) Forms S-3 and F-3 permit prior and subsequent 1934 Act reports to be incorporated by reference into the prospectus. Forms S-1 and F-1 permit only prior 1934 Act reports to be incorporated by reference and, as a result, each time that a 1934 Act report is required to be filed (*e.g.*, annual and other periodic reports, as well as reports disclosing any material developments), the prospectus must be amended or supplemented. Despite these considerations, issuers have registered medium-term note programs on Forms S-1 and F-1. However, it requires close coordination between the drafting of the 1934 Act reports and the prospectus. Due to the semi-annual reporting requirement for many foreign private issuers, clause (ix) may be less onerous for foreign private issuers than U.S. issuers (which are required to file quarterly 1934 Act reports), provided that there are no material developments between semi-annual reports.
- (3) Forms S-3 and F-3 allow an issuer to register medium-term notes of a finance subsidiary if the medium-term notes are guaranteed by such issuer or are rated investment grade by at least one U.S. rating agency. While the SEC has granted certain exemptions from that requirement, obtaining an exemption is a time consuming process.

Private Medium-Term Notes

In order to privately offer and sell medium-term notes in the U.S. capital markets without registration under the 1933 Act, an issuer must follow procedures designed to comply with Section 4(2) or Regulation D and Rule 144A. These procedures are generally similar to those used in private commercial paper programs. In addition to private offers of medium-term notes in the United States, the program may also provide for offers and sales to be made simultaneously outside the United States to non-U.S. persons in accordance with Regulation S.

Private vs. Registered Medium-Term Notes

Apart from the transfer restrictions associated with a private medium-term note program and the exclusion of retail investors in the United States, the characteristics of a registered and private medium-term note program to an investor are largely the same. Credit ratings from one or more of the U.S. rating agencies are generally required for marketing purposes. Furthermore, since the market for medium-term notes is largely composed of institutional investors that are eligible to acquire privately placed medium-term notes, a registered offering of medium-term notes will not necessarily result in a cost of funds that is significantly lower than the cost of funds of privately placed medium-term notes.

One obvious advantage of private medium-term note programs is that the issuer avoids having to go through the SEC registration process. In that regard, there are a number of points to consider:

- (1) For many foreign private issuers, registering a medium-term note program would not require operating segment disclosure in accordance with U.S. accounting standard SFAS 131 if the medium-term notes are rated investment grade.⁴
- (2) The private placement memorandum for a private medium-term note program ordinarily requires, for marketing purposes, more disclosure about the issuer, its financial condition and performance and its prospects than that required for a commercial paper program, but less disclosure than that required for a registered program. For example, in a private placement by a foreign issuer, the differences between U.S. GAAP and the issuer's home country GAAP or IFRS usually are only described qualitatively, unless the issuer is a 1934 Act reporting company or a quantitative reconciliation is required to prevent the disclosure document from being misleading.
- (3) Continuous reporting under the 1934 Act is not required for a private medium-term note program, although it provides a convenient means of updating a private placement memorandum since it avoids the necessity of periodically updating and revising the private placement memorandum itself. SEC-registered medium-term note programs on Form S-3 or F-3 are automatically updated by 1934 Act reporting.
- (4) A private medium-term note program is not required to have an indenture qualified under the 1939 Act. Given the standardization of indentures used for medium-term note programs, this may not represent significant cost savings except insofar as trustee fees are concerned. Moreover, many private medium-term note programs utilize an indenture to address marketing concerns or to ensure uniformity with the issuer's other debt securities.

⁴ This exception will be eliminated for fiscal years ending on and after December 15, 2009. See Release No. 33-8959 (Sept. 23, 2008) (<http://www.sec.gov/rules/final/2008/33-8959.pdf>).

- (5) A private medium-term note program may be the only option for certain issuers that desire to issue medium-term notes through a special purpose U.S. finance subsidiary that is not an operating sales finance company in order to avoid having to register the U.S. finance subsidiary under the 1940 Act.⁵

Private medium-term note programs do have some drawbacks, including the following:

- (1) Private medium-term notes are subject to resale and other transfer restrictions. These restrictions may present liquidity considerations for investors that could affect the amount of interest required to be paid by the issuer, particularly in the case of longer maturities.
- (2) If Rule 144A eligibility is desired, the issuer and, in the case of a guaranteed finance subsidiary, the parent will have to provide secondary market purchasers with the information required under Rule 144A(d)(4) unless the issuer or the parent guarantor, as the case may be, is a reporting company under the 1934 Act or publishes information pursuant to Rule 12g3-2(b) under the 1934 Act.
- (3) If an issuer issues medium-term notes to finance the purchase of securities, the investment banks need to be informed and special procedures need to be followed in order to comply with Federal Reserve Board Regulation T (“Regulation T”).⁶ This issue often arises in the case of structured financings where the issuer’s primary assets are mortgages or other financial assets.
- (4) Although the issuance of private medium-term notes in book-entry form is permitted if the securities are eligible for resale pursuant to Rule 144A and are either investment grade or, if non-investment grade, are PORTAL-eligible, private medium-term notes not satisfying those criteria may not be issued through the facilities of DTC and therefore must be issued in physical, certificated form. See “Book-Entry Medium-Term Notes” below.
- (5) An issuer of private medium-term notes must be careful that its other securities offerings in the U.S. capital markets do not taint the private nature of the medium-term note program. Given the broad range of possible maturities in a medium-term note program and the volume of medium-term note offerings, “integration,” as this problem is called, is more of an issue for medium-term notes than commercial paper. In addition, the issuer needs to ensure that it does not engage in any “general solicitation” or “general advertising,” within the meaning of the U.S. federal securities laws, with respect to the securities being sold while the program is operative.

⁵ For further information on finance subsidiaries, see Chapter 10 (*Finance Subsidiaries*) of the other volumes of *Accessing the U.S. Capital Markets*.

⁶ The same is true for privately placed commercial paper. See Chapter 8 (*Commercial Paper*) in this volume.

BOOK-ENTRY MEDIUM-TERM NOTES

Book-entry medium-term notes, like book-entry commercial paper, are generally issued and traded through the facilities of DTC. Medium-term notes registered under the 1933 Act, all non-convertible investment grade medium-term notes eligible for resale pursuant to Rule 144A, and all medium-term notes eligible for resale pursuant to Rule 144A and eligible to be traded on PORTAL, whether or not investment grade, may be issued in book-entry form.⁷ The two main advantages of book-entry medium-term notes over certificated medium-term notes are that they eliminate the risks and timing associated with delivery and possession of certificated securities and the higher cost of printing certificated medium-term notes. However, most counsel have taken the view that for medium-term notes initially to be issued in book-entry form, they must be sold by the issuer to an investment bank and resold by that investment bank to QIBs in reliance upon Rule 144A. Given the advantages of book-entry medium-term notes, the trend is for private medium-term note programs to be structured as Rule 144A offerings. If an issuer anticipates that medium-term notes may be sold to non-QIB accredited investors, these notes typically are initially issued in physical, certificated form.

Book-entry medium-term note programs usually allow for the issuance of certificated medium-term notes as well, but this is only a safeguard in the event that there is a problem with the DTC book-entry system, if there is an event of default, a special requirement of a prospective purchaser or, as noted above, if the issuer makes sales to accredited investors. There does not appear to be any meaningful demand in the U.S. capital markets for medium-term notes in certificated form. A fully registered global security (or multiple securities if the principal amount exceeds the dollar threshold specified by DTC, currently U.S.\$500 million) will be issued for all medium-term notes having common terms (including date of issue, interest rate or formula, stated maturity date and redemption and repayment terms and covenants).

All medium-term notes issued in book-entry form are tracked by DTC through CUSIP numbers, which are obtained from the CUSIP Service Bureau of Standard & Poor's Ratings Services (a division of the McGraw Hill Companies, Inc.). Issuances, withdrawals and any other operational functions of book-entry medium-term notes are processed by DTC in accordance with an agreement or "letter of representations" among the issuer, the trustee or issuing and paying agent, as the case may be (unless a blanket form is used), and DTC. In addition to CUSIP numbers, medium-term notes which are issued as part of a global offering may also carry securities identification numbers for clearing systems outside the United States, such as Euroclear Bank S.A./N.V. ("Euroclear") or Clearstream Banking, *société anonyme* ("Clearstream").

⁷ When the SEC adopted Rule 144A, it approved PORTAL, an electronic market place for primary offerings and secondary trading of unregistered securities that satisfy the requirements of Rule 144A. Only brokers, dealers and institutional investors have access to PORTAL. PORTAL, which is operated by FINRA, is designed to provide primary and secondary market liquidity through a closed system in which unregistered securities can trade among qualified institutional buyers.

BASIC DOCUMENTS

Set forth below is a list of basic transaction documents for an offering of medium-term notes in the U.S. capital markets. Please refer to Appendix B (*Basic Documents for Securities Offerings in the U.S. Capital Markets*) of this volume and the other volumes of *Accessing the U.S. Capital Markets* for a further description of these documents.

1. Offering documents, including the following:
 - Base offering document;
 - Release of terms of a tranche of medium-term notes on Bloomberg;
 - Term sheet (if SEC-registered, filed as a free writing prospectus relating to the final terms of a tranche of medium-term notes);
 - Medium-term note offering document supplement (if applicable); and
 - Medium-term note pricing supplement.
2. Indenture or issuing and paying agent agreement.
3. Distribution agreement.
4. Administrative procedures.⁸
5. Forms of medium-term notes.
6. DTC letter of representations.
7. Legal opinions and 10b-5 statements.
8. Auditor's comfort letter(s) and related documents.
9. Interest calculation agency agreement.
10. Other closing documents.

⁸ Because of the continuous nature of a medium-term note offering and the many variables of a medium-term note program, administrative procedures clarify the roles of the issuer, the trustee or issuing and paying agent, as the case may be, and the investment banks in connection with the offer, sale, issuance, settlement and maturity of medium-term notes.

CHAPTER 7

STRUCTURED NOTES

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GENERAL

A “structured note” is a term applied to debt securities the return on which is derived from the value or performance of an underlying asset, often referred to as a “market measure.” Though the return that the investor expects to receive on the security is based on the performance of the market measure, the investor has no legal interest in the market measure, and is subject to the credit risk of the issuer of the note. The issuer typically hedges its own exposure to changes in the value or level of the market measure, with the goal of effectively converting this exposure into a known fixed or floating rate obligation. However, the issuer’s payment obligations to holders of its structured notes are not dependent on the effectiveness of its hedge.

Historically, these types of products have been issued by investment and commercial banks that have the ability both to distribute the notes and to structure their own hedges for issuer-related risks. However, in recent years, structured notes have been issued by an increasing number of issuers that are not investment or commercial banks; these issuers hedge their risks through third party swaps. The volume of structured notes offered in the United States, which started with a small number of issues in the mid-1980s, grew to approximately \$114 billion in 2007. Although volumes for 2008 were higher, the growth came in the first half of the year. Structured product sales slowed in the later part of 2008, as cautious investors became more risk-averse with respect to the credit of certain financial institution issuers, and avoided non-principal protected products, while at the same time the cost of principal protection increased. Issuances of structured notes are now also common in European capital markets, where approximately €150 billion of structured notes was issued in 2006.

ECONOMIC CONSIDERATIONS

From an investor’s perspective, there are a number of reasons to invest in structured notes. First, structured notes often allow investors to gain economic exposure to market measures such as commodities, currencies and various equity indices that might otherwise be difficult for many investors to obtain. Second, structured notes allow investors to engineer their exposure to a particular asset class through techniques embedded in the design of the note, including shorting the market measure, leveraging or accelerating returns on the market measure, or limiting the downside exposure to the market measure through varying degrees of principal protection. Third, structured notes may simplify the U.S. federal income tax treatment of exposures to certain market measures, direct investment in which would give rise to complex or

onerous tax consequences. Finally, structured notes are often used by investors to facilitate diversification of risk and balance other investment exposures in their portfolio.

Issuers of structured notes also find them advantageous for several reasons. For financial institutions such as investment and commercial banks, there are several reasons why offering structured notes may be appealing. First, these issuers are able to satisfy their clients' demand for the products based on the investor objectives outlined above. Second, structured notes allow these issuers to be more proactive by synthetically engineering products rather than passively waiting to distribute securities issued by third parties, allowing them to generate revenue in a way that is less dependent on the timing and financing needs of third party issuers. Third, structured notes allow these issuers an ability to significantly expand the range of economic exposures that can be offered to clients, which allows for a larger potential client base. Finally, they are able to earn fees for structuring and hedging structured notes, in addition to the fees earned from distribution.

Structured notes can also have benefits for issuers other than investment and commercial banks, allowing for financing opportunities targeted to new segments of investors. Through related swaps, these opportunities may provide attractive fixed- or floating-rate financing for non-bank issuers.

COMMON STRUCTURED NOTES FEATURES

Structured notes have been linked to a variety of market measures. These have included the common stock of unaffiliated issuers, “baskets” of stocks which give investors exposure to particular “market segments” (*e.g.*, health care, real estate, energy or transportation), broad equity indices (*e.g.*, the S&P 500 or the NIKKEI 225), exchange rates, individual commodities or baskets of commodities, mutual funds, measures of inflation, the relationship between interest rates (*e.g.*, long term vs. short term, or taxable vs. tax exempt), or changes in market volatility.

A structured note may be designed to mirror exactly the performance of the market measure. Such an exposure through a note rather than through a direct investment in the market measure may be more convenient and may yield different tax implications for an investor. However, a structured note may also be designed to reverse the exposure to a market measure. These types of structured notes are frequently referred to as “bear notes,” and are, in essence, short positions in the underlying asset. Accordingly, the value of these types of structured notes varies inversely with the performance of the market measure, rising when the value or level of the market measure declines and declining when the value or level of the market rises. A structured note may also be designed to combine both strategies, such that the note is “long” one market measure and “short” another, in essence bullish on one asset and bearish on another.

The potential volatility of an underlying market measure can be mitigated by including a debt-like fixed income stream or by providing for a return on the maturity date of the note of an amount equal to not less than all, or not less than some lesser percentage of, the principal amount of the structured note. Such protections against downside risk are generally accompanied by the investor's giving up some potential of upside gain on the structured note, for instance by capping the note's possible increase in value. The upside exposure to the market measure can also be leveraged, in the sense that the return on the structured note can be a multiple of the change in

value of the market measure. This, however, may be coupled with a cap on any increase in value of the note and/or with accelerated downside exposure if the market measure loses value (or, in the case of a bear note, increases in value) over the term of the structured note.

The ways in which the performance of the market measure of a structured note is calculated may vary. The return on many structured notes is tied to the performance of the market measure over the entire term of the notes, and an investor's gain or loss on the note is based on the comparison of the value or level the market measure at the time of issuance against the value or level of the market measure at one or more points at or near maturity. Other types of structured notes, however, have a rate of return that either "knocks in" or "knocks out" at specified times during the term of the note, or is in some other way "path dependent" (*i.e.*, dependent upon the pattern of change in the value or level of the market measure during the tenor of the note rather than solely on the absolute change between issuance and maturity).

Structured notes may also provide exposure to underlying market measures that shift between two or more assets based upon an algorithm established at the time of issuance of the notes. Such a structure can, for instance, shift the asset allocation from a more volatile and higher risk (but potentially more profitable) asset (the "asset of interest") partially or fully into zero coupon U.S. Treasuries if the algorithm determines that this is necessary to assure that the value of the market measure, at maturity, will result in a payment equal to not less than the principal of the structured note. Alternatively, if the asset of interest performs well, the algorithm may cause the hypothetical portfolio represented by the market measure to sell Treasuries and borrow cash (the hypothetical interest on which will be applied to reduce the value of the market measure) for the purpose of leveraging up the exposure to the asset of interest.

Certain market measures (such as hedge fund returns) are not used in connection with publicly offered structured notes. These are generally measures that do not have adequate publicly available performance and other data, lack transparent and reliable pricing sources or have other features that give rise to disclosure issues. However, structured notes have been publicly offered that attempt to offer a return that is highly correlated to the return of such market measures by algorithmically shifting exposures between other common market measures based on a continuous, algorithmic look-back and analysis of historical correlations. Offering documents relating to such notes emphasize the transparency of the market measures to which the notes are actually linked, and the fact that the return on the notes will not be linked to the less transparent market measure.

Structured notes may have full, partial or no principal protection. Principal protection may be in the form of (i) an absolute minimum repayment or (ii) a promise to repay principal in full so long as the market measure does not decline below (or, in the case of bear notes, rise above) an indicated level (sometimes called the "buffer"). In the later case, if the market measure does fall below (or rise above) the buffer, principal may be lost on a leveraged basis. Publicly issued structured notes (and, in our experience, privately placed structured notes), even if leveraged on the down side, never provide for a possible loss greater than 100% of the principal amount of the note.

Market professionals often think of structured notes in terms of certain familiar financial instruments that the notes replicate; and this may provide helpful ways for others to understand or analyze these securities as well. For instance, a rather simple structured note might provide an investor with (a) a guaranteed return of its principal at maturity (for the illustration, we will assume that the note is purchased for a price equal to its \$1,000 principal amount) and (b) a possible additional return at maturity if the S&P 500 increases over the term of the note. This note can be seen as the economic equivalent of a purchase by the investor of (a) a deeply discounted, zero coupon note (for the illustration, we will say that the note is purchased for \$900) that will accrue original issue discount at a market rate that, when added to the \$900 purchase price, will result in a \$1,000 payment at maturity, and (b) a call option on the S&P 500 that the investor purchases for \$100 and that gives the investor the right to “buy” the S&P 500 upon the note’s maturity for the S&P 500’s “value” on the note’s issue date. On the structured note’s maturity date, this option may either be “in the money” (in which case the investor will receive an additional payment on the structured note at maturity), or expire worthless (in which case the investor will receive only the return of its principal on the structured note). Other structured notes, while often more complex, may be analyzed in similar ways.

The above discussion is intended only as a summary of the general varieties of structured notes that are currently marketed. Variations on these structures currently exist, and innovations on these structures continue to be made.

DISCLOSURE

Offering documents for structured notes contain (or incorporate by reference) all of the disclosure typical for offerings of debt securities, including information regarding the issuer of the structured note, as the investor will look to the credit of the issuer in connection with all payments due under the notes. In addition to this customary disclosure, offering documents for structured notes will include disclosure regarding the market measure to which the return on the notes will be linked.

General

Disclosure regarding all market measures generally include (a) a description of the market measure, (b) information regarding the historical performance of the market measure, (c) hypothetical examples of returns that would be produced by various changes in the market measure in light of other terms of the structured notes (with relevant terms including whether the notes are bearish or bullish, are leveraged or unleveraged, are principal protected to some degree or not at all, have a cap on the note’s return, or are path dependent due to knock-in, knock-out or other features), (d) the consequences of the market measure ceasing to be published or otherwise ceasing to exist, or undergoing a fundamental change (such as a stock split in the case of a stock based market measure, or a change in the way in which an equity index is calculated by its publisher), and (e) risk factors which are relevant to the market measure. Where the market measure is an index published by a third party, consideration should be given as to whether it is advisable to seek comments from the index publisher on the description of the index that will be included in the offering document for the structured notes.

Common Stock

Market measures which are common stocks of unaffiliated issuers, or baskets of such stocks, present special disclosure issues. If a company (which we will call “Company A”) offers its stock to investors, it must make extensive disclosure about its business, financial condition, business prospects and other matters. If another company (“Company B”) offers its structured notes to investors with a return linked to the performance of the stock of Company A, the principals of adequate disclosure would appear to require that investors in the structured note have access to the same information regarding Company A that they would receive if they purchased the stock of Company A directly. Company B, however, probably has no special access to information concerning Company A and, if it did, would be reluctant to accept liability for that information as a part of its own offering document.

In a no-action letter (available May 21, 1996) to Morgan Stanley & Co. Incorporated (the “Morgan Stanley No-Action Letter”), the Staff provided guidance as to disclosure that must be included by an issuer of a security when the security it issues is exchangeable for equity securities of another issuer, or for the cash value of such securities. The Staff noted that investors should have access to full and fair disclosure about the issuer of the underlying securities. However, the Morgan Stanley No-Action Letter states that where the issuer of the exchangeable securities and the issuer of the underlying securities are not affiliated, complete disclosure is not required to be included or incorporated by reference in the prospectus of the issuer of the exchangeable securities if there is sufficient market interest and publicly available information in respect of the issuer of the underlying securities. The Staff concluded that these criteria are met where the issuer of the underlying securities:

1. Has a class of equity securities registered under Section 12 of the 1934 Act; and
2. Is either:
 - (a) Eligible to use Form S-3 or F-3 under the 1933 Act for a primary offering of non-investment grade securities pursuant to General Instruction B.1 of such forms; or
 - (b) Meets the listing criteria that an issuer of the underlying securities would have to meet if the class of the exchangeable securities were to be listed on a national securities exchange as equity-linked securities.

Assuming these criteria are satisfied, the issuer of the exchangeable securities need only set forth abbreviated disclosure regarding the issuer of the underlying securities, including at least (i) a brief description of the business of the issuer of the underlying securities, (ii) disclosure about the availability of information with respect to the issuer of the underlying securities similar to that called for by Item 502(a) of Regulation S-K and (iii) information concerning the market price of the underlying securities similar to that called for by Item 201(a) of Regulation S-K. (This assumes, of course, that the issuer of the structured notes is not in possession of non-public, material information regarding the issuer of the underlying securities.)

If it did possess such information, general disclosure principals would require it to disclose the information in connection with the offering of any its securities linked to the underlying issuer.)¹

This guidance has been adopted by issuers of structured notes. Consequently, the disclosure standards for structured notes that are linked to or could result in payment of the equity of another company follow those set forth in the Morgan Stanley No-Action Letter. In practice, this means that a short description (normally only a paragraph or two) of the business of the underlying issuer, and historical price information, is set forth in the prospectus. A reference is also made to the availability of 1934 Act filings of the underlying issuer.

The common stock of issuers that do not meet the requirements of the Morgan Stanley No-Action Letter are not used (either individually, or as a part of baskets of stocks) as market measures in connection with publicly issued structured notes.

Equity Indices

Issuers and their counsel have concluded that the disclosure requirements articulated in the Morgan Stanley No-Action Letter are not applicable to broad based equity indices. Ultimately, this conclusion is based upon a view of what would be material to a reasonable investor. While it is reasonable to conclude that a reasonable investor would find information about a single company (or about a relatively small number of companies included in a “basket” of companies) to which the return on its structured note is linked to be material, market participants have concluded that a reasonable investor would not find information about each of the 500 companies included in the S&P 500 Index to be material when investing in a structured note linked to that index. In the latter case, the investor is seeking economic exposure to the broad movements in the U.S. stock market, and not to individual companies included in the index. Similarly, an investor in a structured note linked to the NIKKEI 225 is seeking exposure to the Japanese economy rather than to individual Japanese stocks. An investor also may be seeking exposure to a smaller market segment, such as the performance of energy or health care related stocks, and not to the performance of any particular stock or small group of stocks within that market segment. For structured securities linked to such indices, disclosure required by the Morgan Stanley No-Action Letter has not been included in offering documents. Instead, disclosure relates to the index itself, including information as to who calculates the index, how stocks are selected for the index, whether the index does or does not take into account dividends paid, whether the stocks included in the index may be changed and under what conditions, and other similar information.

The question as to whether a group of stocks is a “basket” (requiring the Morgan Stanley No-Action Letter disclosure) or an “index” (not requiring such disclosure), given an absence of clear guidance from the SEC, is often a matter of judgment. This decision should be made by professionals who are familiar with the law, with market practice and with detailed information about the proposed market measure. In the absence of bright lines for this determination, market

¹ If payment on the exchangeable securities may be made in shares of the underlying company, rather than in cash based on the value of such shares, the shares must have their own exemption from the registration requirements of the 1933 Act.

professionals have considered characteristics which include, but are not limited to, the following to be indicia of an “index.” The market measure:

- includes a large number of stocks;²
- is designed to measure the performance of a recognized market segment;
- has not been designed to out-perform the market; and
- is not subject to active management.

A market measure does not need to satisfy all relevant indicia to be deemed an “index.” Some of the indicia are more important than others, and factors other than those indicated above may be found important in a particular case. It is important to remember that the fundamental question is not the technical distinction between the words “index” and “basket,” but what disclosure would be material to a reasonable investor.

Risk Factors

In addition to customary risks relating to an issuer’s business, financial condition and outlook, offering documents for structured notes contain risk factors which relate to the investors’ economic exposure to the market measure. These risks vary widely between different market measures, and are often extensive. The drafting of risk factors for structured notes that are sufficiently informative to investors to protect the note issuer and underwriters often requires a dialogue between counsel and specialists with in-depth knowledge of the market measure, or who trade in the assets underlying the market measures.

OTHER CONSIDERATIONS

Limitations on Market Measures

As indicated above, a very large range of assets and economic indices have been used as market measures. However, certain market measures present special issues in connection with any public issuance of structured notes. For example, the Staff has informally taken the position that publicly offered structured notes should not be linked to the performance of one or more hedge funds. And although a relatively small number of public issues of credit-linked structured notes (notes linked to the performance of bond indices) have occurred (and although Sidley Austin is not aware that the Staff has objected to any credit-linked notes that have been issued), the Staff has raised special issues with respect to credit-linked notes in general (such as the public availability of the specific terms of the underlying instruments and the transparency of their pricing) that need to be carefully considered in connection with any proposed offering.

Other issues, beyond those relating to hedge funds and credit-linked notes, arise in connection with determining whether an asset or economic index is suitable as a market measure

² A great many structured securities have been issued linked to an “index” containing 50 or more stocks. However, certain market measures which include less than 50 stocks have also been treated as “indices.”

for structured notes, and any novel market measure should be discussed with knowledgeable counsel prior to its use.

1940 Act Issues

Structured notes are not intended to avoid investor protections that are provided by the 1940 Act (or other regulatory requirements). The Staff has in the past indicated that, where necessary to enforce the regulatory protections intended by the 1940 Act, it might find an “investment company” to exist even in the absence of a formal corporate or other legal structure that is typically associated with such companies. (Such an ephemeral entity has been referred to as an “ectoplasmic investment company.”) In the absence of such an “ectoplasmic theory,” an issuer of structured notes could, for example, hire a famous fund manager to manage a hypothetical stock portfolio, and link the return of its structured notes to the performance of this hypothetical, managed pool of assets, passing through, on a one for one basis, the profits and losses of the hypothetical pool. In this case, the investor would be subject to all of the risks of a direct investment in a mutual fund (plus the credit risk of the issuer of the structured note), but would receive none of the benefits of the regulatory structure that exists for the protection of investors in mutual funds.

Questions relating to whether a particular market measure might invite unfavorable regulatory scrutiny for running afoul of the 1940 Act are complicated, and should be reviewed by counsel familiar with both the formal and informal positions that have been taken by the Staff. In general, however, any market measure that involves some degree of active management on an ongoing basis, or that is designed to achieve an enhanced investment performance by periodic adjustments (even if pursuant to a pre-established algorithm) should be carefully considered for potential 1940 Act issues.

Commodity Exchange Act Issues

Structured notes having one or more payments indexed to the value, level, or rate of, or providing for the delivery of one or more commodities are termed “hybrid instruments” under the Commodity Exchange Act (the “CEA”). Hybrid instruments may qualify for an exclusion from substantive regulation under the CEA (except from the provisions that preempt state gaming and bucket shop laws) if they satisfy specified criteria. Without this exclusion, hybrid instruments could be subject to being recharacterized as commodity instruments that may be traded only on regulated futures exchanges. A structured note that is a hybrid instrument must be predominantly a security rather than a commodity interest instrument to qualify for the CEA exclusion. The “predominance test” is satisfied if (a) the issuer of the hybrid instrument receives payment in full of the purchase price of the instrument substantially contemporaneously with delivery, (b) the purchaser or holder of the hybrid instrument is not required to make any payment to the issuer in addition to the purchase price, whether as margin, settlement payment or otherwise, during the life of the instrument or at maturity, (c) the issuer of the hybrid instrument is not subject by the terms of the instrument to mark-to-market margining requirements and (d) the hybrid instrument is not marketed as a futures contract (or option on a futures contract) or commodity option.

The usual investor protections under the CEA that apply to investments in regulated commodity transactions do not apply to notes that are qualifying hybrid instruments.³ However, the customer protection rules under the federal securities laws apply to these notes.

To the extent the indexation depends on human adjustments on an ongoing basis, lawyers must examine whether the note is truly “indexed” for the purpose of qualifying for the CEA exclusion, or may be recharacterized as a commodity instrument subject to substantive regulation under the CEA by the Commodity Futures Trading Commission.

Private Placements

Market measures that are not suitable for use in connection with public offerings may, after considering the knowledge and sophistication of investors, be deemed suitable for use in connection with privately offered structured notes. For example, privately placed structured notes have been linked to less transparent “market measures,” and to securities that lack the transparency that would be required by the Morgan Stanley No-Action Letter. Even in respect of a market measure that is commonly used in public offerings, disclosure with respect to the market measures is often significantly reduced in private placements based upon a conclusion that it would not be material to the targeted investors. (For example, a description of what the S&P 500 measures, how it is calculated and how it has performed historically, may be judged unnecessary for certain large, sophisticated institutional investors.)

Private placements for structured notes are sometimes initiated by the investor, which is generally a large, institutional client that approaches an investment or commercial bank seeking the most favorable “bid,” or economic terms, for a note having a structure proposed by the investor. In such cases, investor representation letters (confirming that the investor approached the investment bank, that the investment bank may be in possession of adverse information, which may be confidential, regarding the requested market measure, and other matters) may be especially important to consider.

3(a)(2) Exempt Offerings

Commercial banks may offer structured notes in the form of certificates of deposit which are exempt from the registration requirements of the 1933 Act pursuant to Section 3(a)(2) of the Act, which exempts “any security issued or guaranteed by any bank.” The offering of such

³ However, in response to Congressional criticism that financial speculators were unduly influencing commodity prices, in 2009 the CFTC announced that it was revisiting the ability of traders, including commodity index funds and commodity-linked note issuers, to purchase or sell futures positions in excess of CFTC-set and exchange-set limits and whether to impose more restrictive limits. In August 2009, the CFTC rescinded relief that it had previously issued to two commodity index-tracking funds that allowed them to exceed agricultural commodity speculative position limits. The Chair of the CFTC publicly announced that “position limits promote market integrity by guarding against concentrated positions.” It is possible that the ability of an issuer to acquire futures positions to hedge against the risks incurred by its issuance of a commodity-linked structured note could be detrimentally affected if the CFTC or an exchange were to determine that such futures positions needed to be aggregated with speculative futures positions acquired by the issuer in other parts of its business or by entities owned or controlled by the issuer. An issuer’s inability to effectively manage the risks associated with its commodity-linked structured notes could limit the amount of notes issued.

securities involves issues that may be different from, or additional to, those discussed elsewhere in this chapter. For instance, although such offerings are exempt from registration with the SEC, we believe that most issuers do not issue certificates of deposit having terms that could not be publicly offered as securities registered under the 1933 Act. Many of these certificates of deposit have been principal protected, due in part to regulatory considerations. Any issuer offering 3(a)(2) exempt structured notes should consult banking and securities lawyers who are experienced in such offerings to better understand these and other important limitations and considerations.

Intellectual Property Issues

Structured notes are often linked to the performance of indices that have been created, calculated and published by parties (“index sponsors”) who have no involvement in the issuance or offering of the notes, and these index sponsors generally claim intellectual property rights in their indices. Prior to the issuance of structured notes linked to such an index, a determination should be made as to the advisability of entering into an agreement with the index sponsor in which the sponsor agrees, typically for a negotiated fee, to the use of its index in connection with the note offering. Such licensing agreements typically require the offering document for the structured notes to include language that the index sponsor believes to be protective of itself, such as the fact that the index sponsor is not involved in the note offering and has no responsibility to consider the interests of the note holders in connection with its calculation or continued maintenance of the index.

Usury Issues

Depending upon the terms of structured notes, they may have the potential to exceed (and perhaps significantly exceed) limitations on the payment of interest imposed by relevant state usury statutes, if such statutes were deemed to be applicable. Issuers of structured notes that provide for possible payments that would exceed these limits should agree for the benefit of note holders that they will not claim the benefit of any such statutes. Because of these agreements and other considerations (including the probable construction of certain usury statutes and equitable considerations), it is generally thought that a court would not set aside or limit payments otherwise due under the terms of the notes if an issuer did seek the benefit of a usury statute. (Whether a trustee in bankruptcy could have a greater chance of successfully challenging a claim as usurious may be less clear.) Some issuers of structured notes that may pay very high returns include in their disclosure document a risk factor with respect to the possible applicability of usury laws.

Tax Considerations

Because the terms of structured notes vary so widely, the U.S. federal tax implications of investing in such notes vary widely as well. In addition, the tax treatment of certain structured notes is uncertain. Depending upon the terms of the note, investors may be required to recognize current income from their structured note even though any return on the note will be paid only upon the note’s maturity. Issuers and underwriters of structured notes should consult with tax counsel knowledgeable about these types of securities products.

Other Matters

Due to the complexity of some structured notes, regulatory attention has been given to issues such as the suitability requirements for investors in such notes, and the adequacy of disclosure in related offering documents.⁴

Because structured notes are hybrid instruments that may involve aspects of different types of traditional securities, additional issues may arise regarding their correct regulatory treatment.

Because structured notes often raise issues under the Employee Retirement Income Security Act of 1974 (“ERISA”), which may require disclosure in the offering document, proposed structures should be reviewed with counsel familiar with both ERISA and structured note offerings.

BASIC DOCUMENTS

In practice, many structured notes are issued from an existing medium-term note program. As a result, certain of the core documents in relation to structured notes are analogous to those discussed in Chapter 6 (*Medium-Term Notes*) of this volume. These documents, as well as the documents set forth below, form a list of basic transaction documents for an offering of structured notes in the U.S. capital markets. Please refer to Appendix B (*Basic Documents for Securities Offerings in the U.S. Capital Markets*) of this volume, as well as the other volumes of *Accessing the U.S. Capital Markets*, for a further description of these documents.

1. Offering documents, which normally include the following:
 - Base offering document;
 - Product supplement;⁵ and

⁴ See, e.g., the NASD Notice to Members 05-59 (September 2005) and <http://www.icma-group.org/snotes.pdf>.

⁵ Most commonly, the general terms of a particular type of structured note are described in a product supplement to the base prospectus. This supplement will describe the terms of the security, and provide the relevant information concerning the particular market measure(s) (including, if applicable, the information required under the Morgan Stanley No-Action Letter). Depending on the nature of the market measure, historical performance may be included. There will also commonly be additional risk factors included in the supplement that detail risk inherent to the market measure and/or the structure of the security. The supplement will also contain any additional tax, regulatory or other disclosure that is not covered by the information contained in the base prospectus.

Because of the great variety of possible structured notes, frequent issuers often attempt to help investors understand the notes by categorizing them by common material terms, and giving distinctive names to these categories. For instance, all notes that have a leveraged, but capped, upside potential return, and that expose the investor to unlimited, unleveraged downside risk, have been categorized by one issuer as “Accelerated Return Notes,” or “ARNs.” The terms that are expected to be common to all of that issuer’s ARNs may then be set out in an “ARN Product Supplement.” The terms of a specific issue of ARNs that may vary, such as the maturity date of the notes and the relevant market measure, are then contained in a term sheet (or “free writing prospectus”). If a note structure such as an ARN is frequently linked to one of an identifiable group of market

(continued)

- Free writing prospectus/term sheet.
2. Indenture or issuing and paying agent agreement.
 3. Closing documents.⁶

indices, a fourth offering document, sometimes called an “Index Supplement,” may be used. In this case, the term sheet will not contain a description of the market measure and the risk factors relevant to that market measure, but instead will cross-reference to the relevant section of the Index Supplement.

⁶ Since most structured notes are issued pursuant to an issuer’s medium-term note program, supplemental closing documents such as legal opinions, comfort letters, officer’s certificates may not be required.

CHAPTER 8

COMMERCIAL PAPER

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GENERAL

Commercial paper is a term used to describe short-term promissory notes with a fixed maturity that are rated investment grade and sold almost exclusively to institutional investors. Commercial paper notes are bearer or book-entry securities normally issued in minimum denominations of U.S.\$100,000, although denominations as low as \$25,000 are available from some issuers. While commercial paper can have maturities of nine months or less, the average maturity for commercial paper is about 30 days.¹ The U.S. commercial paper market is primarily a U.S. dollar market, although U.S. commercial paper programs have been established that permit issuances in other currencies.

Traditionally, issuers in the U.S. commercial paper market have been high credit quality borrowers, although credit enhancement devices such as bank letters of credit and over collateralization have allowed other borrowers to gain access to this market. Commercial paper is normally sold at a discount from the face or principal amount specified on the commercial paper note, with the discount representing an interest component to be paid to investors at maturity.

Commercial paper represents a relatively low-cost method of borrowing. Documentation for establishing most types of U.S. commercial paper programs has become fairly standardized. For standardized U.S. commercial paper documents, see <http://www.sifma.org/standardforms>, which also contains a link to a global commercial paper dealer agreement. The International Capital Market Association and the Issuing and Paying Agent Association have published their joint recommendation on market conventions for commercial paper, which can be found at <http://www.icmagroup.org/ICMAGroup/files/82/829bf741-990a-4b0e-8216-8c8d28e380b3.PDF>. Furthermore, the disclosure requirements for commercial paper are generally not onerous. Since commercial paper offerings are not registered under the 1933 Act, no particular disclosure is required by the 1933 Act and, in a market that trades primarily on the basis of yield and credit rating, only the most basic business and financial information about the issuer (or credit enhancer) is ordinarily necessary for marketing purposes.

Commercial paper programs provide a flexible alternative to bank financing. Unlike bank borrowing facilities, which often require advance notification, a commercial paper program

¹ See data published by the Federal Reserve at www.federalreserve.gov/releases/CP/about.htm. So-called “Section 4(2) commercial paper” can have maturities of 397 days or less.

ordinarily allows an issuer to issue commercial paper with a call to its commercial paper dealers during the morning of the day on which it needs the funds. Orders in the U.S. commercial paper market are usually filled between 8:00 a.m. and 12:00 noon, New York City time (the normal trading hours for most U.S. commercial paper), and issued and delivered by 3:00 p.m. on that day. Commercial paper is generally issued in book-entry form, settles in same day funds and is paid at maturity in same day funds.

Legal considerations that an issuer should take into account when deciding upon the structure of a U.S. commercial paper program are set forth below. In order to obtain the best structure for marketing and legal purposes, an issuer should work closely with its commercial paper dealers and legal counsel.

For a discussion of asset-backed commercial paper, see Chapter 10 (*Asset Backed Securities*) of this volume.

In recent years, many issuers have established programs for issuing both commercial paper and extendible notes, which are described in Chapter 9 (*Extendible Notes*) of this volume.

1933 ACT CONSIDERATIONS

The inconvenience and expense of registering securities whose average maturity is about 30 days makes registration under the 1933 Act impractical. Accordingly, commercial paper sold in the U.S. capital markets is sold pursuant to an available exemption from the registration requirements of the 1933 Act. There are three exemptions commonly used when commercial paper is sold in the U.S. capital markets: Section 3(a)(3), Section 3(a)(2) and Section 4(2). Commercial paper sold pursuant to any of these exemptions generally is not a security under the 1934 Act and is exempt from the indenture qualification requirements of the 1939 Act.

Section 3(a)(3) Commercial Paper

Section 3(a)(3) is known as the commercial paper exemption under the 1933 Act. In recognition of the impracticality of registering commercial paper, the U.S. Congress exempted from registration commercial paper that satisfies two criteria:

- (1) the commercial paper must mature in nine months or less (excluding days of grace); and
- (2) the proceeds of the sale of the commercial paper must be used to finance “current transactions.”

Since the adoption of the 1933 Act, the SEC has imposed a number of additional requirements for commercial paper to qualify for the Section 3(a)(3) exemption.² The commercial paper must not be payable on demand or subject to automatic rollover. It must be of prime quality, which is normally evidenced by an investment grade rating from at least one U.S.

² See SEC No. Release 33-4412 (September 20, 1961) (<http://www.content.lawyerlinks.com/sec/33-4412.htm>).

nationally recognized rating agency.³ Finally, it must not be of a type ordinarily purchased by the general public. This requirement is normally satisfied by selling commercial paper in large denominations (normally U.S.\$100,000 or more) and only to institutions, corporate investors and substantial individual investors of a type that normally participate in the U.S. commercial paper market. The SEC, however, has permitted limited advertisements from time to time relating to commercial paper programs.⁴

The “current transaction” test is the most important requirement of Section 3(a)(3), though the SEC has generally interpreted this test quite broadly. In applying the current transaction test, tracing of proceeds is not required. It is sufficient if an issuer, on a consolidated basis, has current assets and operating expenses for the previous 12 months in an amount equal to or exceeding the amount of its outstanding commercial paper. When the foreign private issuer raises funds by issuing commercial paper through a finance subsidiary (as discussed below), the current transaction test is still applied to the issuer on a consolidated basis.

In determining whether its issuance of commercial paper would satisfy the current transaction test, an issuer should consult experienced U.S. legal counsel. Through the issuance of no-action letters, the SEC has indicated that the following activities satisfy the current transaction test, depending upon (among other things) the maturity of the financed activity involved:

- (1) financing inventories and accounts receivable by industrial or commercial enterprises;
- (2) payment of operating expenses (such as rent, taxes, payroll, etc.) incurred during the preceding 12 months;
- (3) financing receivables of finance companies;
- (4) financing bank activities such as loans having five years or less remaining until maturity and carrying longer-term loans pending their packaging and sale in the form of mortgage-backed securities;
- (5) financing of leasing and related assets;
- (6) financing insurance operations for such purposes as bridging short-term timing differences;
- (7) investments in money market obligations;
- (8) interim construction financing; and

³ If a commercial paper issuer defaults on its commercial paper, a court may well apply hindsight and hold that the obligations could not possibly have been of prime quality regardless of the rating. On the other hand, in appropriate cases, the Staff has been willing to agree that the Section 3(a)(3) exemption is available even though the commercial paper was not rated.

⁴ See, e.g., SEC No-Action Letter General Electric Capital Corporation, available July 13, 1994.

- (9) financing public utility assets such as utility receivables and fuel inventory.

Section 3(a)(2) Commercial Paper

Section 3(a)(2) provides another possible 1933 Act exemption for commercial paper issuers. An issuer can issue commercial paper pursuant to the Section 3(a)(2) exemption in two circumstances:

- (1) if it is a bank and issues debt securities (including deposits) through a regulated U.S. branch or agency; or
- (2) if its commercial paper is unconditionally supported by a letter of credit issued by a U.S. bank or a U.S. branch or agency of a non-U.S. bank whose securities are exempt pursuant to Section 3(a)(2).

Although not required by Section 3(a)(2), Section 3(a)(2) commercial paper, for marketing reasons, has the same terms and is generally sold in the same manner as Section 3(a)(3) commercial paper. In the case of letter of credit-backed Section 3(a)(2) commercial paper, the commercial paper investor is given additional security in the form of the bank letters of credit that back the commercial paper. These letters of credit are usually direct-pay (*i.e.*, the letter of credit bank pays holders of maturing commercial paper and the issuer reimburses the letter of credit bank through a reimbursement agreement).⁵

Commercial paper backed by a Section 3(a)(2) letter of credit provides a number of advantages, including the following:

- (1) it allows the issuer and, in the case of a finance subsidiary, the parent to avoid having to go through the process of obtaining a rating from one or more U.S. nationally recognized rating agencies — the commercial paper notes will carry the credit rating of the letter of credit bank.
- (2) the terms of the commercial paper do not have to comply with the requirements of Section 3(a)(3). Among other things, this allows the issuer or, in the case of a finance subsidiary, the parent and its subsidiaries to use the commercial paper

⁵ These documents are required in the case of a Section 3(a)(2) letter of credit-backed commercial paper program. Although separate letters of credit can be attached to each commercial paper note, it is more convenient to have a master letter of credit that covers all of an issuer's commercial paper. The letter of credit is an unconditional obligation of the issuing bank to pay out of its own funds maturing commercial paper. It is now virtually universal that all letters of credit are direct-pay (*i.e.*, the letter of credit bank pays the commercial paper holders and the issuer or the issuer's parent reimburses the letter of credit bank pursuant to the reimbursement agreement). The other type of letter of credit is a stand-by letter of credit. Under a stand-by letter of credit, the letter of credit bank must pay only in the event that the issuer does not. Due to the short-term nature of commercial paper and the timeliness with which commercial paper investors expect to receive their money, a stand-by letter of credit is not as desirable to investors as a direct-pay letter of credit. The reimbursement agreement is a matter of negotiation between the issuer or its parent and the letter of credit bank. It should be regarded as another liquidity agreement and negotiated accordingly. Some reimbursement agreements provide a loan facility as well in the event that the issuer cannot access the commercial paper market to repay maturing obligations.

proceeds for purposes other than “current transactions,” including acquisitions of other corporations either directly or through the repayment of bank indebtedness incurred for that purpose. Such commercial paper is not ordinarily eligible for the Section 3(a)(3) exemption.

- (3) although the disclosure customarily found in offering memoranda for commercial paper is not onerous, disclosure about the issuer and, if a finance subsidiary, the parent can be minimized since the investor is primarily concerned with the financial condition of the letter of credit bank.
- (4) some operating companies cannot obtain a sufficient credit rating for the U.S. commercial paper market. Other issuers have been set up as special purpose vehicles to acquire assets from their parent or another issuer, or as an arbitrage vehicle. In both those situations, a letter of credit is used to obtain the rating needed to sell the commercial paper.

The disadvantages of Section 3(a)(2) letter of credit-backed commercial paper include:

- (1) the transaction costs are higher due to increased documentation for the letter of credit and related reimbursement agreement and increased fees that the issuer must pay to the letter of credit bank and to the issuing and paying agent as depository for the letter of credit;
- (2) the issuer’s cost of funding under a letter of credit-backed commercial paper program is dependent upon the credit quality of the letter of credit bank. Also, as the number of highly rated banks qualified to issue letters of credit has declined, the remaining letter of credit banks may be more selective or require higher compensation;
- (3) because a letter of credit bank usually limits its obligation to cover commercial paper (*i.e.*, the letter of credit commitment is usually one to three years), the issuer has to be prepared to renegotiate the letter of credit and reimbursement arrangements on a periodic basis;
- (4) because investors are most concerned about the credit quality of the letter of credit bank, a letter of credit-backed commercial paper program is not as effective as a Section 3(a)(3) commercial paper program in introducing the issuer or, in the case of a finance subsidiary, the parent to U.S. investors; and
- (5) letters of credit issued by non-U.S. banks do not qualify for an automatic exemption from the blue sky laws of several states in the United States. In such states, the dealers will be limited to institutional sales.

Section 4(2) Commercial Paper

Commercial paper that does not satisfy the Section 3(a)(3) requirements and is not backed by bank letters of credit may nevertheless be privately placed pursuant to Section 4(2) or Regulation D. Even if the commercial paper is eligible for exemption under Section 3(a)(3) or

3(a)(2), the commercial paper may have to be sold privately if, for example, the issuer is trying to take advantage of the private investment company exemption from the 1940 Act.

Like Section 3(a)(2) commercial paper, the terms of Section 4(2) commercial paper, for marketing reasons, are similar to those for Section 3(a)(3) commercial paper, except that Section 4(2) commercial paper programs typically permit the issuance of notes with maturities to 397 days. However, the offering procedures for Section 4(2) commercial paper differ in order to qualify for the private placement exemption.

The advantages of Section 4(2) commercial paper include:

- (1) like Section 3(a)(2) letter of credit-backed commercial paper, Section 4(2) commercial paper does not have to comply with the requirements of Section 3(a)(3) (particularly the current transactions requirement). If an issuer, either on its own or with the support of its parent, does not require the credit support of a letter of credit and is willing to go through the rating agency process, it can issue commercial paper for such purposes as acquisition funding;
- (2) Section 4(2) commercial paper allows an issuer to access the U.S. commercial paper market when the issuer or, in the case of a finance subsidiary, the parent has difficulty finding an exemption to the 1940 Act and is required to utilize the exemption afforded to private investment companies by Section 3(c)(1) or Section 3(c)(7); and
- (3) like Section 3(a)(3) commercial paper, Section 4(2) commercial paper is a better vehicle than Section 3(a)(2) letter of credit-backed commercial paper for informing the market about the issuer or, in the case of a finance subsidiary, the parent. Investors in Section 4(2) commercial paper look at the issuer's or parent's credit and not that of the letter of credit bank.

The disadvantages of Section 4(2) commercial paper include:

- (1) Section 4(2) commercial paper, unlike the other types, is subject to resale restrictions. Because the U.S. commercial paper market and the U.S. institutional accredited investor market overlap to a large degree, this should not be a major problem for an issuer in the normal course. Furthermore, the short maturities of commercial paper diminish the need for an unrestricted secondary market;
- (2) if Rule 144A eligibility is desired, the issuer and, in the case of a guaranteed finance subsidiary, the parent will have to provide secondary market purchasers with Rule 144A information unless the issuer or the guarantor is a reporting company under the 1934 Act or publishes information pursuant to Rule 12g3-2(b); and
- (3) if an issuer issues commercial paper to finance the purchase of securities, the dealers need to be informed and special procedures need to be followed in order to

comply with Regulation T.⁶ This issue often arises in the case of structured financings where the issuer's primary assets are mortgages or other financial assets.

SALES THROUGH A FINANCE SUBSIDIARY

Many recent U.S. commercial paper programs established by non-U.S. issuers have used a U.S. finance subsidiary to issue the commercial paper with an unconditional guarantee or support agreement of the parent backing the subsidiary's obligation. The proceeds are advanced to the parent or to the parent's operating subsidiaries. As discussed in the other volumes of *Accessing the U.S. Capital Markets*, special purpose U.S. finance subsidiaries are used primarily for marketing purposes, in that certain institutional investors are limited by corporate policy or otherwise in the amount of securities issued by non-U.S. issuers that they may purchase.⁷

Commercial paper gives non-U.S. issuers the most flexibility when choosing a 1940 Act exemption for their finance subsidiary:

- (1) Rule 3a-5 gives a foreign private issuer that guarantees the commercial paper of its U.S. finance subsidiary the ability to issue conventional Section 3(a)(3) commercial paper provided the other requirements of the rule are satisfied, including the requirement that 85% of the subsidiary's borrowings be loaned to its parent or subsidiaries thereof (and that neither the parent nor subsidiaries receiving proceeds be investment companies or certain types of entities excepted from the 1940 Act). If the parent company is a "foreign bank" under Rule 3a-6 under the 1940 Act, a letter of credit meeting certain prescribed conditions may be used as credit enhancement instead of a guarantee. In other situations, such as where a parent wishes to use a support agreement, Rule 3a-5 may be used but the offering must be limited to a private placement in accordance with Section 4(2) of, or Regulation D under, the 1933 Act;
- (2) Rule 3a-3 allows the U.S. finance subsidiary of an operating company to issue Section 3(a)(3) commercial paper without a parent guarantee. However, Rule 3a-3 effectively limits the securities activities of the U.S. finance subsidiary to commercial paper. Section 3(b)(3) of the 1940 Act contains a similar exemption;
- (3) Rule 3a-7 exempts any U.S. finance subsidiary in the business of acquiring and holding virtually any type of asset that can be securitized (except equity securities), provided the subsidiary satisfies conditions adopted by the SEC to protect investors;

⁶ Regulation T governs securities credit extended or arranged by broker-dealers to purchase or carry securities. Pursuant to Regulation T, as interpreted by the Federal Reserve Board, the purchase by a commercial paper dealer of privately placed securities issued to finance the purchase of securities would constitute extending purpose credit and would be subject to the restrictions of Regulation T. (Federal Reserve Board Staff Opinion of December 11, 1984, reprinted in *Federal Reserve Regulatory Service* ¶5-606.4.) However, an exception for Rule 144A resales was announced by the Federal Reserve Board on July 18, 1990.

⁷ For further information on finance subsidiaries, see Chapter 10 (*Finance Subsidiaries*) of the other volumes of *Accessing the U.S. Capital Markets*.

- (4) Section 3(c)(1) limits the U.S. finance subsidiary to private placements pursuant to Section 4(2). Although Section 3(c)(1) allows the U.S. finance subsidiary to issue securities other than commercial paper, it limits to 100 the number of investors (including its non-U.S. parent) who at any one time may hold its outstanding securities (other than commercial paper). Section 3(c)(1) is a useful alternative to Rule 3a-5 if the U.S. finance subsidiary cannot meet all the requirements of that rule. Once again, with respect to securities other than commercial paper issued by the U.S. finance subsidiary, the Section 3(c)(1) attribution rules should be kept in mind;
- (5) Section 3(c)(5)(A) or (B) exempts traditional sales finance companies that are subsidiaries of U.S. or non-U.S. parents; and
- (6) Section 3(c)(7) exempts any issuer whose securities are privately offered and are beneficially owned exclusively by one or more persons who, at the time of the acquisition, are “qualified purchasers.”

BASIC DOCUMENTS

Set forth below is a list of basic transaction documents for an offering of commercial paper into the U.S. capital markets. These documents have become largely standardized. Please refer to Appendix B (*Basic Documents for Securities Offerings in the U.S. Capital Markets*) of this volume, as well as the other volumes of *Accessing the U.S. Capital Markets*, for a further description of these documents.

1. Offering document.⁸
2. Dealer agreement (the convention is for the issuer to enter into a separate dealer agreement with each dealer).
3. Issuing and paying agency agreement.
4. Commercial paper notes.⁹
5. Letter of credit and reimbursement agreement.¹⁰
6. DTC letter of representations.

⁸ Commercial paper offering documents are generally only a few pages, unless they are being delivered in connection with a structured commercial paper program. The documentation usually contains a brief description of the commercial paper and the use of proceeds, along with a few pages describing the issuer and, if the issuer is a U.S. finance subsidiary, its non-U.S. parent. Selling restrictions and legends are described in the case of Section 4(2) commercial paper. A description of the letter of credit bank, including summary financial information, is normally provided for Section 3(a)(2) commercial paper.

⁹ If the notes are issuable in book-entry form, there will normally be master notes provided by DTC, and the issuing and paying agent updates its records each time there is a sale or retirement of notes.

¹⁰ Used for Section 3(a)(2) letter-of-credit-backed commercial paper.

7. Legal opinion(s).
8. Other closing documents.

CHAPTER 9

EXTENDIBLE NOTES

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GENERAL

Extendible notes are short-term promissory notes that typically have an initial maturity of up to 397 calendar days from the trade date and can be extended at the option of the investor, usually for periods of one year for up to a total of five years. Extendible notes are rated investment grade and sold almost exclusively to institutional investors and primarily to money market funds.¹ Typically, the interest rate to the investor increases with each election to extend. In some cases, the broker-dealer that sells the extendible notes to the investor receives additional compensation if the investor elects to extend.² The fact that the notes are extendible at the option of the investor means that extendible notes have greater appeal for issuers that maintain substantial portfolios of liquid assets that can be sold as necessary to pay maturing notes should investors choose not to extend their notes.³

Extendible notes provide a flexible alternative to bank financing. Extendible notes typically are book-entry securities issued in minimum denominations of U.S.\$250,000.

¹ To this end, the SEC has issued a Money Market Reform release (SEC Release No. IC-28807 (June 30, 2009) (<http://www.sec.gov/rules/proposed/2009/ic-28807.pdf>)) containing proposed rules that, if adopted, could impact investments made by money market funds.

² Generally, the issuer and the dealer will enter into a separate letter agreement providing for the rebate of a portion of the dealer's fees for notes that investors have elected not to extend on any election date. The amount of this rebate will typically decrease the longer the notes remain outstanding.

³ Since mid-2008, as a result of global financial conditions, the issuance of extendible notes has fallen dramatically, primarily due to the shift toward shorter term investments by U.S. money market funds, the primary investors in extendible notes. In their place, the market has seen the growth of debt securities that are puttable, typically on a monthly basis, by the investor back to the issuer. The interest rate spread over LIBOR on puttable securities, like the interest rate spread on extendible securities, increases the longer the investor holds the securities, thus incentivizing investors to hold the securities longer. However, unlike extendible securities, which have a maturity of 397 days or less that can be extended on a monthly or quarterly basis, puttable securities typically have a final maturity of longer than 397 days that may be shortened by the put. For a consideration of certain original issue discount ("OID") tax considerations in connection with the issuance of extendible notes and puttable securities, see the discussion of OID in *Appendix B: Tax Considerations for Non-U.S. Issuers Accessing the U.S. Capital Markets* under the heading "Original Issue Discount" (which applies to both U.S. and non-U.S. issuers).

Extendible notes normally are sold at par value, pay interest on a monthly or quarterly basis, settle in same day funds and are paid at maturity in same day funds.

To date, issuers of extendible notes have been high credit quality borrowers. This is largely because Rule 2a-7 compliant U.S. money market funds, which make up the bulk of the investors in the extendible notes market, can only invest in those securities with a maturity of 397 calendar days or less that are rated in the two highest short-term ratings categories (or the equivalent thereof as determined by the fund's board of directors).⁴ As money market funds can only invest in U.S. dollar-denominated securities (as defined in Rule 2a-7), the extendible note market is a U.S. dollar market.

Extendible notes represent a relatively low-cost method of borrowing. Documentation for establishing extendible note programs or issuing extendible notes on a stand-alone basis has become fairly standardized. Furthermore, the disclosure requirements for extendible notes are generally not onerous. Since extendible note offerings are typically not registered under the 1933 Act, no particular disclosure is required by the 1933 Act and, in a market that trades primarily on the basis of yield and credit rating, only the most basic business and financial information about the issuer is ordinarily necessary for marketing purposes and is typically referred to, but not incorporated by reference in, the extendible notes offering documentation.

Financial issuers, particularly financial institutions seeking access to funding in the U.S. market, securities firms and finance companies are the most frequent issuers in the extendible notes market.

Legal considerations that an issuer should take into account when deciding upon the structure of an extendible note program and/or an offering are set forth below. In order to obtain the best structure for marketing and legal purposes, an issuer should work closely with its financial advisors and legal counsel.

EXTENDIBLE NOTE MECHANICS

Election Dates

The election dates will be specified in the offering documentation. On each election date, investors may choose to extend the maturity date of their notes. Investors may choose to extend only a portion of the notes, provided such portion is in a minimum denomination specified in the offering documentation (usually at least U.S.\$250,000 and integral amounts of U.S.\$1,000 in excess thereof).

Once an election is made to extend, the new maturity date will be the date occurring 366 calendar days from and including the date specified in the offering documentation of the next succeeding month following the election date. For example, if the extendible note has an election date in September 2009, and an investor holding such notes elects to extend, the new maturity date for such notes will occur in October 2010. The maturity of the notes cannot be

⁴ See Rule 2a-7(a)(10) and (c)(2)-(3) under the 1940 Act.

extended beyond the final maturity date specified in the offering documents. These provisions are designed to enable money market funds that must hold Rule 2a-7 eligible securities to invest in these securities.

If an investor elects not to extend the maturity date of the notes on an election date, then the principal amount of such non-extended notes will be due and payable on the initial maturity date or any later date to which the maturity date has been previously extended. For example, if an investor holding extendible notes with an initial maturity date of September 1, 2009, elects not to extend its notes on the first election date, then the maturity date for the non-extended notes will be the initial maturity date of September 1, 2009. Failure to extend the maturity date of a note is irrevocable and binding upon subsequent holders of the note.

Election dates usually occur on a monthly or quarterly basis, and the timing of election dates does not need to correlate with the timing of interest payment dates. For example, an extendible note can have quarterly election dates coupled with monthly interest payments.

The principal amount of any non-extended notes will be represented by a substitute non-extendible note. This substitute non-extendible note will have the same terms as the extendible notes, except that it will not be extendible and will have a separate CUSIP number. At the outset of each extendible notes offering, it is important to ensure that sufficient CUSIP numbers are reserved to account for all possible non-extensions throughout the life of the notes.

Notice Requirements

An investor in extendible notes must deliver a notice of its election to extend its notes to the issuing and paying agent during a specified “notice period.” This notice period usually begins five days before the election date and ends at 12:00 noon (typically, New York City time) on the election date. An extension election notice delivered during the notice period is revocable until the end of the notice period, after which time it becomes irrevocable.

Notice of an election to extend must be delivered to the issuing and paying agent through the Depository. Since most extendible notes are deposited with DTC, each investor should familiarize itself with the notice procedures and timing requirements of the DTC participant through which it holds its interest in the notes to ensure that timely notice can be provided to DTC in order for DTC to provide notice to the issuing and paying agent before the end of the notice period.

Interest Calculation

Interest is typically calculated on a monthly or quarterly basis. The method of interest rate calculation and the relevant benchmark will be specified in the offering materials.

The interest rate is usually based on one-month U.S. dollar based LIBOR (for notes with monthly interest payments) or three-month LIBOR (for notes with quarterly interest payments), plus a “spread” specified in the offering materials that typically increases the longer the notes are held.

Listing

While there is typically very little trading of extendible notes in the secondary market, certain non-U.S. issuers of extendible notes may desire to have the notes listed on an exchange, especially where listing the notes may help the issuer avoid the application of withholding taxes on interest payments to investors. Typical listing venues include London, Singapore and Luxembourg and there are local law firms in each of these countries that are familiar with extendible note listings. Many issuers listing extendible notes will also want to list the non-extended notes that are issued when investors elect not to extend the maturity of their notes. In this regard, it is useful to speak to the applicable exchange at the outset of a transaction or a program to determine the timing and manner of the listing of such notes on the applicable exchange.

1933 ACT CONSIDERATIONS

Extendible notes sold in the U.S. capital markets are typically sold pursuant to the Section 4(2) exemption from the registration requirements of the 1933 Act. Extendible notes sold pursuant to this exemption are also exempt from the registration requirements of the 1934 Act and the indenture qualification requirements of the 1939 Act.

Upon a failure to elect to extend the maturity of an extendible note, a new non-extended note is issued. For purposes of the 1933 Act, this new note should be considered a separate security, and thus the issuer should ensure the placement of the new non-extendible note at the time it is issued (which, in essence, is to then-holder of the prior extendible note) complies with Section 4(2) or another exemption from the registration requirements of the 1933 Act.

1940 ACT CONSIDERATIONS

An issuer that intends to offer extendible notes in the U.S. capital markets, either directly or through a U.S. finance subsidiary, should ensure that experienced U.S. counsel analyze whether the issuer is an investment company within the meaning of the 1940 Act, as well as the terms of the notes.

The primary investors in the extendible note market are U.S. money market funds that must hold securities permitted by Rule 2a-7 under the 1940 Act. One implication of this in the extendible notes arena is that there can be no grace period for defaults by an issuer on payment of principal. A number of the leading money market funds are favoring either no grace period or, in appropriate circumstances, a nominal grace period for defaults in the payment of interest. Depending on the features of the security offered, it is possible that grace periods on either principal or interest payments will be prohibited under Rule 2a-7.

An investor in extendible notes can elect to extend the maturity of all or a part of those notes beyond the initial maturity date on certain election dates. The election dates are specified in the offering memorandum or applicable pricing supplement, and the dates typically occur on a monthly or quarterly basis. In no event will any such election to extend result in a maturity that is greater than 397 calendar days from the trade or applicable election date.

If an investor chooses not to extend the maturity of the extendible notes, and the terms of the transaction so provide, the issuer can redeem all or part of the non-extended notes at a contingent redemption price included in the offering memorandum or applicable pricing supplement. Investors should be aware that, in the case of an unanticipated early redemption, they may be unable to receive a return of the amortized cost of their investment as required under Rule 2a-7.

BLUE SKY LAW CONSIDERATIONS

Due to the institutional nature of investors in the extendible note market, compliance with the securities laws of the various U.S. states and territories for extendible note offerings usually involves little effort. See the discussion of “Blue Sky’ or State Securities Laws” in “*Overview of U.S. Securities Regulators and Laws*” in the other volumes of *Accessing the U.S. Capital Markets*.

BASIC DOCUMENTS

Set forth below is a list of basic transaction documents for an offering of extendible notes in the U.S. capital markets. Please refer to Appendix B (*Basic Documents for Securities Offerings in the U.S. Capital Markets*) of this volume, as well as the other volumes of *Accessing the U.S. Capital Markets*, for a further description of these documents.

1. Offering memorandum.
2. Pricing supplement/term sheet.
3. Dealer agreement.
4. Terms agreement.
5. Issuing and paying agency agreement.
6. Calculation agency agreement.
7. Extendible notes master note.⁵
8. Form of non-extendible note.
9. DTC letter of representations.
10. Legal opinions.
11. Other closing documents.

⁵ Extendible notes are typically represented by a Master Note that follows a standard form. It represents an obligation to pay a specified amount on a particular date. In the event the notes are guaranteed, that fact is noted. If the notes are privately placed pursuant to Section 4(2), they will bear a restrictive legend as described above.

CHAPTER 10

ASSET-BACKED SECURITIES

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GENERAL

Asset-backed securities are securities the payments on which are derived primarily from the cash flow generated by a pool of assets. The underlying assets are usually financial assets, such as mortgage loans or credit card receivables, which by their terms require payments on a regular basis. The more common asset-backed securities are similar to amortizing debt securities in that interest is payable on a periodic basis and principal is paid from time to time, depending on the structure of the security.

A company holding a portfolio of receivables may wish to securitize them for a number of reasons. It may need the liquidity provided by the sale proceeds, it may want to improve its balance sheet by applying the sale proceeds to pay down debt, it may want to generate earnings or, if it is a regulated entity such as a bank, it may want to remove assets from its balance sheet against which it would otherwise have to maintain regulatory capital. Through securitization, the company can isolate the value of the portfolio of receivables from its credit risk, thereby significantly reducing the cost of funding those assets. In addition, many companies securitize assets to diversify the types of available funding.

Characteristics of Asset-Backed Securities

One major feature of asset-backed securities that sets them apart from other debt securities is that the timing of the payments of principal of an asset-backed security is often unpredictable because it depends upon the timing of collections of principal (or cash flow treated as principal) of the underlying assets, which itself is inherently unpredictable. Another differentiating feature is that the issuer of asset-backed securities is normally not an actively managed entity for which a balance sheet and income statement are relevant to an investment decision. The issuer is instead a passive entity that merely owns the underlying assets and contracts with a third party to collect the cash flows due on those assets.

Prior to the adoption of Regulation AB (17 CFR 229.1100, *et seq.*), which became effective January 1, 2006, most U.S. securities law issues relating specifically to asset-backed securities arose from the fact that the basic framework of the U.S. securities laws, having been developed prior to the development of asset-backed securities, was designed to accommodate offerings of debt obligations and equity securities of corporations and other entities that are actively managed. In contrast, the essential elements of an asset-backed security are (i) the

nature and quality of the underlying assets, (ii) the timing of the receipt of the cash flows from those assets and (iii) the structure for distributing those cash flows to the securityholders. Regulation AB codifies the various positions taken by the Staff that rationalized the application of the U.S. securities laws to asset-backed securities and their unique disclosure requirements. In some cases, Regulation AB creates new registration, disclosure and reporting requirements.

Common to almost all securitizations is the legal separation of the credit risk of the cash flow of the assets being securitized from the credit risk of the company that initially holds those assets, with the result that the credit rating of the asset-backed securities is primarily based on the creditworthiness of those assets and the legal structure of the securitization and is not affected by the financial condition of the company. A principal structural feature of a securitization is that if the company becomes subject to the insolvency laws of its jurisdiction, the transfer of the assets from the company into the securitization vehicle must be a “true sale” (*i.e.*, a transfer that removes the assets from the bankruptcy estate of the company).

Basic Structure of an Asset-Backed Transaction

In a typical U.S. securitization, the originator of the assets, which usually continues to service the assets (the “Originator/Servicer”), sells or contributes the assets to a wholly-owned “bankruptcy remote” subsidiary (the “Depositor”), which in turn transfers the assets to a special purpose vehicle (an “Issuing Entity”), which issues the asset-backed securities. In a typical U.S. securitization, the Issuing Entity is often a trust. The asset-backed securities are simultaneously sold to investors with the net proceeds going to the Depositor. The Depositor in turn uses the net proceeds to pay the Originator/Servicer for the purchased assets. In a non-U.S. securitization, the Originator/Servicer often transfers the receivables directly to the Issuing Entity. The Issuing Entity is often a corporation, though in certain countries it may be a trust.

In a securitization, collections on the assets are applied to make distributions of interest and principal on the asset-backed securities. Many securitizations have multiple classes of securities (known as “tranches”). Tranching may be used to create classes with different maturities or to create internal credit enhancement for a transaction by subordinating one or more classes to other classes. Classes of asset-backed securities may be structured to pay interest only or principal only or to defer the distribution of interest by adding accrued interest to the principal balance for some period of time. This flexibility allows investment bankers to structure classes specifically addressing the needs of investors.

Synthetic Securitizations

In the basic securitization described above (often called a “cash flow securitization”), the cash flow producing assets that support the securitization are actually transferred to an Issuing Entity. In a synthetic securitization, there is no such transfer. In one commonly used synthetic securitization structure, the Issuing Entity enters into a credit default swap with a counterparty under which the Issuing Entity (referred to in this capacity as a “protection seller”) synthetically assumes the risk of owning specified assets (referred to as “reference assets”) by agreeing to pay the counterparty (referred to as a “protection buyer”) any losses incurred on those assets. The economic effect to the Issuing Entity is substantially the same as if it purchased the reference assets (and therefore bears the risk of losses incurred on the assets), but no actual transfer of the

reference assets to the Issuing Entity takes place. The protection buyer pays a premium to the Issuing Entity to acquire the protection. The economic effect to the protection buyer is as follows: (i) if it owns the reference assets, it has purchased credit protection against losses on those assets and (ii) if it does not own the assets, it has, in effect, sold the assets short, since it will realize a gain in the form of payments to it by the Issuing Entity under the credit default swap if the assets incur a loss. When the Issuing Entity enters into the credit default swap, it issues asset-backed securities and invests the net proceeds in highly rated short-term securities or other liquid investments. The interest earned on those investments plus the premiums received from the protection buyer are intended to be the sources of funds from which to pay interest on the asset-backed securities. The invested principal is used to pay losses, if any, under the credit default swap and, to the extent not so applied, to repay principal of the asset-backed securities.

In another common synthetic structure, an Issuing Entity may purchase a credit-linked note issued by a third party pursuant to which principal is written down if losses are incurred on the specified reference assets. The Issuing Entity's asset-backed securities would incur losses of principal in the amount of such principal write-downs.

Asset-Backed Commercial Paper

A large segment of the asset-backed market consists of asset-backed commercial paper. Asset-backed commercial paper is commonly issued by “commercial paper conduit vehicles,” which are entities set up to purchase receivables or receivables-backed securities from one or more Originator/Servicers. The commercial paper is payable from the cash flow generated by this diverse pool of receivables, as well as from bank liquidity facilities backing the commercial paper programs. In addition, the commercial paper often has credit support in the form of either bank letters of credit or surety bonds issued by monoline insurers.¹

1933 ACT CONSIDERATIONS

Registered Asset-Backed Securities

To register asset-backed securities (as defined in Regulation AB) under the 1933 Act, the asset-backed securities must satisfy the definition of “asset-backed security” set forth in Item 1101(c)(1) of Regulation AB, which defines an asset-backed security as:

a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the securityholders; provided that in the case of financial assets that are leases, those assets may convert to cash partially by the cash proceeds from the disposition of the physical property underlying such leases.

¹ For a more detailed discussion of commercial paper, see Chapter 8 (*Commercial Paper*) of this volume.

To satisfy the general definition of asset-backed security, a pool of assets must not contain any non-performing assets. In addition, asset-backed securities that are backed by a pool of financial assets that are 50% (by dollar volume) or more delinquent do not satisfy the general definition of asset-backed security.

Availability of Shelf Registration

Asset-backed securities must be registered under the 1933 Act on Form S-1 or S-3. Form S-11 and Form F-1 are no longer available to register asset-backed securities. Form S-1 may be used for any asset-backed securities that satisfy the definition of “asset-backed security.” In order to use Form S-3, which permits a shelf-registration, three additional requirements must be satisfied. First, the asset-backed securities must be rated investment grade at the time of issuance. Second, delinquent assets cannot constitute 20% (by dollar volume) or more of the pool of assets backing the asset-backed securities. Third, the Depositor and any Issuing Entity previously established, directly or indirectly, by the Depositor or any affiliate of the Depositor must have complied in a timely manner with the reporting obligations under the 1934 Act for all asset-backed securities transactions involving the same asset class as is covered by the applicable Form S-3 registration statement for the 12 months and any portion of the month prior to the time of filing. In 2008, the SEC issued a release containing proposed amendments to the requirements for the registration of asset-backed securities on Form S-3.² These amendments would eliminate the requirement that the registered asset-backed securities be rated investment grade at the time of issuance but would require that initial sales of the registered asset-backed securities be made only to qualified institutional buyers (as defined under Rule 144A of the 1933 Act) and that all initial sales and any resales of the registered asset-backed securities be made in minimum denominations of \$250,000. As of August 2009, these proposed amendments have not been adopted.

Registrant

In a securitization, the Depositor (*i.e.*, the entity that transfers the receivables to the Issuing Entity), and not the Issuing Entity itself, is the registrant and therefore has the liabilities of a registrant under the 1933 Act. The staff also requires that a pre-existing master trust or other Issuing Entity be a registrant along with the related Depositor. Under the 1933 Act, the Depositor is deemed to be a different issuer for each Issuing Entity for which it acts as Depositor as well as for its own securities. The SEC does not require financial statements for the Issuing Entity.

Forms; Disclosure

As described above, Form S-1 and Form S-3 are the two available forms for the registration of asset-backed securities. As part of the adoption of Regulation AB, Form S-1 and Form S-3 were amended to specify the disclosure requirements that would be applicable to asset-backed securities. In many cases, the amendments codified the disclosure principles underlying existing market practices and SEC positions, but in some cases, new disclosure requirements

² See SEC Release No. 33-8940 (July 1, 2008) (<http://www.404.gov/rules/proposed/2008/33-8940.pdf>).

were established. Several of the items in Form S-1 and Form S-3 require disclosure of information applicable to an actively managed operating company and have no relevance to an issuer whose assets are self-liquidating assets described in its prospectus and whose business plan is to service those assets and distribute all of the related collections. These items are required if applicable. The disclosure items contained in Regulation AB generally do not prescribe a particular form of disclosure for particular asset types, rather the items identify the type of information that must be disclosed.

The forms require that the substantive disclosure for non-U.S. asset-backed securities cover the same topics as would be required for comparable U.S. asset-backed securities. However, for non-U.S. asset-backed securities, disclosure must be provided regarding any relevant governmental, legal, regulatory or administrative matters and any tax matters, exchange controls, currency restrictions or other economic, fiscal or monetary factors.

Some of the key elements of disclosure under Regulation AB — which supplement the disclosure otherwise required by Form S-1 or S-3, as applicable — are the following:

Sponsors. Regulation AB requires disclosure regarding the entity who initiated the asset-backed securities transaction by transferring assets, directly or indirectly, to the Issuing Entity (the “Sponsor”). The Sponsor is often the Originator/Servicer or a parent of the Originator/Servicer. Item 1104 of Regulation AB requires a general discussion of the Sponsor’s experience in securitizing assets of any type, as well as a more detailed discussion of the Sponsor’s experience in and overall procedures for originating or acquiring and securitizing assets of the type to be included in the current transaction. To the extent material, disclosure should be included regarding the size, composition and growth of the Sponsor’s portfolio of assets of the type to be securitized. In addition, Item 1104 of Regulation AB also requires disclosure regarding information or factors related to the Sponsor that may be material to an analysis of the origination or performance of the pool assets, such as whether any prior securitizations originated by the Sponsor have defaulted or experienced an early amortization triggering event.

Static Pool Data. Item 1105 of Regulation AB requires disclosure (to the extent material) of five years of “static pool” information indicating how similar assets of the Sponsor have performed over time. Under Item 1105 of Regulation AB, the form of disclosure depends on whether the asset-backed securities transaction involves an amortizing asset pool (such as residential mortgages) or a revolving asset master trust (such as a credit card master trust). In the case of amortizing asset pools, the disclosure should include delinquency, cumulative loss and prepayment information for the Sponsor’s prior securitized pools of that asset type. If the Sponsor has less than three years of securitization experience with the asset type being securitized, the Sponsor should provide delinquency, cumulative loss and prepayment information for the related asset type by “vintage origination years,” *i.e.*, the years in which the Sponsor originated or purchased assets of the same type as those being securitized.

Item 1105 of Regulation AB also requires disclosure of summary information regarding the original characteristics of the Sponsor’s prior securitized pools or vintage origination years (as applicable and material). These characteristics will vary depending on the asset type, but some examples include: the number of pool assets, the original pool balance, weighted average

information related to the loan balances, interest rates, original term and remaining term of the pool assets, weighted average and minimum and maximum credit scores for the related obligors of the pool assets, loan-to-value information and data regarding the geographic distribution of the pool assets.

In the case of revolving asset master trusts, Item 1105 of Regulation AB requires information regarding delinquencies, cumulative losses, prepayments, payment rate, yield and standardized credit scores (or other applicable measures of credit quality) in separate increments based on the date of origination of the pool assets, in each case, to the extent material. Issuers are instructed to consider presenting such data at a minimum in twelve-month increments through the first five years of the account's life.

In order to accommodate “rent-a-shelf” and “aggregator” transactions, Item 1105 of Regulation AB permits static pool information regarding a party or parties other than the Sponsor to be provided in addition to or in lieu of the contemplated information regarding the Sponsor to provide material disclosure.

Item 1105 of Regulation AB also permits the following information not to be deemed part of the prospectus or the registration statement if the Depositor includes a statement to that effect in the prospectus:

- with respect to information regarding prior securitized pools that do not include the currently offered pool, information regarding prior securitized pools that were established before January 1, 2006; and
- with respect to information regarding the pool described in the related prospectus supplement, information about the pool for periods before January 1, 2006.

Although not part of the prospectus or the registration statement, the information remains subject to the antifraud provisions of the 1933 Act and the 1934 Act.

Since static pool information can be voluminous, the SEC included a unique “temporary filing accommodation” permitting static pool information to be provided through a website identified in the prospectus until December 31, 2009. For a registrant to take advantage of this accommodation, it must comply with Rule 312 under Regulation S-T which provides, among other things, that the Depositor must include a statement in the registration statement indicating that the static pool information provided through the website (other than the information described in the preceding paragraph) is deemed to be a part of the prospectus included in the registration statement.

Issuing Entity. Item 1107 of Regulation AB requires disclosure of general information about the Issuing Entity, such as its name, form of organization, capitalization, fiscal year end, permitted activities, restricted activities and discretionary activities related to the administration of the pool assets or the asset-backed securities. The sale or transfer of the pool assets to the Issuing Entity must be described together with any related security interests in favor of the Issuing Entity, the trustee or the holders of the asset-backed securities. If the pool assets are

securities, the market price of such securities must be disclosed together with the basis on which such price was determined.

Servicers. Item 1108 of Regulation AB requires information on the servicing of the pool assets, including a clear description of the roles, responsibilities and oversight requirements of any servicers. Where multiple servicers are involved, separate information is required for the master servicer, each affiliated servicer, each unaffiliated servicer that services 10% or more of pool assets and any other material servicer (*e.g.*, a special servicer) that is responsible for calculating or making distributions on the asset-backed securities, for performing work-outs or foreclosures or for any other aspect of the servicing of the pool assets upon which the performance of the pool assets or the asset-backed securities is materially dependent.

Disclosure must also be included (to the extent material) regarding each servicer's experience in servicing assets of any type, each servicer's procedures for servicing the assets of the type included in the current transaction and any changes in those procedures during the past three years, the material terms of each servicing agreement, each servicer's loss mitigation procedures and the arrangements for a servicer's resignation or removal and for a successor or "back-up" servicer. Information about the servicer's financial condition is required if there is a material risk that the servicer's financial condition could materially and adversely affect the performance of the pool assets or the asset-backed securities. These additional disclosure requirements are not applicable to unaffiliated servicers that service less than 20% of the pool assets.

Originators. In many cases, the pool assets are originated by the Sponsor or one of its affiliates. In some cases, the pool assets are purchased by the Sponsor or one of its affiliates from a third-party originator or from one or more intermediaries in the secondary market before they are securitized. Item 1110 of Regulation AB requires identification of any originator that originated or is expected to originate 10% or more of the pool assets. If an originator originated or is expected to originate 20% or more of the pool assets, the prospectus must describe (to the extent material) the originator's origination program, the originator's experience in originating assets of the type being securitized and information regarding the size and composition of the originator's origination portfolio as well as any other information relevant to an analysis of the performance of the pool assets, such as the originator's underwriting criteria for the type of assets being securitized.

Pool Assets. Item 1111 of Regulation AB requires a description of pool assets, including the type of pool assets and their material terms, the underwriting criteria used to originate or purchase the pool assets, material characteristics of the asset pool, delinquency and loss information for the asset pool, sources of pool cash flow, representations and warranties and repurchase obligations regarding pool assets, third-party claims on pool assets and the terms under which assets may be added to, substituted for or removed from the asset pool.

Significant Obligors of Pool Assets. A "significant obligor" is an obligor, a property or a lessee (or a group of affiliated obligors, related properties or affiliated lessees) in respect of a pool asset or group of pool assets that make up 10% or more of the asset pool as of the cut-off date for the transaction. Item 1112 of Regulation AB requires information about each significant obligor, including its name, organizational form, a description of its business and the material

terms of the pool assets and the agreements with the significant obligor involving the pool assets. If the pool assets related to the significant obligor represent 10% or more but less than 20% of the asset pool, then the financial data required by Item 301 of Regulation S-K for the significant obligor must be provided. If the pool assets related to the significant obligor represent 20% or more of the asset pool, then the significant obligor's financial statements meeting the requirements of Regulation S-X must be included. Modified disclosure is permitted for significant obligors that are asset-backed issuers and in cases where the obligations of the significant obligor as they relate to the pool assets are backed by the full faith and credit of the United States or of a foreign government. If a significant obligor is a "foreign business" as defined in Regulation S-X, then at the 10% level the Issuing Entity may instead include selected financial data of the significant obligor pursuant to Item 3A of Form 20-F (with a reconciliation to U.S. GAAP unless unavailable or not obtainable without unreasonable cost or expense), but at the 20% level the Issuing Entity must include full financial statements of the significant obligor pursuant to Item 17 of Form 20-F if it does not include the significant obligor's financial statements meeting the requirements of Regulation S-X.

In many instances, the information required by Item 1112 of Regulation AB with respect to a significant obligor is not publicly available and can only be provided by the significant obligor. In addition, the registrant is liable under U.S. securities laws for the information regarding the significant obligor that is included in the prospectus related to the asset-backed securities and in any periodic report required to be filed by the Issuing Entity under the 1934 Act. Consequently, a registrant would be well-advised to enter into an agreement with each significant obligor which will obligate the significant obligor to provide the information required by Item 1112 of Regulation AB in connection with the preparation of the prospectus for the initial offering of the asset-backed securities and on an on-going basis for inclusion in any periodic reports required to be filed under the 1934 Act or in any supplement to the prospectus in connection with a subsequent offering of any unsold asset-backed securities. That agreement should also provide for indemnification of the registrant by the significant obligor for any liability that may arise for material misstatements or omissions contained in the information provided by the significant obligor.

Transaction Structure. Item 1113 of Regulation AB expands upon Item 202 of Regulation S-K by requiring a description of specific information related to the asset-backed securities to be issued, including information about the types or categories of asset-backed securities that may be offered, the flow of funds for the transaction, a separate table with an itemized list of all fees and expenses to be paid or payable out of the cash flows from the pool assets, information on distributions and arrangements for any "clean up" call or other optional or mandatory redemption of the asset-backed securities. Any model used to identify cash flow patterns with respect to pool assets must be described, including the related material assumptions, as well as the degree to which each class of asset-backed securities is sensitive to changes in the rate of payment on the pool assets (*e.g.*, prepayment or interest rate sensitivity). In the case of a master trust, additional disclosure is required regarding the effect on the offered securities of additional securities that might be issued by the master trust in the future.

Credit Enhancement and Other Support. Some securitizations may include (i) external credit enhancement to protect against losses due to defaults or (ii) external cash flow enhancements, which may supplement low yielding assets in the pool or provide a currency swap

(*e.g.*, the assets pay in one currency and the asset-backed securities pay in another), an interest rate swap (*e.g.*, the assets bear a fixed rate of interest and one or more of the asset-backed securities bear interest at a floating rate) or an interest rate cap. Item 1114 of Regulation AB requires a description of any external credit enhancement of pool assets or the asset-backed securities (*e.g.*, bond insurance, letters of credit or guarantees), mechanisms to ensure timely payment of the asset-backed securities (*e.g.*, liquidity or lending facilities), derivatives whose primary purpose is to provide credit enhancement and internal credit enhancement structured into the transaction (*e.g.*, subordination provisions, overcollateralization, reserve accounts, cash collateral or spread accounts). Derivatives whose primary purpose is to alter the payment characteristics of the pool assets and not to provide credit enhancement are dealt with under Item 1115 of Regulation AB, discussed below.

In addition to the disclosure requirements that arise in respect of external credit enhancements, registrants must consider whether an external credit enhancement is a separate security that itself must be registered. A third party credit enhancer in a securitization is generally not considered a co-issuer under the 1933 Act. Unlike a guarantor that has direct obligations to securityholders and is therefore considered a co-issuer whose guarantee must be registered under the 1933 Act, a third party credit enhancer's obligations in a securitization normally run to the Issuing Entity or a trustee. External enhancements that are themselves exempted securities are not required to be separately registered. A surety bond issued by an insurer is normally within the exemption for insurance policies provided in Section 3(a)(8) of the 1933 Act, and a letter of credit provided by a domestic bank (or, under certain circumstances, the U.S. branch of a non-U.S. bank) is normally within the exemption for bank securities provided in Section 3(a)(2) of the 1933 Act.

Occasionally, an Originator/Servicer or its parent provides a guarantee of one or more classes of asset-backed securities. In such cases, the guarantor is named as a registrant in the registration statement for the asset-backed securities, and if the guarantor qualifies for use of Form S-3, the information on the guarantor is incorporated by reference to the extent permitted by Form S-3.

Even if credit enhancement does not result in a separate security required to be registered, it may require additional disclosure if it is significant in amount and is provided by a single person or group of affiliated persons. In these situations, Item 1114 of Regulation AB (like Item 1112 of Regulation AB in the case of significant obligors) requires the inclusion of (a) selected financial data as required by Item 301 of Regulation S-K if the provider of credit enhancement is liable or contingently liable to provide payments representing 10% or more of the cash flow supporting any offered class of asset-backed securities or (b) financial statements in accordance with Regulation S-X if such support amounts to 20% or more of relevant cash flow. Like Item 1112 of Regulation AB, Item 1114 of Regulation AB permits modified disclosure in the case of credit enhancement provided by a "foreign business" or where the obligations of the enhancement provider are backed by the full faith and credit of the United States or of a foreign government.

As with significant obligors and the delivery of the information required by Item 1112 of Regulation AB, registrants should enter into an agreement with each credit enhancement provider that will obligate the credit enhancement provider to deliver the information required by

Item 1114 of Regulation AB at the time of the offering and on an on-going basis and that requires indemnification of the registrant for any material misstatements or omissions in such information.

Derivative Instruments Whose Primary Purpose Is Not to Provide Credit Enhancement. Item 1115 of Regulation AB applies to derivatives whose primary purpose is to alter the payment characteristics of the pool asset and not to provide credit enhancement. Apart from requiring a description of basic information regarding the derivative counterparty, Item 1115 of Regulation AB also requires the inclusion of selected financial information or financial statements (as in the case of Items 1112 and 1114 of Regulation AB discussed above) if the “aggregate significance percentage” related to any derivative counterparty or group of affiliated derivative counterparties is greater than 10% or 20%, respectively. The “aggregate significance percentage” is based on a reasonable good-faith estimate of maximum probable exposure to the derivative counterparty under the derivative instrument, calculated using substantially the same methodology that the Sponsor uses in respect of similar instruments for internal risk management purposes.

As with significant obligors and the delivery of the information required by Item 1112 of Regulation AB, registrants should enter into an agreement with each derivative counterparty that will obligate the derivative counterparty to deliver the information required by Item 1115 of Regulation AB at the time of the offering and on an on-going basis and that requires indemnification of the registrant for any material misstatements or omissions in such information.

The issuance of asset-backed securities may involve a currency swap or an interest rate swap. Section 2A of the 1933 Act makes clear that a simple swap agreement is not a separate security that must be separately registered under the 1933 Act. Counsel should be consulted on this issue, especially in the case of a highly structured swap.

Other Disclosure Items in Regulation AB. Other items in Regulation AB set forth the registration statement disclosure requirements relating to the trustee for the asset-backed securities transaction, tax matters, legal proceedings, reports to be provided to securityholders or filed with the SEC, affiliations among and transactions involving participants in the offering of asset-backed securities and information as to whether the transaction is conditioned upon the issuance of any rating by one or more rating agencies.

Proposed Securitization Reform Legislation³

Legislation has recently been proposed in the U.S. Congress to effect certain securitization reforms. The legislation as currently proposed would

- require that the “securitizers” retain at least 5% of the credit risk of any securitized exposure;

³ For a further discussion regarding the recently proposed legislation, see the Sidley Client Update at <http://www.sidley.com/FinancialRegulatory072709.pdf>.

- increase 1933 Act disclosure requirements for asset-backed securities;
- increase 1934 Act periodic reporting requirements for issuers of asset-backed securities; and
- increase the regulation of the use of representations and warranties in respect of asset-backed securities.

Private Asset-Backed Securities

Many issuances of asset-backed securities have been privately offered in the U.S., both on a traditional private placement basis and pursuant to Rule 144A. The procedures and considerations for privately offering and selling asset-backed securities are similar to those for private medium-term notes in Chapter 6 (*Medium-Term Notes*) of this volume. The advantages and disadvantages of a registered offering and a private offering of asset-backed securities are similar to those discussed for medium-term notes in Chapter 6 (*Medium-Term Notes*) of this volume.

1934 ACT CONSIDERATIONS

General

Issuers of asset-backed securities have different reporting requirements from corporate issuers, tailored to require the information that is relevant to the particular asset-backed security. 1934 Act forms specific to asset-backed securities were introduced as part of Regulation AB, replacing the ad hoc system of 1934 Act reporting that had grown out of SEC no-action letters and industry-practice.

Under the 1933 Act and the 1934 Act, a Depositor in an asset-backed securities transaction, acting solely in its capacity as depositor with respect to a specific issuing entity, is the “issuer” of the asset-backed securities issued by that entity. Accordingly, for 1934 Act reporting purposes, the Depositor is considered a separate “issuer” with respect to each issuing entity for which it acts as Depositor and it is responsible for complying with the 1934 Act reporting requirements related to registered offerings of asset-backed securities. “Issuers” of asset-backed securities are required to file reports under the 1934 Act with the first bona fide sale of the specific asset-backed securities and the suspension of the duty to file these reports is determined separately for each related issuing entity. Under Section 15(d) of the 1933 Act, if an issuance of asset backed securities is held by fewer than 300 investors at the beginning of a fiscal year (other than the year of issuance), the Section 15(d) reporting obligations will be suspended. The relevant 1934 Act reports must be filed with respect to the year of issuance.⁴

⁴ Under the recently proposed legislation discussed above, the reporting obligations of an asset-backed issuer would no longer be eligible for automatic suspension under Section 15(d) of the 1933 Act. However, the SEC would be authorized to adopt new suspension schemes for different classes of issuers of asset-backed securities under terms and conditions as it deems necessary for the protection of investors.

Changes to Form S-3 at the time Regulation AB became effective linked Form S-3 eligibility for offerings of asset-backed securities to the 1934 Act reporting compliance of the Depositor and any Issuing Entity formed by that Depositor or any affiliated depositors. As a result, the failure by a Depositor or any affiliated depositor to comply with the 1934 Act reporting requirements can prevent a Sponsor from accessing the public capital markets through an offering of asset-backed securities on Form S-3.

1934 Act Reporting Obligations

The 1934 Act reports applicable to asset-backed securities are:

- Form 10-D — a periodic report covering a distribution period, requiring performance information with respect to the pool assets and information regarding distributions to the securityholders on the related payment date;
- Form 10-K — an annual periodic report, requiring information related to significant obligors on the pool assets, credit enhancement providers and credit derivative counterparties, legal proceedings, certain affiliations and relationships, and most significantly, annual servicer compliance statements, certifications of compliance with applicable servicing criteria and related accountant's attestations and Sarbanes-Oxley certifications; and
- Form 8-K — a current report form, requiring disclosure of a change of servicer or trustee, a change in credit enhancement or other external support or a failure to make a material required distribution.

Because asset-backed securities transactions frequently involve third parties unrelated to the Depositor, such as one or more trustees, credit enhancement providers, derivative counterparties and, in many cases, servicers, for which information must be provided in the Issuer's 1934 Act reports, contractual obligations to provide the required information, as well as remedies, where possible, for the failure to provide such information within the time periods required, are of critical importance for Issuers in public asset-backed securitizations. Moreover, the expansion of 1934 Act reporting requirements in 2006 to include servicers that are not in privity with the Issuing Entity, as well as "entities participating in the servicing function" (for purposes of the certifications of compliance with applicable servicing criteria and related accountant's attestations), significantly increased the Issuer's reporting obligations. The many transaction parties and disclosure requirements related to pool triggers necessitate tracking and control systems for a Depositor with public asset-backed securitizations. In addition to concerns related to 1934 Act reporting compliance, information provided by third parties also raises potential liability issues for an Issuer for the information that must be included, the 1934 Act reports and consideration should be given to contractual provisions related to indemnification for such information. Overall, the 1934 Act reporting requirements related to third-parties can complicate compliance for an Issuer and potentially jeopardize the related Sponsor's ability to access the capital markets if eligibility to use Form S-3 is lost.

1940 ACT CONSIDERATIONS

The definition of “investment company” in Section 3(a)(1) of the 1940 Act includes any person that is primarily engaged in the business of investing and reinvesting in securities, as well as any person engaged in the business (whether primarily or not) of investing in or holding investment securities (as defined in the Section) and more than 40% of whose assets consist of such securities. Assets that generate cash flow may, at least under certain circumstances, come within the definition of “security” in Section 2(a)(36) of the 1940 Act, which includes, among other items, evidences of indebtedness. Unlike the 1933 Act, the 1940 Act includes as securities even commercial and consumer loans. Consequently, absent an exemption, most Issuing Entities would come within the definition of “investment company” in Section 3(a)(1) of the 1940 Act because their primary activity of acquiring and holding cash flow assets amounts to engaging in the business of investing in securities. Registering an Issuing Entity as an investment company under the 1940 Act is not practical since the 1940 Act is a pervasive regulatory scheme that is incompatible with the operation of most types of entities other than true investment companies. For example, 1940 Act provisions would likely limit the ability of the Originator/Servicer to engage in certain transactions with the Issuing Entity and, moreover, would limit the Issuing Entity’s ability to issue asset-backed securities at all because of restrictions on the ability of registered investment companies to issue debt.

Prior to the adoption of Rule 3a-7, Issuing Entities issuing asset-backed securities relied on the exemptions provided in Section 3(c)(5) of the 1940 Act. These exemptions worked well for asset types (such as mortgage loans) within the terms of the exemption.

The SEC responded to the limited applicability of Section 3(c)(5) by adopting Rule 3a-7, which was intended to exclude virtually all structured financings from the definition of investment company, subject to certain conditions. An issuer (*i.e.*, an Issuing Entity) that satisfies the conditions of the Rule will not be deemed to be an investment company. The Rule provides that:

1. the issuer must acquire and hold “eligible assets” (basically, assets that will convert to cash by their terms within a finite period of time), may engage in related activities and must not issue redeemable securities;
2. the issuer’s securities must be paid primarily out of cash flow on its eligible assets;
3. the issuer’s fixed-income securities that are rated investment grade may be sold to anyone; other types of its securities may only be sold to accredited investors or qualified institutional buyers; “fixed-income” securities for this purpose are securities that have either a principal amount or, subject to certain limitations, provide for the payment of interest on a principal amount (which may be a notional amount) or any combination of such features;
4. the issuer may acquire or dispose of its eligible assets only in accordance with the documents governing its securities and only if such acquisitions or dispositions do not result in a downgrading of the rating of the issuer’s outstanding fixed-income

securities and are not made for the purpose of recognizing gains and decreasing losses resulting from changes in market value (*i.e.*, no active management of the issuer's assets as would be typical of an investment company); and

5. except in the case of an issuer of commercial paper exempt pursuant to Section 3(a)(3) of the 1933 Act, a non-affiliated trustee meeting the requirements of Section 26(a)(1) of the 1940 Act must be appointed and receive a perfected security interest or ownership interest in the eligible assets.

Subparagraph (5) above may be difficult to satisfy in a non-U.S. securitization, since Section 26(a)(1) of the 1940 Act requires that the trustee be a U.S. financial institution. In this regard, a non-U.S. branch of a U.S. financial institution may be used as a trustee, depending on the requirements of local law. If such an option is unavailable, the non-U.S. Issuing Entity making a public offering will have to own only the asset types covered by the exemption in Section 3(c)(5) of the 1940 Act.

In 2008, the SEC issued a release proposing amendments to Rule 3a-7 that would remove provisions of the rule that rely on credit ratings of the asset-backed securities in furtherance of the Credit Rating Agency Reform Act of 2006 and its goal of eliminating undue reliance on the credit rating process.⁵ If adopted in their current form, the amendments would (i) limit sales of any fixed-income security issued by the Issuing Entity to “accredited investors” and limit sales of any other securities issued by the Issuing Entity to “qualified institutional buyers” (consequently, sales of investment grade rated fixed-income securities to the general public, referred to in subparagraph (3) above, would not be permitted); (ii) require the Issuing Entity to have procedures to ensure that the acquisition or disposition of its assets does not adversely affect the timely payment of its fixed-income securities (as opposed to not result in a ratings down-grade of its fixed-income securities, as noted in subparagraph (4) above); and (iii) require the Issuing Entity to deposit its collections of cash into a segregated account on a periodic basis that is consistent with timely payment of its fixed-income securities rather than just on a basis that maintains the credit ratings of its fixed-income securities. As of August 2009, these proposed amendments have not been adopted.

The “private placement” exemption in Section 3(c)(1) of the 1940 Act, which was historically the only alternative, is basically too confining. Section 3(c)(7) of the 1940 Act provides greater flexibility than Section 3(c)(1) in that it imposes a sophistication test as an alternative to a numerical limit on buyers. However, Section 3(c)(7) also permits only private placements.

TERM ASSET-BACKED SECURITIES LOAN FACILITY

In late 2008, the Federal Reserve Board authorized the creation of the Term Asset-Backed Securities Loan Facility (“TALF”) under which the Federal Reserve Bank of New York (“FRBNY”) was permitted to make up to \$200 billion of non-recourse loans available to eligible borrowers to enable them to purchase highly rated eligible asset-backed securities. The Federal

⁵ See SEC Release No. IC-28327 (July 2, 2008) (<http://404.gov/rules/proposed/2008/ic-28327.pdf>).

Reserve Board subsequently announced that the lending limit for the TALF may be increased to \$1 trillion. As of June 2009, the permitted asset classes underlying TALF-eligible asset-backed securities consisted of newly and recently originated auto loans and leases; credit card receivables; student loans; SBA-guaranteed small business loans; equipment loans and leases; rental, commercial, and government fleet leases; floor plan loans; residential mortgage loan servicing advances; commercial mortgage loans; and insurance premium finance loans. The Federal Reserve Board has announced that the TALF may be expanded to include additional types of asset-backed securities as eligible collateral for TALF loans.

The FRBNY provides loans to eligible borrowers pursuant to the terms of the Master Loan and Security Agreement (the “MLSA”). The MLSA is an agreement entered into among the FRBNY, as lender, The Bank of New York Mellon, as administrator and custodian, and each primary dealer through which the FRBNY makes its loans to TALF borrowers. The MLSA incorporates terms from the “TALF Standing Loan Facility Procedures” (*i.e.*, the terms, conditions, frequently asked questions, procedures and other information with respect to the TALF, as published from time to time by the FRBNY and posted to the TALF website at <http://www.ny.frb.org/markets/talf.html>). By accepting loans under the TALF, borrowers become bound by the provisions that relate to them and their loans in the MLSA — representations, warranties, covenants and indemnification, among others. TALF borrowers themselves are not parties to the MLSA. Instead, each borrower must execute a customer agreement authorizing the borrower’s primary dealer to execute the MLSA as the borrower’s agent with respect to the TALF loans requested through that primary dealer. Each customer agreement between a borrower and a primary dealer must contain the terms set forth in Appendix 2 to the MLSA, which relate primarily to agency, security interests, notices, instructions, know-your-customer information and the disbursement of funds.

A U.S. company that owns eligible asset-backed securities may borrow from the FRBNY under the TALF. An entity is a “U.S. company” for purposes of the TALF if it is (1) a business entity or institution that is organized under the laws of the United States or a political subdivision or territory thereof (U.S.-organized) and conducts significant operations or activities in the United States, including any U.S.-organized subsidiary of such an entity; (2) a U.S. branch or agency of a foreign bank (other than a foreign central bank) that maintains reserves with a Federal Reserve Bank; (3) a U.S. insured depository institution; or (4) an investment fund (*i.e.*, any type of pooled investment vehicle, including a hedge fund, a private equity fund, a mutual fund and any type of single investor vehicle that is organized as a business entity or institution) that is U.S.-organized and managed by an investment manager that has its principal place of business in the United States (the foregoing will include investment funds that are newly formed expressly for the purpose of participating in the TALF). The term “U.S. company” excludes any entity, other than those described in clauses (2) and (3) above, that is controlled by a foreign government or is managed by an investment manager, other than those described in clauses (2) and (3) above, that is directly or indirectly controlled by a foreign government.

The FRBNY is scheduled to cease making loans under the TALF on December 31, 2009; however, this date may be extended if the Federal Reserve Board determines that unusual and exigent circumstances support such extension.

BASIC DOCUMENTS

Securitization Documents

The documents in a U.S. securitization include a sale agreement for the sale of the receivables from the Originator/Servicer to the Depositor and another sale agreement for the sale from the Depositor to the Issuing Entity. There is also a servicing agreement between the Originator/Servicer and the Issuing Entity. The document that governs the issuance of the asset-backed security is most often an indenture governed by New York law (or in the case of many mortgage loan securitizations, a pooling and servicing agreement). The documents in a non-U.S. securitization that transfer the receivables to the Issuing Entity will normally be the documentation used in the particular non-U.S. jurisdiction. The document that governs the issuance of the asset-backed security may often be a trust deed governed by English law or an indenture governed by New York law.

Offering Documents

The content of a registration statement for registered offerings of asset-backed securities is discussed above. The offering documents used in a private transaction are usually similar in form to the prospectus used in a registered offering.

Underwriting Agreement

The asset-backed securities are normally distributed through a sale to underwriters pursuant to an underwriting agreement or other purchase agreement or on a best efforts basis pursuant to a placement agency agreement. Broker/dealers normally require indemnification from an entity with substantial assets (such as the Originator/Servicer) and not just from the Issuing Entity or the Depositor.

Legal Opinions

The legal opinions include those referred in Appendix B (*Basic Documents for Securities Offerings in the U.S. Capital Markets*) in addition to opinions specific to securitization, such as true sale and non-consolidation opinions, security interest opinions and tax opinions as to no entity-level taxes on the Issuing Entity and no withholding taxes on each of the cross-border transfers in the transaction.

Agreed Upon Procedures Letters

Because asset-backed securities depend on the cash flow of the underlying assets for payments rather than income generated from an actively managed company, the numerical information included in an offering document for an asset-backed securities offering relates to the assets in the underlying pool and historical performance information (or static pool information) of the Sponsor and in some cases, other entities that may have originated or aggregated the assets in the underlying pool. The underwriters or placement agents will require an agreed upon procedures letter that (i) agrees each applicable number in the disclosure document with the related records of the Originator/Servicer and (ii) performs certain agreed upon procedures that in effect provide a reasonable basis for believing that the

Originator/Service's records containing information about the assets (from which many of the numbers in the disclosure document are taken) accurately reflect the information in the files for the assets.

CHAPTER 11

COVERED BONDS

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GENERAL

What is a Covered Bond?

A covered bond is a dual-recourse debt obligation that provides recourse, either directly or indirectly, to a regulated financial institution and is secured by an insolvency-protected “cover” pool of assets which remains on the balance sheet of the issuing financial institution. A covered bond is considered a hybrid debt markets instrument that shares characteristics of both recourse debt securities and mortgage-backed securities, but is identical to neither of these forms of securities. A primary feature of covered bonds is “call protection.” Programs are designed so that if an issuer defaults in payment, its covered bonds may remain outstanding, relying on collections from, or proceeds of, the Cover Pool assets to provide scheduled payments of principal and interest. Typically, covered bonds are fixed rate, bullet repayment notes and rated AAA. There are two main types of covered bonds, legislative and structured, but the basic characteristics of all covered bonds are substantially similar. Covered bonds are a relatively new product in the United States. To date, two U.S. depository institutions have issued covered bonds utilizing a two-tier SPV structure.

History of the Covered Bond Market

Covered bonds have long existed as a source of funding for mortgage lending in many European countries, dating back more than 230 years to the initial issuance in Prussia in 1770.¹ The German Pfandbriefe is one of the first iterations of the covered bond. Covered bonds have traditionally been supported by European governments as a means to promote wider home ownership. While covered bonds remained popular in Europe throughout the 19th century, during the 20th century they were somewhat eclipsed by other products in the inter-bank financing markets. However, in 1995 the first “Jumbo Pfandbriefe” was issued, meeting investor demand for increasingly liquid products. Since then the covered bond market has accelerated in

¹ Covered bonds were initially used to finance agriculture and later concentrated on housing and commercial real estate.

Europe and has become a pan-European funding mechanism. Over the past decade, covered bonds have developed into a primary financing instrument for European mortgage lenders and the covered bond market comprises a large segment of Europe's capital markets. More recently, covered bonds have been introduced in the United States and Canada.

Economic Considerations

Issuer's Perspective. Covered bonds represent a potential additional source of financing for depository institutions with a large mortgage lending business. Financial institutions may find that covered bonds provide a relatively cheap alternative to securitization. By diversifying their funding sources, depository institutions may strengthen their balance sheets. Covered bonds also facilitate borrowing at medium and long term periods (e.g., 5-10 years or more) that may be otherwise difficult for banks to obtain.

Investor's Perspective. Historically, covered bond investors have included central banks, pension funds, insurance companies, asset managers and bank treasuries that find features such as the AAA credit ratings and liquidity of the bonds attractive. Covered bonds appeal to investors seeking low risk, yield-bearing products that have long maturities. Investors also perceive benefits in the dual recourse to a regulated financial institution as well as an asset pool. In addition, an attractive feature of the covered bonds is that the loan originator retains exposure to the covered bond collateral, which may encourage more robust underwriting standards.

LEGISLATIVE AND STRUCTURED COVERED BONDS

The market distinguishes between special law- and general law-based covered bonds. Covered bonds issued pursuant to dedicated covered bond laws are referred to as “statutory or legislative” covered bonds. Covered bonds issued in accordance with an existing legal framework are referred to as “structured” covered bonds.

Legislative Covered Bonds

In most European countries, special covered bond legislation has been enacted to provide for the dual nature of protection for, and the “privileged” position of, covered bond investors in the event of issuer insolvency. As of the end of 2008, more than 25 countries have implemented a special covered bond law.² Covered bond statutes typically set forth guidelines with respect to the following: (1) the types of institutions that can issue covered bonds; (2) the assets that qualify for inclusion in the Cover Pool; (3) the measures to be undertaken by the issuing institution to ensure monitoring and reporting with respect to the assets securing the covered bonds; (4) the preferential claim to the Cover Pool assets that investors will have in the event of issuer insolvency; and (5) the mechanics that enable covered bonds to be paid according to their terms if the issuer becomes insolvent. The insolvency “ring-fencing” of the Cover Pool assets is central to the provisions of a statutory covered bond regime. It is this ability to segregate Cover

² These include Austria, the Czech Republic, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Romania, Russia, Slovakia, Slovenia, Spain, Sweden, Switzerland, Turkey, Ukraine and the United Kingdom. (Source: Merrill Lynch, *The Covered Bond Book*, December 2008)

Pool assets from an issuer's insolvency proceeding that provides the asset-based leg of the instrument's "dual recourse." Most covered bond regimes provide for an administrator to take control of an insolvent bank's Cover Pool assets with powers to manage those assets over the life of the covered bonds. This also permits covered bonds to remain outstanding notwithstanding an issuer default so long as the value of the Cover Pool assets is sufficient to satisfy in full the principal and interest payments due and payable on the covered bonds. A legislative framework provides certainty regarding the rights of bondholders and ensures that covered bonds issued in a particular jurisdiction will be largely homogenous.

Structured Covered Bonds

Structured covered bonds do not rely upon specifically tailored laws or regulations. Instead, the rights of covered bondholders and the obligations of the issuing institution are principally defined by the contractual arrangements among the parties and a jurisdiction's existing legal framework. Structured covered bonds replicate the characteristics of legislative covered bonds but do so employing existing principals of contract, banking and insolvency law.³ Covered bonds issued under the existing U.S. covered bond programs fall within this category.

COMPARISON WITH MBS

Both mortgage-backed securities ("MBS") and covered bonds offer a potential source of long-term funding for residential mortgage loans, and both are secured by mortgage loans. There are, however, essential distinctions between the two instruments that make each attractive to different types of investors:

- Covered bonds are on-balance sheet, recourse obligations of a depository institution secured by Cover Pool assets; MBS are non-recourse off-balance sheet securities that are supported by pools of mortgage loans sold into special purpose vehicles, which issue the MBS. Covered bond investors have recourse to the issuing bank and to the Cover Pool assets, while MBS investors have recourse only to the cash flows from a portfolio of assets transferred by the issuing entity to the off-balance sheet vehicle.⁴
- The cash flow from the mortgage loans and credit enhancements in MBS transactions are generally the only source of principal and interest payments to investors. In a

³ Prior to the introduction of its own legislative regime on March 6, 2008, the United Kingdom was perhaps the most prominent jurisdiction with a developed structured covered bond market with the first issuance taking place in 2003. The introduction of the U.K.'s Regulated Covered Bonds Regulations in 2008 was a major step for the U.K. covered bond market as it brought covered bond issuances into compliance with the European Undertaking for Collective Investment in Transferable Securities Directive ("UCITS") thereby allowing covered bond issuers to benefit from higher prudential limits set forth in UCITS, as well as a more favorable credit risk weighting for investors. The UK regime was unusual in that it did not dictate the precise form of covered bond programs and allowed existing "structured" covered bond programs to qualify under its provisions.

⁴ Given that covered bond investors have dual recourse, spreads of covered bonds are expected to trade tighter than senior financials and MBS.

covered bond structure, principal and interest are paid by the issuer's own corporate funds.

- The collateral underlying the covered bonds is dynamic and may be substituted relatively freely, while MBS mortgage loan pools are generally static.
- Covered bonds are characteristically bullet repayment notes and programs are structured so that the bonds will pay until their scheduled maturity even in the event of an issuer default; MBS are exposed both to prepayment risk and extension risk depending on the performance of the underlying loans.
- In the event that covered bonds are accelerated and repay investors an amount less than the principal and accrued interest, investors retain an unsecured claim against the issuer. MBS investors have no claim against the issuer in the event of repayment at an amount less than the principal and interest owed.

CURRENT U.S. COVERED BOND STRUCTURE

In the absence of dedicated covered bond legislation, issuers in the United States have relied upon existing legal framework to form the basis of the current U.S. covered bond structures. To date, two U.S. depository institutions have issued covered bonds. In September of 2006, Washington Mutual Bank⁵ became the first U.S. bank to issue covered bonds, followed by Bank of America in 2007.⁶

The two current U.S. covered bond programs employ a two-tier, SPV structure. The relevant bank (“Mortgage Bond Issuer”) issues mortgage bonds, secured by a pool of residential mortgage loans, to a bankruptcy-remote, special purpose Delaware statutory trust (“SPV”). The SPV is organized in series, each of which holds a mortgage bond to secure a separate series of the SPV's covered bonds. The mortgage loans comprising the Cover Pool remain on the Mortgage Bond Issuer's balance sheet and are pledged to an independent trustee to secure the Mortgage Bond Issuer's obligation to make payments of interest on, and principal of, the mortgage bonds. The SPV issues covered bonds, secured by the mortgage bonds, to investors. In the event of a default by the Mortgage Bond Issuer, the trustee for the covered bondholders is entitled to direct the mortgage bond trustee to liquidate the pool of assets and deposit the proceeds into a guaranteed investment contract or similar arrangement. The funds so invested are designed to provide for the payment of scheduled interest and principal on the covered bonds.

⁵ Following the appointment of the FDIC as receiver of Washington Mutual Bank in September 2008, JPMorgan Chase Bank, National Association, assumed Washington Mutual Bank's obligations under the covered bond program.

⁶ Sidley Austin LLP acted for both Washington Mutual Bank and Bank of America in establishing their covered bond programs.

Structural Overview of the Existing U.S. Covered Bond Programs

Covered Bonds: Under the terms of a covered bond indenture, the SPV issues its covered bonds in one or more series to investors. The covered bonds are limited recourse obligations of the SPV secured principally by the related series of mortgage bonds purchased by the SPV from the Mortgage Bond Issuer, which, in turn, are secured, *pari passu* with all other series of mortgage bonds, by the collateral pledged by the Mortgage Bond Issuer (the “Cover Pool”). The SPV grants to the covered bond indenture trustee (for its benefit and for the benefit of each series of covered bondholders) a security interest in the series of mortgage bonds, the specified instrument(s) and the swap agreement(s) (each as described below) relating to each such series of covered bonds. The SPV uses amounts received in respect of each swap agreement to pay the interest on, and the principal of, the related series of covered bonds.

Cover Pool: The assets in the Cover Pool in the existing U.S. structures consist of a pool of residential mortgage loans and substitution assets,⁷ in each case owned by the Mortgage Bond Issuer. Substitution assets, except for cash, are limited to 10% of the total assets of the Cover Pool. The assets must satisfy specific eligibility criteria in effect at the time such assets are added to the Cover Pool. The eligibility criteria and certain representations and warranties relating to the Cover Pool assets are specified in the mortgage bond indenture and are largely determined by the rating agencies. These criteria may change from time to time, subject to receipt by the Mortgage Bond Issuer of a written confirmation from each rating agency then rating the covered bonds that such change will not result in a reduction or withdrawal of its then current ratings of any series of covered bonds. The Mortgage Bond Issuer may add and remove any assets from the Cover Pool at any time and from time to time subject to its continued compliance with an “asset coverage test” (described below). The Mortgage Bond Issuer grants a first priority security interest in the Cover Pool assets to the mortgage bond indenture trustee to secure all series of mortgage bonds at any time outstanding on a *pro rata* and *pari passu* basis.

Mortgage Bonds: Under the terms of a mortgage bond indenture, the Mortgage Bond Issuer issues mortgage bonds in one or more series, which are direct and unconditional obligations of the Mortgage Bond Issuer and secured by the Cover Pool. Under the terms of a mortgage bond purchase agreement, the Mortgage Bond Issuer sells and the SPV purchases each series of mortgage bonds. The maturity date of each series of mortgage bonds coincides with the maturity date of each corresponding series of covered bonds.

Asset Coverage Test: For so long as any mortgage bonds remain outstanding, the Mortgage Bond Issuer must perform the asset coverage test and ensure that on each monthly determination date the adjusted value of the Cover Pool assets is equal to or greater than the aggregate unpaid principal amount of the outstanding mortgage bonds. For the purposes of the asset coverage test, the value of the mortgage loans in the Cover Pool is discounted, according to methodologies prescribed by the rating agencies, to offset various credit and liquidity risks. In

⁷ Substitution assets include: (1) cash, (2) obligations issued by, or guaranteed by, central governments, regional governments, central banks, public entities, local authorities or international organizations that qualify for 0% risk-weighting under the European Capital Requirements Directive, (3) obligations of 10% or 20% risk-weighted institutions under the European Capital Requirements Directive, and (4) U.S.\$ denominated AAA-rated liquid RMBS.

addition, on any date on which any asset is removed from the Cover Pool, the Mortgage Bond Issuer must ensure that the asset coverage test will be complied with.

Under the terms of an asset monitor agreement, an independent asset monitor will test the arithmetic accuracy of the Mortgage Bond Issuer's calculation of the asset coverage test annually and, under certain circumstances, monthly.⁸ A breach of the asset coverage test on any monthly determination date which is not cured by the next following monthly determination date will constitute a Mortgage Bond Issuer event of default, which will require the mortgage bond indenture trustee to declare all of the mortgage bonds then outstanding immediately due and payable and enforce its security interest over the Cover Pool.

Swap agreements: On each issue date, the SPV enters into one or more swap agreements for each series of covered bonds with one or more swap providers in order to hedge against one or more of the following: (i) prior to the acceleration of the mortgage bonds and the receipt by the SPV of the proceeds from the liquidation of the Cover Pool, certain mismatches between the rate and frequency of interest payments on a series of mortgage bonds and the rate and frequency of interest payments on the corresponding series of covered bonds; (ii) on or following the acceleration of the mortgage bonds and the receipt by the SPV of the proceeds from the liquidation of the Cover Pool, certain mismatches between (a) the rate and frequency of interest payments provided by the Specified Instrument and the rate and frequency of interest payments in respect of such covered bonds, and (b) to the extent of any interest payments prior to the payment in full of all proceeds from the Cover Pool, the rate and frequency of interest payments in respect of a series of mortgage bonds and the rate and frequency of interest payable in respect of the related series of covered bonds; (iii) timing discrepancies between the dates on which the proceeds from the Cover Pool are received by the SPV and the dates on which interest and principal is payable on the covered bonds; and (iv) certain mismatches, if any, between (a) the U.S. dollar denominated mortgage bonds, the proceeds from the Cover Pool and the Specified Instrument and (b) the currency in which interest and principal are payable on such covered bonds.

If the SPV has insufficient funds available to it to pay to the swap provider for a series of covered bonds all amounts due or which except for the appointment of the U.S. Federal Deposit Insurance Corporation ("FDIC") as conservator or receiver of the Mortgage Bond Issuer would otherwise be due by the SPV to the swap provider, the SPV's payment will be reduced to the extent of its available funds and the payment obligation of the swap provider will be reduced proportionately. However, in limited circumstances and for limited periods, such swap provider will be obliged to make payments to the SPV under the related swap agreement, without taking into account any inability of the SPV to pay such amounts in full. Failure by the SPV to pay such swap provider in full all amounts due to the swap provider relating to a series of covered bonds will not constitute a termination event under the related swap agreement but the obligations of the relevant swap provider to pay amounts to the SPV will be reduced proportionately.

⁸ The mortgage bond indenture trustee serves as asset monitor in the two current U.S. covered bond programs.

Specified Instruments: Following the occurrence of a Mortgage Bond Issuer event of default and the receipt by the SPV of the proceeds from the liquidation of the Cover Pool, the SPV will invest such proceeds in the Specified Instrument for each series of covered bonds. The Specified Instruments in the two current U.S. covered bond programs are guaranteed investment contracts and deposit agreements. The SPV will pay the investment income from each such Specified Instrument to the relevant swap provider and will receive amounts from such swap provider at the rate and in the specified currency as amounts due on the related series of covered bonds. The SPV will exchange the principal balance of each such Specified Instrument with the relevant swap provider in return for the principal amounts in the specified currency due in respect of the related series of covered bonds at its stated maturity. If a covered bond event of default occurs, including a breach of the Proceeds Compliance Test (described below), the covered bonds will accelerate. The SPV will liquidate each Specified Instrument and exchange the proceeds with the relevant swap provider for amounts paid in the specified currency specified in the relevant swap agreement, which the SPV will apply to pay the outstanding principal of, and accrued interest on, the covered bonds.

Events of Default: Following a Mortgage Bond Issuer default, covered bond investors rely upon the liquidated value of the assets in the Cover Pool to provide scheduled payments of interest and principal in respect of the covered bonds. A Mortgage Bond Issuer event of default for any series of mortgage bonds will cause a Mortgage Bond Issuer event of default to occur for all series of mortgage bonds. Investors retain an unsecured claim to the other assets of the Mortgage Bond Issuer ranking *pari passu* with other unsecured creditors. It is important to note that a default or insolvency of the Mortgage Bond Issuer does not automatically trigger an acceleration of the covered bonds. Instead, covered bonds programs are structured such that collections on, or liquidation proceeds of, the Cover Pool may continue to pay scheduled interest and principal on the covered bonds, notwithstanding that the Mortgage Bond Issuer becomes insolvent or otherwise defaults. In the event that the value of the collateral proceeds in the Cover Pool is insufficient to repay the covered bonds in full, the covered bonds will accelerate. Because the mortgage bonds are secured *pari passu* and without priority as to the collateral in the Cover Pool, following a Mortgage Bond Issuer event of default and the receipt by the SPV of the proceeds from liquidation of the Cover Pool, each series of covered bonds will share *pro rata* in any collections on, or proceeds of, the Cover Pool (based on their entitlements to proceeds from the related series of mortgage bonds), which will be invested in a Specified Instrument for such series of covered bonds.

Proceeds Compliance Test: The covered bond indenture trustee will perform the “proceeds compliance test” each month following a mortgage bond acceleration but prior to an event of default with respect to the covered bonds. On each monthly determination date, the covered bond indenture trustee will determine whether the sum of (a) the aggregate of the amounts credited to the Specified Instrument account for each series of covered bonds *less* any interest accrued that has been added to the principal thereof and (b) the aggregate unpaid principal amounts of each related series of outstanding mortgage bonds is equal to or greater than the aggregate principal amount of all series of mortgage bonds outstanding on the date on which the mortgage bond acceleration occurred. A breach of the proceeds compliance test will constitute an event of default for all series of covered bonds, which will entitle the covered bond indenture trustee to declare all series of covered bonds then outstanding immediately due and payable.

U.S. REGULATORY DEVELOPMENTS

Two significant developments occurred in 2008 that provide greater clarity and guidance with respect to the treatment of covered bonds in the U.S. and set parameters for the development of U.S. covered bonds. On July 15, 2008, the FDIC issued a final policy statement (the “FDIC Policy Statement”) concerning the treatment of covered bonds in the event of the FDIC’s appointment as conservator or receiver of a sponsor bank. On July 28, 2008, the U.S. Treasury issued guidelines for best practices in the issuance of covered bonds backed by residential mortgage loans (the “Guidelines”). In June 2009, Representative Scott Garrett (R. New Jersey) and Paul Karjorski (D. Pennsylvania) introduced the Equal Treatment of Covered Bonds Act of 2009 (the “Covered Bond Act”). The proposed legislation attempts to clarify and strengthen the status of covered bonds. Its principal provision is to accord U.S. covered bonds the status of a “qualified financial contract” (“QFC”) under the Federal Deposit Insurance Act (the “FDIA”) (12 U.S.C. 1821(e)(8)(D)). Under a QFC, covered bond holders would be entitled to exercise their rights in respect of the Cover Pool notwithstanding the FDIC’s general power to control and dispose of the property of failed depository institutions.

It is worth noting that the FDIC Policy Statement, the Guidelines and the proposed Covered Bond Act has stimulated much discussion among market participants, for example with respect to what types of institutions should be permitted to issue covered bonds and what types of assets can be included in a Cover Pool. Some commentators have suggested that non-depository institutions should be allowed to issue covered bonds. Others argue that non-mortgage assets should be eligible as collateral, such as student loans or consumer loans. The ultimate parameters of a U.S. covered bond regime are not yet clear.

The FDIC Policy Statement

If a sponsor bank is placed in conservatorship or receivership, collateral pledged to secure covered bonds is subject to the limits on contract enforcement set forth in the FDIA. One such limitation is a temporary stay on enforcement. When the FDIC is appointed conservator or receiver, the FDIA stays the enforcement of perfected security interests against the bank for 45 days following the FDIC’s appointment as conservator or for 90 days in a receivership unless the FDIC otherwise consents.⁹ This stay is a disincentive to investment in U.S. covered bonds in the absence of additional protections provided at the bank sponsor’s expense.

The FDIC Policy Statement provided for, among other things, a holder’s expedited access to collateral pledged to secure covered bonds. The FDIC consented to reducing the stay on enforcement of contractual collateral rights to 10 business days provided that covered bond programs satisfy certain conditions as further described below. The FDIC Policy Statement also clarified and confirmed the FDIC’s existing position of recognizing properly perfected security interests over a depository institution’s assets.¹⁰

⁹ 12 U.S.C. § 1821(e)(13)(C)(i).

¹⁰ See FDIC Policy Statement, Part I (Background); see also, 12 U.S.C. §1821(e) (12).

Parameters for “Covered Bonds”

The FDIC Policy Statement defines a “covered bond” as a non-deposit, recourse debt obligation of an FDIC-insured depository institution, with a term greater than one but less than thirty years, that is secured directly or indirectly by a perfected security interest in eligible mortgages or AAA-rated mortgage-backed securities secured by eligible mortgages, which mortgage-backed securities may comprise no more than 10% of the collateral for any covered bond issuance or series. Additionally, the FDIC Policy Statement allows a sponsor bank to use cash, U.S. Treasury securities and U.S. agency securities as substitution assets to “top-up” the sponsor bank’s Cover Pool of pledged mortgage loans. The use of these “substitution assets” allows the sponsor bank to maintain the over-collateralization required to secure covered bonds.

The FDIC Policy Statement imposes two other conditions on covered bonds. It requires that the sponsor bank’s primary federal regulator consent to the issuance of the covered bonds and limits the total amount of the sponsor bank’s covered bonds outstanding at the time of issuance to 4% of the sponsor bank’s total liabilities.¹¹

Definition of “Eligible Mortgages”

The FDIC Policy Statement defines “eligible mortgages” as (i) performing, (ii) first lien mortgages on one-to-four family residential properties, (iii) underwritten at the fully indexed interest rate, (iv) underwritten using documented income and (v) otherwise underwritten in accordance with existing supervisory guidance governing the underwriting of residential mortgages and such additional guidance applicable at the time of loan origination.¹² Eligible collateral also includes AAA-rated mortgage-backed securities secured by eligible mortgages. Such mortgage-backed securities could secure up to 10% of an issuance or series of covered bonds. The FDIC Policy Statement urges sponsoring banks to disclose loan-to-value ratios for the Cover Pool to enhance transparency for the covered bond market.

Expedited Consent Available to Eligible Covered Bonds

If a covered bond program satisfies the FDIC Policy Statement criteria, the FDIC will consent in advance to a holder’s request to exercise contractual rights to the collateral securing the covered bond: (i) 10 business days after the holder delivers notice of a payment default (if the payment default continues for such period) or (ii) 10 business days after the FDIC’s repudiation of the covered bond. Upon expiration of the applicable 10 business day period, the holder may liquidate the collateral using commercially reasonable methods, taking into account existing market conditions, or exercise other contractual rights with respect to the collateral. An

¹¹ The FDIC has expressly reserved the right to revisit the 4% limitation as the U.S. covered bond market develops.

¹² The FDIC Policy Statement further requires that mortgage loans be underwritten in accordance with two regulatory statements that address mortgage underwriting: The Interagency Guidance on Non-Traditional Mortgage Products dated October 5, 2006, and the Interagency Statement on Subprime Mortgage Lending dated July 10, 2007.

expedited consent applies only upon a payment default by the depository institution and, in particular, is not triggered by a depository institution insolvency.¹³

The FDIC Policy Statement provides confirmation of the measure of damages or liquidated collateral to which holders of covered bonds will be entitled following a depository institution insolvency. The FDIC defines this amount as an amount up to the par value of the covered bonds plus accrued interest thereon to the date of the FDIC's appointment as conservator or receiver, provided that the amount of damages does not exceed the value of the Cover Pool collateral.

If the value of the proceeds of the Cover Pool collateral exceeds the total amount of all valid claims held by the secured parties to the covered bond program, such excess value or over-collateralization, will be returned to the FDIC, as conservator or receiver for distribution as mandated by the FDIA. If the value of the pledged Cover Pool collateral is insufficient to cover all valid claims by the secured parties to the covered bond program, the amount of the claims in excess of the pledged Cover Pool collateral will be unsecured claims in the receivership.

The FDIC Policy Statement expresses a positive stance toward future developments in the U.S. covered bond market. The FDIC states that it anticipates that future developments in the marketplace “may present interim final covered bond structures and structural elements that are not encompassed” within the FDIC Policy Statement and therefore the FDIC “may consider future amendments of the FDIC Policy Statement as the U.S. covered bond market develops.”

U.S. Treasury Best Practices Guidelines for Residential Covered Bonds

Like the FDIC Policy Statement, the Guidelines do not constitute a statutory covered bond regime of the type that exists in Europe. Rather, the stated purpose of the Guidelines is to provide a starting point for covered bond issuers in the United States and promote “clarity” and “homogeneity” to the U.S. market. In the Guidelines, the U.S. Treasury sets out its view that covered bonds represent a potential additional source of financing that could reduce borrowing costs for homeowners, improve liquidity in the residential mortgage market and help depository institutions strengthen their balance sheets by diversifying their funding sources. The Guidelines complement the FDIC Policy Statement.

¹³ “As conservator or receiver for a depository institution, the FDIC has three options . . . : 1) continue to perform on the covered bond transaction under its terms; 2) pay-off the covered bonds in cash up to the value of the pledged collateral; or 3) allow liquidation of the pledged collateral to pay-off the covered bonds. If the FDIC adopts the first option, it would continue to make the covered bond payments as scheduled. The second or third options would be triggered if the FDIC repudiated the transaction or if a monetary default occurred. In both cases, the par value of the covered bonds plus interest accrued to the date of the appointment of the FDIC as conservator or receiver would be paid in full up to the value of the collateral. If the value of the pledged collateral exceeded the total amount of all valid claims held by the secured parties, this excess value or over collateralization would be returned to the FDIC . . . [I]f there were insufficient collateral pledged to cover all valid claims by the secured parties, the amount of the claims in excess of the pledged collateral would be unsecured claims in the receivership.” (FDIC Policy Statement, Part I (Background)).

Defining Covered Bonds

The Guidelines define a covered bond as “a debt instrument secured by a perfected security interest in a specific pool of collateral.” Cover Pool assets must consist principally of residential mortgage loans and related credit risk on the issuer’s balance sheet.¹⁴ The mortgage loans must meet underwriting criteria specified in the Guidelines. The Guidelines also specify that covered bonds must be over-collateralized by the Cover Pool and mortgage loans that are more than 60-days delinquent must be removed from the Cover Pool. Upon a default by the issuer, investors will have recourse to the Cover Pool and an unsecured claim against the issuer (ranking *pari passu* with other unsecured creditors) for any amounts remaining unpaid after liquidation of the Cover Pool.

The Guidelines present a “standardized model” for the issuance of covered bonds in the United States called the “Best Practices Template.” The Guidelines recommend that an issuer’s covered bond program adhere to the provisions set out in the Guidelines at issuance and throughout the lifetime of that issuer’s covered bonds. The U.S. Treasury’s guidance also incorporates the majority of the FDIC’s recommendations set out in the FDIC Policy Statement and is somewhat more stringent on collateral requirements. The main parameters for covered bonds are summarized below.

Structures. Two general types of covered bond structures are contemplated. The first is the “SPV Structure,” which mirrors the two current US covered bond programs. A newly created bankruptcy-remote, special purpose vehicle issues covered bonds secured by mortgage bonds purchased from a depository institution. The mortgage bonds are in turn secured by residential mortgage loans owned by the depository institution.¹⁵ In the “Direct Issuance Structure” covered bonds are issued by a depository institution, or a wholly-owned subsidiary, that designates a Cover Pool of residential mortgage loans held by the depository institution. In both structures, investors must have the benefit of a perfected security interest in the assets in the Cover Pool.¹⁶

Trustee. The issuer must appoint an independent trustee for the covered bonds.

Maturity. Covered bonds must have a maturity of at least one year but no greater than 30 years.

Eligible Cover Pool Collateral. The Cover Pool must consist of first lien mortgage loans on one- to four-family residential properties that were underwritten according to “existing

¹⁴ Treasury restricted the Guidelines to residential mortgage loans to focus on an additional funding source for the housing market and to simplify the concept of covered bonds for market participants.

¹⁵ The Guidelines also contemplate that several depository institutions may use a single special purpose vehicle to issue covered bonds on a pooled basis.

¹⁶ The Guidelines do not specify how “Direct Issuance” and “Shared Cover Pool” structures are to be constructed. Market participants will need to establish workable structures for these covered bond models.

supervisory guidance”¹⁷ and at the “fully indexed rate”¹⁸ with documented income. Each mortgage loan must be current (*i.e.*, not delinquent), have a loan-to-value ratio (“LTV”) of 80% or less at the time it is included in the Cover Pool and may not be a negative amortization mortgage loan. Any mortgage loans that become more than 60-days delinquent must be removed from the Cover Pool, and eligible mortgage loans, cash, U.S. Treasury securities or agency securities may be substituted for such mortgage loans. Finally, a single Metro Statistical Area¹⁹ cannot make up more than 20% of the Cover Pool. Treasury adopted a relatively conservative definition of eligible collateral, in line with the FDIC Policy Statement.

Overcollateralization. At all times, the value of the Cover Pool must be at least 5% greater than the unpaid principal balance of the covered bonds. To compute the value of the Cover Pool, mortgage loans having an LTV equal to or less than 80% will be valued at par while mortgage loans with LTVs greater than 80% will be discounted to reflect mortgage loans with an 80% LTV. LTVs must be updated on a quarterly basis using a nationally-recognized, regional housing price index or other comparable measurement.

Asset Coverage Test. On each monthly determination date the issuer must perform an asset coverage test to monitor the eligibility of the mortgage loans in the Cover Pool and the overcollateralization level. The issuer must appoint an independent asset monitor to periodically test the arithmetic accuracy of the issuer’s calculation of the asset coverage test. The results of the asset coverage test and any review by the asset monitor must be reported to investors. A breach of the asset coverage test which is not cured by the next monthly determination date will entitle the trustee to declare all of the issuer’s mortgage bonds immediately due and payable and effectively terminate the covered bond program.

Derivatives. Issuers may enter into interest rate swap agreements or similar financial agreements with “financially sound counterparties” that are disclosed to investors. Interest rate swaps may be used to (i) provide scheduled interest payments for a limited period of time should the issuer become insolvent, (ii) mitigate any rate mismatch between the interest rate on the covered bonds and the rate payable under the Specified Investment Contract or (iii) cover possible differences between any interest rate and/or timing mismatch between the issuer’s payments on the mortgage bonds and interest payments on the covered bonds. If the Cover Pool is denominated in a currency that is different from the related covered bonds, a currency swap must be utilized.

Specified Investment Contract. To enhance the likelihood that investors will continue to receive interest on, and principal of, the covered bonds until maturity following a depository institution default, the issuer must enter into a guaranteed investment contract or other

¹⁷ Including the Interagency Guidance on Non-Traditional Mortgage Products, dated October 5, 2006, and the Interagency Statement on Subprime Mortgage Lending, dated July 10, 2007, and any applicable guidance available at the time of loan origination.

¹⁸ The “fully indexed rate” is equal to the applicable mortgage index determined at the time of loan origination plus the margin applicable after the expiration of any introductory interest rate.

¹⁹ The U.S. Office of Management and Budget defines the Metropolitan Statistical Areas. The most recent list of Metropolitan Statistical Areas can be found at: <http://www.whitehouse.gov/omb/bulletins/fy2008/b08-01.pdf>.

arrangement (a “Specified Investment Contract”) into which proceeds of a Cover Pool liquidation or damages paid by the FDIC are deposited or invested with one or more “financially sound” counterparties. The Specified Investment Contract (augmented by the SPV’s interest rate swaps) is intended to fund payment of scheduled interest and principal payments on the covered bonds, provided that the proceeds of the mortgage loans in the Cover Pool are at least equal to the unpaid principal balance of the covered bonds.

Disclosure to Investors. An issuer must make information available to investors regarding the mortgage loans in the Cover Pool and the financial profile of the issuer itself. The Guidelines suggest that Regulation AB under the 1933 Act be used as a template for covered bond disclosure stating that it “provides a helpful template” for presenting Cover Pool information “such as summary information in tabular or graphical format and using appropriate groups or ranges.”²⁰ The information regarding the Cover Pool must be provided at issuance and no later than 30 days after the end of each month. If there is a substitution of collateral involving more than 10% of the Cover Pool in one month, or more than 20% in one quarter, the issuer must provide updated Cover Pool data. The depository institution and the SPV (in an SPV Structure) must also disclose information regarding its financial profile and other relevant information that an investor would find material.

Regulatory Authorization. Issuers must receive permission from their primary federal regulator to issue covered bonds and may not issue covered bonds equal to more than 4% of their liabilities after issuance.

Pro Rata Allocation of Losses. If several covered bond issuances are secured by a single Cover Pool, any losses arising from an issuer default must be allocated *pro rata* across the covered bond issuances.

It is important to observe that while Treasury has mapped out a “starting point” with which it hopes to encourage the development of covered bonds, it is not promoting covered bonds “over other financing options available to ‘depository institutions’.” The Guidelines are non-binding and, as Treasury makes clear, it does not endorse a specific structure but rather it “fully expects the structure, collateral and other key terms of covered bonds to evolve with the growth of this market in the United States.”

1933 ACT CONSIDERATIONS

Under the existing U.S. covered bond programs, covered bonds have been offered in the U.S. pursuant to Rule 144A under the 1933 Act. The sale of the mortgage bonds issued by the Mortgage Bond Issuer to the SPV have been issued in an exempt transaction pursuant to Section 4(2) of the 1933 Act.

Registration of a U.S. covered bond program under the 1933 Act is a logical next step to enhance the liquidity of covered bonds in the secondary market. Registration presents challenges, such as establishing the appropriate level of disclosure on the Cover Pool assets.

²⁰ For a further discussion of Regulation AB, see Chapter 10 (*Asset-Backed Securities*) of this volume.

Some market participants have suggested that Cover Pool disclosure should be similar to that of medium-term note programs, with relatively little information on the Cover Pool assets, as is the case in Europe. Such market participants argue that because the Cover Pool is dynamic, permitting relatively free substitution of assets, detailed disclosure of loan characteristics is difficult to keep current and less important than the eligibility criteria (such as those set forth in the Guidelines that limit what types of collateral can be included in the Cover Pool). It is uncertain whether investors or the SEC would accept such reduced asset level disclosure. The current climate suggests that the SEC, and many market participants, are likely to require significant disclosure of Cover Pool assets consistent with the standards of Regulation AB and those currently evolving for asset-based finance generally.

1940 ACT CONSIDERATIONS

Under the existing U.S. covered bond programs, the SPV has relied on the exemption provided by Rule 3a-7 of the 1940 Act. The Mortgage Bond Issuer has relied on the exemption provided by Section 3(c)(3) of the 1940 Act. Other potential structures can raise complex 1940 Act issues, such as whether arrangements to hold and vest proceeds of a sale of Cover Pool assets requires registration as an “investment company” under the 1940 Act.

BASIC DOCUMENTS

Set forth below is a list of basic documents for an offering of covered bonds in the U.S. market.²¹ Please refer to Appendix B (*Basic Documents for Securities Offerings in the U.S. Capital Markets*) of this volume, as well as the other volumes of *Accessing the U.S. Capital Markets*, for a further description of these documents.

1. Base offering document and pricing supplements for each series of covered bonds.
2. Mortgage bond indenture and series supplements pursuant to which the mortgage bond issuer issues series of mortgage bonds.
3. Form of mortgage bonds.
4. Asset monitor agreement.
5. Mortgage bond purchase agreements pursuant to which the SPV purchases series of mortgage bonds from the mortgage bond issuer.
6. SPV constitutive documents (*i.e.*, declaration of trust and series trust supplements).
7. Covered bond indenture and series supplements, including terms and conditions of the covered bonds, pursuant to which the SPV issues series of covered bonds.
8. Form of covered bonds.

²¹ The list assumes that an offering of covered bonds is based on the current U.S. covered bond structure.

9. Interest rate and currency swap agreement(s) for each series of covered bonds.
10. Specified investment contract(s) for each series of covered bonds.
11. Program agreement and subscription and sale agreement(s).
12. DTC letter of representations.
13. Legal opinions.
14. Auditor's comfort letter(s).
15. Other closing documents.
16. Listing documents (if applicable).²²

²² Covered bonds issued under the existing U.S. covered bond programs are listed on the London Stock Exchange.

CHAPTER 12

TRADITIONAL PRIVATE PLACEMENTS

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Depending on the type of transaction an issuer is interested in pursuing, a private placement is frequently a viable alternative to an SEC-registered public offering. The three most common types of institutional private placement are (1) a stand-alone Rule 144A placement with U.S. institutional investors of a significant amount of securities of either a domestic or foreign issuer, where the methods used to negotiate terms and distribute the securities closely resemble those used in a registered public offering; (2) a continuous Section 4(2) private program, following Regulation D or Rule 144A procedures, involving either commercial paper that does not qualify for the Section 3(a)(3) exemption or medium-term notes, which in either case are continuously sold to institutions; and (3) a traditional Section 4(2) institutional private placement of debt securities with a relatively small number of institutional purchasers. The first two types of methods are addressed elsewhere in this volume or in the other volumes of *Accessing the U.S. Capital Markets*. This chapter focuses on the traditional Section 4(2) institutional private placement (“traditional private placement”).

GENERAL

A traditional private placement is a method of raising equity or debt from institutional investors. In the United States, traditional private placements are exempt from SEC registration pursuant to the exemption provided by Section 4(2) of the 1933 Act. This exemption allows companies to avoid SEC registration and some of the liabilities and other regulation associated with public offerings, including the Sarbanes-Oxley Act.

Traditional private placements with insurance companies and other large institutional investors are a popular method of capital raising, as issuers benefit from the flexibility and confidentiality associated with these transactions and investors’ willingness to invest in unrated “story” companies. Traditional private placements also tend to overcome some of the delay, expense and inconvenience associated with other types of capital raising in the U.S. capital markets.

Since 1993, traditional private placements have become more streamlined and efficient, predominantly through the efforts of a group of institutional investors, investment banks and law firms that established the Private Placement Enhancement Project (the “PPEP”). The PPEP’s working group published two model forms of note purchase agreements in 1994, and a *Financial Covenants Reference Manual* followed in 1996.

In 1995, *Private Placement Process Enhancements* was published, which included recommendations for facilitating the documentation process. A *Guide to Amendments* brochure followed in 1996 and sets forth preferred procedures for the amendment process. In 2004, the American College of Investment Counsel (a group comprised primarily of legal counsel working for or representing insurance companies) undertook to update and publish additional model form note purchase agreements (including, among others, a cross-border version for use by non-U.S. issuers), together with other guides and position papers relevant to the traditional private placement market. Those model form note purchase agreements, as well as most of the other above-referenced documents, term sheets, checklists and legal due diligence guidelines, can be found on the website of the American College of Investment Counsel at http://aciclaw.org/forms_guides/default.asp.

In 2008, U.S.\$28 billion was reported to have been raised in the traditional private placement debt market. Approximately half of the funds raised in the traditional private placement debt market in 2008 were by non-U.S. issuers in cross-border transactions. Like all capital markets, issuance levels in the traditional private placement debt market were down in 2008. Prior to 2008, annual capital raisings in the traditional private debt market were approximately U.S.\$50 billion.

The main investors in traditional private placements are the large United States insurance companies and major pension and other retirement funds, and are sometimes referred to as the “super-QIBs.”¹ One of the hallmarks of the traditional private placement is the participation of very large, very sophisticated investors, who are given direct access to the issuer prior to making any investment decision.

The traditional private placement market started primarily as a market in which U.S. issuers sold securities to major U.S. institutional investors. However, today this market has expanded to the point that currently approximately half of the issuances on a volume basis involve non-U.S. issuers. In addition to the more “standard” cross-border issuer jurisdictions such as the United Kingdom and Australia, issuers from such jurisdictions as China, Russia, Israel, India and Kazakhstan have issued debt in traditional private placements. Also, the investor base of the traditional private placement market is no longer limited to the large U.S. institutional investors, but also now includes other institutional investors from developed countries around the world. Furthermore, the traditional private placement debt market has proven to be very flexible in terms of issuing structures, including deals with fixed interest rates, floating interest rates, zero coupon bonds, multi-currencies and unique structures where the investors buy bonds in a foreign currency and swap to their local or preferred currency (as opposed to the more standard approach where the issuer does so).

For high quality issuers, deal size in the traditional private placement debt market can rival the Rule 144A bond market, and numerous traditional private placements in excess of U.S.\$1 billion have been completed.

¹ This term has no actual legal meaning, but is used to denote the largest institutional investors.

For companies investigating ways to tap the U.S. capital markets, the traditional private placement market offers a number of attractive features including the following:

- The documentation is less rigid than in the larger Rule 144A bond market.
- The traditional private placement market allows more flexibility with regard to bond structures and, since these bonds will be infrequently traded (the traditional private placement market is considered to be relatively illiquid), investors can receive tailored securities that better address their particular investment requirements.
- The traditional private placement market stresses confidentiality and offering materials are distributed to a very limited group of potential investors. For this reason, many notable privately held companies and associations have accessed the traditional private placement market, such as the Hallmark Company, the National Basketball Association, Cabelas Inc (pre-IPO) and the Packer family companies in Australia.
- Investors do not require the standard and sometimes costly credit ratings required in other bond markets, including the Rule 144A and Eurobond markets. Traditional private placement bonds are rated by the United States insurance company regulator, the National Association of Insurance Commissioners, thus obviating the need for credit ratings by the outside credit rating agencies.
- Traditional private placements provide flexibility with regard to the amount of financing and whether the financing will be in the form of debt, equity or debt and equity capital.
- The transaction costs associated with a traditional private placement are usually lower than other forms of capital raising, such as Rule 144A transactions, venture capital raisings or selling stock to the public as an initial public offering.

Conversely, there are certain disadvantages to a traditional private placement. Due to a relatively limited investor base, there can be reduced price tension as compared to other markets, which may result in slightly higher interest rates in the traditional private placement market. In addition, traditional private placements will generally include covenants more restrictive than those in other capital markets transactions. In addition, issuers frequently must agree to assume a greater amount of the issuance expenses, including investors' counsel costs.

Many observers view the traditional private placement debt market as a stepping stone, used by investment grade issuers before they have two credit ratings and can access the Rule 144A market. However, in certain jurisdictions (*e.g.*, Australia) the traditional private placement debt market has become the preferred U.S. capital market for some issuers due to its ease of issuance and cost efficiency and is frequently utilized by issuers who could otherwise access the Rule 144A market.

THE TRANSACTION PROCESS

Typically, an issuer that is interested in accessing the traditional U.S. private placement market will need to select an investment banker. The issuer and the investment banker's private placement group will review the current market conditions and will then draw up a tentative term sheet that will include the financial covenants that the purchasers are likely to require. Investors' counsel is almost always pre-selected from among a small group of law firms that include Sidley and specialize in acting in this capacity and that are known to be acceptable to the major investing institutions. This step is critical because the investors' counsel will be selected prior to the investors being identified.

The note purchase agreement will be drafted on the basis of the terms sheet and one of the previously-mentioned model forms and circulated to the prospective investors. Generally the note purchase agreement will be drafted by investors' counsel, although a small number of firms that specialize in issuer representation and who are familiar with the model form documents, such as Sidley, may draft the note purchase agreement on behalf of the issuer. In drafting the note purchase agreement, the various financial covenants will need to be negotiated, depending on the creditworthiness of the issuer. Typical negotiations will revolve around, for instance, limitations on additional debt that the issuer may incur, limitations on liens and debt of subsidiaries and maintenance of an interest coverage ratio.

A private placement memorandum ("PPM") will be prepared by the investment bank, with the assistance of the issuer. The PPM will generally be drafted based on publicly available information with respect to the issuer. To the extent that the issuer is closely held, the PPM content may be significantly limited and information will be conveyed to the investors primarily through direct communication with the issuer. In the event that the issuer is an SEC-reporting company, the PPM will consist of a term sheet and the issuer's 1934 Act reports.

In an effort to place the issue, the investment banker will contact institutional investors. Typically the issuer will undertake a road show with the investment banker and will personally meet the prospective investors. A draft of the PPM, the term sheet and the note purchase agreement will be delivered to each investor prior to the start of the road show. The investors will have the opportunity to review the documents and ask questions of the issuer prior to making any investment decision. If they wish, the investors may comment on the terms of the note purchase agreement and any supporting documents. However, the investors risk that the issuer may reject any bid that is contingent upon certain documentary changes being made.

Once the investor bids are submitted, consisting of bid sizes and required credit spreads to applicable U.S. treasury securities (for fixed rate bonds) or LIBOR (for floating rate bonds), the issuer determines what bids it will accept. This is termed the "circle" process. Once the transaction is circled, each bond of each series receives interest at the clearing price for that series. The investors' counsel then works with the issuer's counsel to incorporate the deal terms and any accepted circle comments into the note purchase agreement and to otherwise close the transaction. Lengthy documentary negotiations post-circle are not typical, but they do occur from time to time.

INVESTMENT REPRESENTATIONS

The note purchase agreement will contain a representation by each investor that such investor is purchasing the securities for its own account and not with a view to distribution, and that the securities will not be resold without an available exemption under the 1933 Act. Securities legends are generally thought to be unnecessary in traditional debt private placements.

AVAILABILITY OF SECTION 4(2) EXEMPTION

Traditional private placements rely on the exemption from registration provided by Section 4(2) of the 1933 Act. Section 4(2) is available because the issuer will privately sell securities directly to the ultimate investors (as opposed to securities being sold publicly). Each investor will be a sophisticated institutional investor that has the bargaining power to fend for itself. Of critical importance, the investors should have access to the issuer and be provided with the opportunity to ask questions of the issuer prior to making any investment decision. The notes will be placed through direct negotiation and therefore the proscribed actions of general solicitation and general advertising under the 1933 Act generally should not be an issue.

TRANSFERS OF TRADITIONAL PRIVATE PLACEMENT SECURITIES IN THE SECONDARY MARKET

A relatively thin secondary market exists for traditional privately placed securities. Institutions do not generally purchase privately placed securities with a view to resale. To the extent that an investor in traditional privately placed securities does wish to sell its securities, it has two options. First, it may contact other investors in the traditional private placement market to trade directly. Second, an investor may contact one of the few broker-dealer desks that specializes in brokering trades in traditional private placement securities.

BASIC DOCUMENTS

Set forth below is a list of basic transaction documents for an institutional private placement conducted on a stand-alone basis. The note purchase agreement has become largely standardized by the American College of Investment Counsel. Please refer to Appendix B (*Basic Documents for Securities Offerings in the U.S. Capital Markets*) of this volume, as well as the other volumes of *Accessing the U.S. Capital Markets*, for a further description of these documents.

1. Terms sheet.
2. Note purchase agreement.
3. Private placement memorandum.
4. Form of note.
5. Legal opinions.
6. Other closing documents.

GLOSSARY

This glossary contains or refers to certain definitions of terms used in this volume of Sidley’s Accessing the U.S. Capital Markets. The page reference after the definition for each term is to the page in this volume where that term is first used or defined.

10b-5 statement.....	a statement to the underwriters by U.S. counsel to the effect that nothing has come to such counsel’s attention to cause it to believe that the registration statement (in the case of a 1933 Act-registered offering) or the offering documents contains or incorporates by reference any material misstatement or omits any material fact necessary required to be stated therein (in the case of a 1933 Act-registered offering) or to make the statements, in light of the circumstances under which they were made, not misleading. (p. 12)
1933 Act.....	U.S. Securities Act of 1933 (p. 2)
1934 Act.....	U.S. Securities Exchange Act of 1934 (p. 14)
1939 Act.....	U.S. Trust Indenture Act of 1939 (p. 47)
1940 Act.....	U.S. Investment Company Act of 1940 (p. 17)
ADR.....	American depository receipts issued by a depository, typically a U.S. bank, that evidence a direct interest in underlying securities held by the Depository (p. 12)
ADS.....	American depository shares are securities (or a fraction or multiple thereof) that are evidenced by an ADR and that represent underlying securities held by or on behalf of the Depository that issued the ADR (p. 14)
ATI.....	adjusted taxable income (p. A-20)
Basel Committee.....	Basel Committee on Banking Supervision (p. 44)
‘Blue Sky’ or State Securities Laws.....	securities laws of U.S. states and territories (p. 101)
CEA.....	U.S. Commodity Exchange Act (p. 83)
Clearstream.....	Clearstream Banking, <i>société anonyme</i> (p. 74)
Code.....	U.S. Internal Revenue Code of 1986 (p. A-1)

cooling-off period	delay in an offering of securities that may be required by SEC in the event of a gun-jumping violation (p. 10)
Cover Pool	collateral pledged by a Mortgage Bond Issuer to secure covered bonds (p. 119)
CUSIP	Committee on Uniform Securities Identification Procedures (p. 21)
deposit agreement	deposit agreement under an ADR facility (p. A-3)
Depository	the depository bank that issues ADRs and GDRs pursuant to a deposit agreement (p. 14)
Depositor.....	a wholly-owned “bankruptcy remote” subsidiary of an asset originator in an asset-backed transaction which in turn transfers the assets to a special purpose vehicle (p. 103)
DR.....	depository receipt (p. 14)
DS	depository share (p. 14)
DSP	directed share program (p. 9)
DTC.....	The Depository Trust Company (p. 12)
EBITDA.....	earnings before interest, taxes, depreciation and amortization (p. 55)
EDGAR.....	the SEC’s Next-Generation Electronic Data Gathering, Analysis, and Retrieval System (p. 19)
ERISA.....	Employee Retirement Income Security Act of 1974 (p. 86)
Euroclear.....	Euroclear Bank S.A./N.V. (p. 74)
exempt distributor	certain distributors, offers to whom will not be considered offers or sales to a person within the United States or to U.S. persons under applicable U.S. Treasury regulations (p. A-12)
Exxon Capital No-Action Letter..	SEC No-Action Letter <u>Exxon Capital Holdings Corp.</u> , available May 13, 1988 (p.)
FDIA	Federal Deposit Insurance Act (p. 126)
FDIC	Federal Deposit Insurance Corporation (p. 124)

FDIC Policy Statement	final policy statement (published July 15, 2008) concerning the treatment of covered bonds in the event of the FDIC's appointment as conservator or receiver of a sponsor bank (p. 126)
Federal Reserve Board.....	Board of Governors of the Federal Reserve System (p. 44)
FIN 46R	Financial Accounting Standards Board Interpretation 46R (p. 48)
FINRA.....	Financial Industry Regulatory Authority (p. 8)
GDR	global depositary receipt (p. 14)
Green Shoe.....	underwriter's option to purchase additional shares from an issuer or a selling securityholder (p. 8)
Guidelines	U.S. Treasury guidelines for best practices in the issuance of covered bonds backed by residential mortgage loans (p. 126)
gun-jumping.....	offers made in violation of certain regulatory requirements of the 1933 Act (p. 10)
Holder Sanctions.....	penalties imposed on a holder of bearer debt securities with a maturity of more than one year that are offered, sold or delivered in contravention of the U.S. tax law (p. A-9)
IASB	International Accounting Standards Board (p. 4)
IFRS	International Financial Reporting Standards (p. 4)
IPO	initial public offering (p. 2)
IRS	U.S. Internal Revenue Service (p. A-3)
ISIN.....	International Security Identification Number (p. 23)
Issuer Sanctions	penalties imposed on an issuer of bearer debt securities with a maturity of more than one year that are offered, sold or delivered in contravention of the U.S. tax law (p. A-9)
Issuing Entity	a special purpose vehicle, often a trust, that is the recipient of an asset transfer from a Depositor and is the issuer of asset-backed securities (p. 103)
JGTRRA	Jobs and Growth Tax Relief Reconciliation Act of 2003 (p. A-3)

Level One.....	ADR facility in which the ADRs are issued against shares of a foreign private issuer that have been deposited with the custodian bank under the ADR facility. These ADRs (i) trade in the U.S. over-the-counter market through market makers that publish quotations or indications of interest in the “Pink Sheets,” (ii) are not listed on a U.S. national securities exchange or quoted on the OTC Bulletin Board Service, and (iii) have not been sold in the United States as part of a 1933 Act-registered public offering. (p. 15)
Level Two.....	ADR facility in which the ADRs are issued against shares of a foreign private issuer that have been deposited with the custodian bank under the ADR facility. These ADRs are listed on a U.S. national securities exchange, but have not been sold in the United States as part of a 1933 Act-registered public offering. (p. 16)
Level Three.....	ADR facility in which the ADRs are issued against new shares of a foreign private issuer that have been deposited with the custodian bank under the ADR facility. These ADRs are listed on a U.S. national securities exchange and have been sold in the United States as part of a 1933 Act-registered public offering. (p. 16)
LIBOR.....	London interbank offered rate (p. 69)
LTV.....	loan-to-value ratio (p. 130)
market measure.....	underlying asset performance from which return on a structured note is derived (p. 76)
MBS.....	mortgage-backed security (p. 121)
Medium-term notes.....	notes offered pursuant to certain continuous offering procedures (p. 69)
Moody’s.....	Moody’s Investors Service (p. 44)
Mortgage Bond Issuer.....	a depository institution that issues mortgage bonds, secured by a pool of residential mortgage loans, to a newly created, bankruptcy-remote, special purpose Delaware statutory trust (p. 122)
NAIC.....	National Association of Insurance Commissioners (p. 44)

NASDAQ.....	National Association of Securities Dealers Automated Quotation System (p. 5)
NYSE.....	New York Stock Exchange (p. 5)
NYSE Amex.....	the U.S. securities exchange formerly referred to as the American Stock Exchange prior to its acquisition by NYSE Euronext (p. 5)
OFAC.....	Office of Foreign Assets Control of the U.S. Treasury (p. B-6)
OID.....	original issue discount (p. A-6)
Originator/Servicer.....	the originator and servicer of the assets in an asset-backed transaction (p. 103)
OTC Bulletin Board.....	the over-the-counter securities quotation system maintained by FINRA (p. 15)
PFIC.....	passive foreign investment company (p. A-1)
PORTAL.....	an institutional trading system established by FINRA for the trading of restricted securities (p. 34)
PPEP.....	Private Placement Enhancement Project (p. 134)
PPM.....	private placement memorandum (p. 137)
QEF election.....	an election that permits avoidance of certain penalty taxes related to holding PFIC stock (p. A-2)
QIB.....	qualified institutional buyer as defined in Rule 144A (p. 20)
Reasonable Arrangements Test....	test to avoid Issuer and Holder Sanctions under TEFRA D (p. A-11)
red herring.....	a preliminary prospectus or offering document (p. 11)
Regulation AB.....	Regulation AB under the 1933 Act and the 1934 Act (p. 102)
Regulation D.....	Regulation D under the 1933 Act (p. 71)
Regulation S.....	Regulation S under the 1933 Act (p. 14)
Regulation S-X.....	Regulation S-X under the 1933 Act (p. 46)

Regulation T.....	Federal Reserve Board Regulation T (p. 73)
restricted payments	certain payments limited by high-yield debt securities negative covenant packages (p. 54)
restricted securities.....	securities subject to the resale restrictions of Rule 144 (p. 21)
restricted subsidiaries.....	certain subsidiaries of an issuer bound by high-yield debt securities negative covenant packages (p. 51)
RRA	Revenue Reconciliation Act of 1993 (p. A-16)
Rule 144.....	Rule 144 under the 1933 Act (p. 21)
Rule 144A.....	Rule 144A under the 1933 Act (p. 14)
Sarbanes-Oxley or SOA.....	Sarbanes-Oxley Act of 2002 (p. 4)
SEAQ.....	Stock Exchange Automated Quotation system (p. 22)
SEC	U.S. Securities and Exchange Commission (p. 2)
SFAS 131	Statement of Financial Accounting Standards No. 131 (p. 47)
short-term debt.....	debt obligation with a maturity of 183 days or less (p. A-13)
SPV	special purpose vehicle formed for the specific purpose of an offering to isolate assets, obligations and cash flows (p. 119)
SRO.....	SEC-registered self-regulatory organization (p. 34)
Staff.....	the staff of the SEC (p. 30)
STRIPS	Separate Trading of Registered Interest and Principal of Securities (p. 41)
structured note.....	debt securities the return on which is derived from the value or performance of an underlying asset (p. 76)
Tax Treaty.....	tax convention between the United States and another country (p. A-3)
TEFRA.....	Tax Equity and Fiscal Responsibility Act of 1982 (p. A-11)

TEFRA D	Part D of TEFRA (p. A-11)
trust preferred securities.....	equity securities, issued by a trust, normally a Delaware trust, holding debt securities of the sponsor of an affiliate (p. 44)
UCITS.....	European Undertaking for Collective Investment in Transferable Securities Directive (p. 121)
Underlying Shares.....	in an ADR facility, the segregated equity shares of a foreign private issuer that have been deposited at a custodian bank in the country of origin (p. 14)
U.S. GAAP.....	U.S. generally accepted accounting principles (p. 4)
U.S. Treasury	U.S. Department of the Treasury (p. 41)
WKSI	well-known seasoned issuer, as defined in Rule 405 under the 1933 Act (p. 32)

Appendix A

U.S. Tax Considerations for Non-U.S. Issuers Accessing the U.S. Capital Markets

APPENDIX A

U.S. TAX CONSIDERATIONS FOR NON-U.S. ISSUERS ACCESSING THE U.S. CAPITAL MARKETS¹

EQUITY OFFERINGS.....	A-1
ADR PROGRAMS.....	A-4
DEBT OFFERINGS.....	A-6
TEFRA D.....	A-11
COMMERCIAL PAPER OFFERINGS.....	A-14
COMMERCIAL PAPER FINANCE SUBSIDIARIES.....	A-15
PARENT GUARANTEED DEBT.....	A-16
DEBT REOPENINGS.....	A-21

Circular 230

This publication has been prepared by Sidley Austin LLP for informational purposes only and does not constitute legal advice. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. In addition, any discussions of U.S. federal income tax matters set forth in this publication were written in connection with the promotion and marketing of the transactions or matters described in this publication. Such discussions were not intended or written to be legal or tax advice to any person and were not intended or written to be used, and they cannot be used, by any person for the purpose of avoiding any U.S. federal tax penalties that may be imposed on such person. Each taxpayer should seek advice based on its particular circumstances from an independent tax advisor.

EQUITY OFFERINGS

The U.S. tax implications to an issuer or an investor in equity securities can be quite simple. However, there are at least three important issues that will need to be addressed in offering foreign equity securities in the United States:

- (1) status of the issuer as a Passive Foreign Investment Company (“PFIC”) for U.S. tax purposes,
- (2) withholding taxes, and
- (3) qualification of the issuer’s distributions as dividends.

¹ All “section” references are to the United States Internal Revenue Code (“Code”), and all “Treas. Reg. §” references are to the United States Treasury department regulations promulgated thereunder.

A primary concern of a portfolio investor (*i.e.*, an investor owning less than 10 percent of the issuer's voting stock) is that the issuer not be classified as a PFIC. Generally, U.S. investors are not subject to federal income tax on equity securities they hold unless a dividend is paid or the securities are sold. However, classification of the issuer as a PFIC could subject a U.S. investor to more burdensome taxation and tax reporting requirements.

PFIC Status

A foreign private issuer that is a corporation for U.S. federal income tax purposes is classified as a PFIC if either: (1) 75 percent or more of its income is passive income or (ii) 50 percent or more of its assets produce, or are expected to produce, passive income. Passive income generally includes interest, dividends, royalties and rents as well as net gains derived in connection with the sale of assets which produce any of the aforementioned types of income. There is a special exemption for certain active banks and insurance companies. The application of the PFIC rules is highly technical and may require an in-depth analysis of the foreign private issuer's income statement and balance sheet. Generally, an industrial company should be able to avoid PFIC status. However, financial entities (including banks, trust companies, and insurance companies) may find it more difficult to avoid PFIC status if they cannot qualify for the active banking or insurance exemption. Non-U.S. issuers planning to offer their equity securities in the United States should determine their status under the PFIC rules prior to committing themselves to offering such securities.

A U.S. shareholder of a PFIC will be subject to special penalty taxes on (i) "excess distributions" received from the PFIC and (ii) gain recognized on the disposition of the PFIC stock. An "excess distribution" is defined as the excess of (i) the distributions received from the PFIC during the current taxable year over (ii) 125 percent of the average of distributions ("average distributions") received from the PFIC over the preceding three taxable years ("averaging period"). If the U.S. shareholder has held the PFIC stock for less than three years, average distributions are computed over the period the stock was held prior to the current taxable year. If the issuer makes certain financial information available, a U.S. investor may avoid paying the penalty taxes by making an election (referred to as a "QEF election") to include in such shareholder's gross income its respective share of the PFIC's ordinary earnings and net capital gains for the taxable year. A U.S. shareholder making a QEF election must pay tax on such income whether or not it is distributed unless a separate election is made to defer the tax payment, subject to an interest penalty charge, on the amount of such income that remains undistributed by the PFIC. Importantly, a U.S. shareholder is permitted to make the QEF election only if the issuer makes available financial information (in accordance with U.S. tax principles) which enables the U.S. shareholder to calculate its pro rata share of the PFIC's ordinary earnings and net capital gains.

Certain shareholders of a PFIC are permitted to elect out of the PFIC regime by marking-to-market their stock on an annual basis to the extent the stock of the PFIC is "marketable." Mark-to-market gains are included in the shareholder's income as ordinary income. Mark-to-market losses may offset ordinary income to the extent of previously recognized mark-to-market gains. The election applies to stock regularly traded on certain established securities exchanges or other markets the Secretary of the Treasury determines "ensure the market price represents a legitimate and sound fair market value" as provided by regulation.

For additional information on PFICs, please refer to the Sidley Austin LLP outline on Passive Foreign Investment Companies which is available upon request.

Withholding Taxes

Dividend payments, like interest, are often subject to withholding taxes. In many cases, a tax convention between the United States and another country (a “Tax Treaty”) reduces the withholding tax on dividends paid by a non-U.S. corporation to a U.S. resident to 15 percent.

A foreign private issuer offering its securities in the U.S. markets should, to the extent it expects to pay regular dividends, make whatever arrangements are necessary so that U.S. investors can qualify for the lower rate under the Tax Treaty. For example, if the foreign private issuer’s home jurisdiction requires a U.S. investor to execute a special form to secure the reduced withholding rate, the form should be made readily available to U.S. investors. Except as discussed below, U.S. investors do not generally expect a gross-up payment on withholding taxes imposed on dividends.

Non-U.S. financial institutions have offered guaranteed fixed rate preferred stock through a subsidiary located in a jurisdiction that does not impose a withholding tax. Investors have viewed these securities as an alternative to fixed income debt securities and purchase them for their stated return. Thus, investors normally demand a gross-up payment (similar to that discussed below with respect to debt obligations) for any withholding taxes on this type of preferred stock.

Qualification of the Issuer’s Dividends for the Reduced Dividend Rate

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (“JGTRRA”) was signed into law on May 28, 2003, and is currently set to expire on December 31, 2010. JGTRRA amends the Code to, among other things, reduce federal income tax rates on certain dividends. With respect to foreign private issuers, JGTRRA generally provides that (i) dividends paid by a “qualified foreign corporation” are subject to a fifteen percent rate of tax for individuals, subject to certain limitations, (ii) a “qualified foreign corporation” includes certain foreign corporations that are eligible for the benefits of a comprehensive income tax treaty with the United States that the IRS determines is satisfactory for purposes of JGTRRA and that includes an exchange of information program (the “Treaty Test”), and (iii) a foreign corporation not otherwise treated as a “qualified foreign corporation” is so treated with respect to any dividend it pays if the stock with respect to which it pays such dividend is “readily tradable on an established securities market in the United States” (the “Trading Test”).

JGTRRA itself does not specify the treaties that would satisfy the Treaty Test. Accordingly, the IRS has published Notice 2006-101, which lists the current U.S. tax treaties that meet the requirements of the Act, as well as those current treaties that do not. Notice 2006-101 also provides guidance on additional requirements of the Treaty Test that an issuer must meet in order to be a “qualified foreign corporation.”

The IRS has also published Notice 2003-71, which provides guidance on the Trading Test. Notice 2003-71 states that common or ordinary stock, or an American depository receipt in respect of such stock, meets the Trading Test if it is listed on a national securities exchange that

is registered under Section 6 of the 1934 Act, including the NASDAQ Stock Market. Notice 2003-71 also provides a list of registered national exchanges.

For additional information on JGTRRA, please refer to the Sidley Austin LLP Tax Practice Alerts regarding JGTRRA, which are available on the firm's web site.

ADR PROGRAMS

An ADR program, if properly structured, should be transparent for U.S. federal income tax purposes. That is, the holder of an ADR will be treated as the owner of the underlying share(s) represented by the ADR. For U.S. tax purposes, the ADR represents nothing more than a custodial receipt. To determine the tax consequences of holding an ADR, the investor would look to the tax treatment of the underlying share(s).²

Issuing ADRs may be more attractive to foreign private issuers as a result of certain provisions of the JGTRRA. JGTRRA provided that certain dividends paid by "qualified foreign corporations" would be subject to a reduced rate of tax. A foreign corporation will be treated as a "qualified foreign corporation" with respect to any dividend paid by the corporation with respect to stock that is readily tradable on an established securities market in the United States. The legislative history to JGTRRA indicates that shares of a foreign corporation will be treated as readily tradable on an established securities market in the United States if ADRs backed by such shares are so traded. Therefore, JGTRRA permits foreign issuers to take advantage of the reduced rate of tax on dividends even if only ADRs, and not the underlying share(s), are traded on a U.S. securities market.

There are, however, three technical U.S. tax issues that may arise under the typical ADR deposit agreement ("deposit agreement") relating to the pre-release of ADRs, fixing of the record date, and conversion of foreign currency.

Pre-Release

The deposit agreement may allow the Depository to issue ADRs prior to actual physical receipt of the underlying share(s). For U.S. tax purposes, this raises the question as to who is the owner of the underlying share(s) prior to their delivery to the Depository (*i.e.*, the ADR holder (which may be different from the depositor or its agent due to an interim sale of the ADR) or the depositor). The ownership question is important because only the beneficial owner of the underlying share(s) is entitled to, and must report, the dividends and any related tax credit.

We have been advised by certain Depositories that, in practice, this should not be a concern because Depositories require transferors to represent that they actually own the underlying share(s) purported to be transferred and will deliver to the Depository any dividends or other rights accompanying each underlying share(s) that is deposited with the Depository. This practice should be confirmed with the Depository. Alternatively, the deposit agreement could be worded to make it clear that the transferor:

² See IRS Rev. Rul. 65-218, 1965-2 C.B. 566.

- (1) owns the underlying share(s) upon a pre-release of an ADR,
- (2) will retain ownership of such underlying share(s) and any property distributed on the underlying share(s) until they are delivered to the Depository, and
- (3) will hold such underlying share(s) as agent for the Depository.

Record Dates

Generally, the deposit agreement allows the Depository to “fix a record date for the determination of the owners who shall be entitled to receive such dividend, distribution or rights, or net proceeds from the sale thereof” Thus, the deposit agreement allows the Depository to set a date (other than the record date) for the above mentioned items distributed on the underlying share(s). For U.S. tax purposes, it is important that the record dates on the ADRs be the same as those set on the underlying share(s). This is so because the owner of a dividend (or other distribution) and the person (or entity) responsible for including the distribution in income is the beneficial owner of such distribution. For this purpose, the tax owner will be the beneficial owner on the underlying share(s) record date regardless of the ADR record date.

In practice, however, certain Depositories have advised us that they always set the record date on the same day as the underlying share(s) so long as the issuer gives it sufficient notice. This practice should be confirmed with the Depository. Alternatively, the deposit agreement could be worded more restrictively so that the Depository must set the same record date. In either case, the issuer must give the Depository sufficient notice so it will be able to fix consistent record dates.

Foreign Currency Exchange

Generally, a deposit agreement may permit the Depository to convert non-U.S. currency into U.S. dollars in any manner that it may determine. For example, if the Depository receives a dividend in non-U.S. currency (or receives non-U.S. currency on the sale of non-cash distributions) and converts such currency into U.S. dollars on that same day, a U.S. holder will report, for U.S. tax purposes, the amount of U.S. dollars received. However, if the Depository converts the non-U.S. currency on a later day, a U.S. holder will have to account for non-U.S. currency exchange gain or loss (if any).³

Certain Depositories have advised us that in practice they convert all non-U.S. currency on the day it is received or made available. This practice should be confirmed with the Depository, and the deposit agreement should provide that the Depository shall convert all non-U.S. currency immediately upon receipt or availability.

³ Generally, the value of non-U.S. currency received as a dividend is included in a U.S. shareholder’s income, for U.S. federal income tax purposes, at the spot rate on the day such dividend is received (or unqualifiedly made subject to the demands of shareholders) and the U.S. shareholder takes a tax basis in the currency for such amount. When the non-U.S. currency is later converted, the U.S. shareholder will account for the difference between the proceeds from the sale of the non-U.S. currency and its tax basis in such amount as exchange gain or loss. Such gain or loss is generally treated as ordinary income or loss. See section 988.

DEBT OFFERINGS

Original Issue Discount

For U.S. tax purposes, “original issue discount” (“OID”) is the excess (if any) of the “stated redemption price at maturity” of a debt instrument over its “issue price,” if such excess equals or exceeds a specified *de minimis* amount (generally 1/4 of 1% of the debt instrument’s stated redemption price at maturity (i) multiplied by the number of complete years to its maturity from its issue date or, (ii) in the case of a debt instrument providing for the payment of any amount other than “qualified stated interest” (as defined below) prior to maturity, multiplied by the “weighted average maturity”⁴ of such debt instrument).⁵ If a debt instrument is issued with *de minimis* OID, the Treasury Regulations dealing with OID (the “OID Regulations”) provide that the amount of OID is deemed to be zero.⁶ The OID rules generally apply to all debt instruments issued after July 1, 1982.

The issue price of each debt instrument in an issue of debt instruments equals the first price at which a substantial amount of such debt instruments has been sold (ignoring sales to bond houses, brokers or similar persons or organizations acting in the capacity of underwriters, placement agents or wholesalers). The stated redemption price at maturity of a debt instrument is the sum of all payments provided by the debt instrument other than “qualified stated interest” payments.

The term “qualified stated interest” generally means stated interest that is unconditionally payable in cash or property (other than debt instruments of the issuer) at least annually at a single fixed rate or certain floating rates (as more fully described below). In addition, under the OID Regulations, if a debt instrument bears interest for one or more accrual periods at a rate below the rate applicable for the remaining term of such debt instrument (*e.g.*, debt instruments with

⁴ A debt instrument’s “weighted average maturity” is the sum of the following amounts determined for each payment on a debt instrument (other than a payment of qualified stated interest): (i) the number of complete years from the issue date until the payment is made multiplied by (ii) a fraction, the numerator of which is the amount of the payment and the denominator of which is the debt instrument’s stated redemption price at maturity.

⁵ In addition, debt instruments that have a fixed maturity of one year or less (“Short-Term debt instruments”) are treated as having been issued with OID. In general, an individual or other cash method holder of a Short-Term debt instrument is not required to accrue OID on such instrument unless the holder elects to do so. If such an election is not made, any gain recognized by the holder on the sale, exchange or maturity of the Short-Term debt instrument will be ordinary income to the extent of the OID accrued on a straight-line basis, or upon election under the constant yield method (based on daily compounding), through the date of sale or maturity, and a portion of the deductions otherwise allowable to the holder for interest on borrowings allocable to the Short-Term debt instrument will be deferred until a corresponding amount of income is realized. Holders who report income for U.S. tax purposes under the accrual method, and certain other holders including banks and dealers in securities, are required to accrue OID on a Short-Term debt instrument on a straight-line basis unless an election is made to accrue the OID under a constant yield method (based on daily compounding).

⁶ In the case of a debt instrument issued with *de minimis* OID, a holder generally must include such *de minimis* OID in income as stated principal payments on the debt instruments are made in proportion to the stated principal amount of the debt instrument. Any amount of *de minimis* OID that has been included in income in accordance with the foregoing rule will generally be treated as capital gain upon the sale, exchange, redemption or retirement of the debt instruments.

teaser rates or interest holidays), and if the greater of either the resulting foregone interest on such debt instrument or any “true” discount on such debt instrument (*i.e.*, the excess of the debt instrument’s stated principal amount over its issue price) equals or exceeds a specified *de minimis* amount, then the stated interest on the debt instrument would be treated as OID rather than qualified stated interest.

A holder of a debt instrument that is issued with OID (a “Discount Instrument”) must include OID in income as ordinary interest for U.S. tax purposes as it accrues under a constant yield method in advance of receipt of the cash payments attributable to such income, regardless of such holder’s regular method of tax accounting, with such holder generally being required to include in income increasingly greater amounts of OID in successive accrual periods.

The OID Regulations provide special rules for certain floating rate debt instruments and indexed debt instruments (“Variable debt instruments”), whereby a Variable debt instrument will qualify as a “variable rate debt instrument” if (a) its issue price does not exceed the total noncontingent principal payments due under the Variable debt instrument by more than a specified *de minimis* amount and (b) it provides for stated interest, paid or compounded at least annually, at current values of (i) one or more “qualified floating rates” (*i.e.*, generally a rate that can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which the debt instrument is denominated, such as a rate based on LIBOR plus/minus a specified spread), (ii) a single fixed rate and one or more “qualified floating rates,” (iii) a single objective rate (*i.e.*, a rate that is determined using a single fixed formula and that is based on objective financial or economic information), or (iv) a single fixed rate and a single objective rate that is a qualified inverse floating rate. If a Variable debt instrument that provides for stated interest at either a single “qualified floating rate” or a single objective rate throughout the term thereof qualifies as a “variable rate debt instrument” under the OID Regulations, and if the stated interest on such Variable debt instrument is unconditionally payable in cash or property (other than debt instruments of the issuer) at least annually, then all stated interest on the Variable debt instrument will constitute qualified stated interest and will be taxed accordingly. Thus, a Variable debt instrument that provides for stated interest at either a single qualified floating rate or a single objective rate throughout the term thereof and that qualifies as a “variable rate debt instrument” under the OID Regulations will generally not be treated as having been issued with OID unless the Variable debt instrument is issued at a “true” discount (*i.e.*, at a price below the debt instrument’s stated principal amount) in excess of a specified *de minimis* amount.

If a Variable debt instrument does not qualify as a “variable rate debt instrument” under the OID Regulations, then the Variable debt instrument would be treated as a contingent payment debt obligation under applicable Treasury regulations (the “CPDI Regulations”). In general, the CPDI Regulations would cause the timing and character of income, gain or loss reported on a contingent payment debt instrument to substantially differ from the timing and character of income, gain or loss reported on a conventional noncontingent payment debt instrument under general principles of current U.S. tax law. Specifically, the CPDI Regulations generally require a holder of such an instrument to include future contingent and noncontingent interest payments in income as OID as such OID accrues based upon a projected payment schedule. Moreover, in general, under the CPDI Regulations, any gain recognized by a holder on the sale, exchange, or retirement of a contingent payment debt instrument will be treated as

ordinary income and all or a portion of any loss realized could be treated as ordinary loss as opposed to capital loss (depending upon the circumstances).

In addition, under the OID Regulations, if the issuer or the holder of a debt instrument has an unconditional option to call or put (*i.e.*, redeem) a debt instrument prior to its stated maturity date, this option will be presumed to be exercised if, by utilizing any date on which the debt instrument may be redeemed as the maturity date and the amount payable on that date in accordance with the terms of the debt instrument as the stated redemption price at maturity, in the case of the issuer's option, the yield on the debt instrument would be lower than its yield to stated maturity or, in the case of the holder's option, the yield on the debt instrument would be higher than its yield to stated maturity.⁷ As a result, in the case of a typical extendible note (as more fully described in Chapter 9 above), a holder will be deemed to elect to extend the maturity of the notes on any election date, if on such date there is a "step-up" in the specified spread payable on the notes (or extending the maturity would otherwise increase the yield on the notes). Similarly, with respect to puttable securities, a holder of a puttable security will be treated as not having exercised its right to have its securities redeemed by the issuer on any election date, if on such election date there is a "step-up" in the spread (or not putting the securities back to the issuer would otherwise increase the yield on the puttable securities). Since, under the OID Regulations, generally only part of the stated interest on an extendible or puttable security will qualify as "qualified stated interest" (*i.e.*, generally only the amount of the base rate and the specified spread that is unconditionally payable throughout the term of such securities, as described above), issuers of such securities have to make certain that any increase in the specified spread payable on such securities does not result in OID in excess of the applicable *de minimis* amount. Typically, this is achieved by having the spread increase limited to a fairly nominal number of basis points with respect to each election period (depending upon the terms and maturity date of the notes).

U.S. -Only Debt Offerings

Debt instruments with a maturity of more than one year issued in the United States must be issued in registered form (*i.e.*, registered in the name of the owner rather than in bearer form) in order to meet U.S. tax law requirements. These obligations are sometimes referred to as registration-required obligations. The registration requirement is designed to limit the availability of bearer debt securities within the United States because, for income tax reporting purposes, registered obligations and the income thereon can be more readily traced to their respective beneficial owners.

There are two sets of penalties imposed if bearer debt securities with a maturity of more than one year are offered, sold or delivered in contravention of the U.S. tax law: issuer sanctions ("Issuer Sanctions") and holder sanctions ("Holder Sanctions").

The Issuer Sanctions include:

⁷ If this option is not in fact exercised, the debt instrument would be treated, solely for purposes of calculating OID, as if it were redeemed, and a new debt instrument were issued, on the presumed exercise date for an amount equal to the debt instrument's adjusted issue price on that date.

- (1) an excise tax penalty on the issuer in an amount equal to one percent of the face amount of the debt securities multiplied by the number of years to maturity, and
- (2) the denial of an interest deduction, including original issue discount (“OID”), for interest payments on the debt securities where the issuer is a U.S. taxpayer.

The Holder Sanctions include:

- (1) the denial of a deduction for any loss recognized in connection with the debt security, and
- (2) the conversion of any capital gain recognized on the sale of the debt security into ordinary income. (This sanction is of significance since capital gains generally are treated more favorably than ordinary income under U.S. tax law.)

For U.S. tax purposes, a “registered obligation” is:

- (1) an obligation that is registered as to both principal and any stated interest with the issuer (or its agent) and the transfer of the obligation may be effected only by the surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder,
- (2) an obligation where the right to principal and stated interest may be transferred only through a book entry system maintained by the issuer (or its agent), or
- (3) an obligation that is registered as to both principal and any stated interest with the issuer (or its agent) and may be transferred through both of the methods described in (1) or (2) above.

A debt obligation that may be converted from registered form into bearer form is not considered a “registered obligation.” A “bearer obligation” is any obligation that does not fall within the definition of a registered obligation.

Euro/Global Debt Offerings

An issuer may not want to be restricted to the U.S. markets in offering its debt obligations and may simultaneously seek to offer the obligations in a Euro or global offering. In many cases, however, debt securities issued outside the United States, particularly in the European capital markets, are in bearer form. To comply with the registration requirements discussed above, and to satisfy the non-U.S. demand for bearer debt securities, an issuer may offer registered debt securities in the United States and bearer debt securities outside the United States. In order to simultaneously offer registered debt obligations within the United States and bearer obligations outside the United States, the offering must comply with the TEFRA D⁸ restrictions.

⁸ As discussed below, TEFRA, the Tax Equity and Fiscal Responsibility Act of 1982, is the U.S. tax act that adopted the registration requirement for U.S. debt instruments. “D” stands for Treasury Regulation § 1.163-5(c)(2)(i)(D), the provision of the U.S. Treasury regulations that addresses when an obligation is sold under (continued)

Generally, TEFRA D requires that the offering documents contain provisions so that the bearer obligations being sold pursuant to the offering will only be offered, sold and delivered outside the United States to non-U.S. persons. The offering documents, however, would permit obligations issued only in registered form to be offered in the United States or to U.S. persons (these sales are generally done as private placements). An offering designed in this manner will allow the obligations to be sold wherever there is investor demand. The specific TEFRA D provisions needed to avoid the Issuer Sanctions are discussed below under Section II.

For U.S. tax law purposes, there is no requirement that a certain percentage of a particular offering be sold in registered form or in the United States. Furthermore, the bearer obligations may be converted into registered obligations and delivered into the U.S. at any time. However, under the TEFRA D rules, debt obligations may not be converted from registered debt obligations to bearer debt obligations even if such registered obligations were initially sold in bearer form and previously converted from bearer to registered form.

Withholding Taxes and Gross-Up Payments

Generally, a taxing jurisdiction will subject interest payments to a withholding tax or a similar type of tax when such payments are made to a foreign person. However, many jurisdictions provide an exemption from the general withholding tax rule if certain requirements are satisfied. An issuer which seeks the lowest cost of funding will need to pay interest free of withholding tax. If interest on an obligation is subject to withholding tax on the day of issue, investors will generally have an inherent gross-up for such taxes by demanding a higher rate of interest. Thus, the issuer, in effect, reimburses the holder for imposition of withholding taxes.

Alternatively, if no withholding tax is imposed as of the issue date, an investor will bear the cost of any withholding taxes enacted in the future. However, investors generally perceive any withholding tax risk as an issuer risk and will demand a gross-up provision to make investors whole. The gross-up provision will require the issuer to make an additional payment such that the interest payment, together with the gross-up amount, will result in a total payment that would put an investor in the same position as if the withholding tax were not imposed.

Although gross-up provisions may be worded differently, all are designed to shift the risk of future withholding tax liability onto the issuer. There are several generally accepted exclusions to the gross-up provisions that will relieve the issuer from making the gross-up payment. Generally, an issuer may be excused from making the gross-up payment if:

- (1) a holder is liable for withholding tax by reason of having some connection with the taxing jurisdiction other than a mere holding of such obligation or the receipt of income therefrom,

“arrangements reasonably designed to ensure sale to non-U.S. persons.” An obligation sold under such arrangements can be sold in bearer form.

- (2) the withholding tax would not have been imposed on a holder but for such holder's failure to comply with any certification, identification or other reporting requirements concerning the nationality, residence or identity of such holder, or
- (3) the holder collects interest or principal on the obligation more than a set period (*e.g.*, 30 days) after such amounts were made available by the issuer, except to the extent that the gross-up payment would have been payable prior to the end of such period.

Gross-up payments can be potentially expensive protection given to the investors and may materially change an issuer's funding cost. To balance the issuer's risk, a debt offering typically allows the issuer to redeem the obligations if the issuer becomes subject to the gross-up requirement. This right is commonly referred to as a "tax call."

TEFRA D

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") added the Issuer Sanctions discussed above for any person who issues "registration-required obligations" in bearer form to U.S. persons. These rules are commonly referred to as the "TEFRA D" provisions. To avoid these sanctions, issuers can comply with what is commonly known as the "Eurobond exception."⁹ The Eurobond exception provides an exception from the Issuer (as well as the Holder) Sanctions for a bearer obligation:

- (1) which is sold under arrangements reasonably designed to ensure that it will be sold (or resold in connection with the original issue) only to non-U.S. persons (the "Reasonable Arrangements Test"),
- (2) the interest on which is payable only outside the United States and its possessions, and
- (3) which has a legend on its face stating that any U.S. person that holds the obligation will be subject to limitations under the U.S. income tax laws, including the limitations provided in sections 165(j) and 1287(a).

Three requirements are included in the Reasonable Arrangements Test to ensure that an obligation is sold only to non-U.S. persons:

Prohibition on U.S. Offers and Sales to U.S. Persons During Restricted Period

Neither the issuer nor any distributor may offer or sell the obligation during the restricted period¹⁰ to a person who is within the United States or its possessions or to a U.S. person.

⁹ The Eurobond exception is contained in section 163(f)(2)(B) and Treas. Reg. §1.163-5(c).

¹⁰ The restricted period is defined in Treas. Reg. §1.163-5(c)(2)(i)(D)(7) as the period beginning on the earlier of the closing date (or date when the issuer receives proceeds if there is not closing with respect to the obligation) or the first date on which the obligation is offered to persons other than a distributor and ending 40 days thereafter. Additionally, any offer of the obligation by the issuer or a distributor is deemed to occur during the restricted period if the issuer or distributor holds the obligation as part of an unsold allotment or subscription.

To satisfy the offer and sale restriction a distributor must (i) covenant it will not offer or sell the obligation during the restricted period to a person who is within the United States or its possessions or to a U.S. person and (ii) have in effect procedures reasonably designed to ensure that its employees or agents directly engaged in selling the obligation know that the obligation cannot be offered or sold during the restricted period to a person who is within the United States or its possessions or to U.S. persons.¹¹ An offer or sale is considered an offer or sale to a person who is within the United States or its possessions for this purpose where the offeror or seller has an address within the United States or its possessions for the offeree or purchaser. However, specific offers to a U.S. office of certain distributors (“exempt distributors”), international organizations such as the World Bank, a foreign central bank, or a foreign branch of a U.S. financial institution¹² will not be considered offers or sales to a person within the United States or to U.S. persons. An exempt distributor is basically one that buys for resale in connection with the original issuance and only retains the obligation if it agrees to comply with the section 165(j) restrictions.¹³

Delivery

Neither the issuer nor any distributor may deliver the obligation in definitive form within the United States or its possessions in connection with a sale that occurred during the restricted period.

Certification

Except in the case of certain offshore offerings targeted to a single foreign country, on the earlier of the date of the first actual interest payment by the issuer or the date of delivery by the issuer of the obligation in definitive form, a certificate must be provided to the issuer stating that

¹¹ For purposes of the Reasonable Arrangements Test, a distributor is defined as (i) a person that offers or sells the obligation during the restricted period pursuant to a written contract (not including a confirmation or other notice of the transaction) with the issuer, (ii) any person that offers or sells the obligation during the restricted period pursuant to a written contract with any person described in (i) above, and (iii) any affiliate (as generally described in section 1504(a)) of the issuer or another distributor that acquires the obligation during the restricted period for the purpose of offering or selling the obligation during the restricted period.

¹² The term financial institution is defined in Treas. Reg. § 1.165-12(c)(1)(iv) as a person which itself is, or more than 50 percent of the total combined voting power of all classes of whose stock entitled to vote is owned by a person which is, (i) engaged in the conduct of a banking, financing or similar business (as those terms are defined in section 954(c)(3)(B) of the pre-1986 Code), (ii) a broker or dealer in securities, (iii) an insurance company, (iv) a person that provides pensions or other similar benefits to retired employees, (v) an investment adviser, (vi) a regulated investment company or other mutual fund, or (vii) a finance corporation a substantial portion of the business of which consists of making loans, acquiring accounts receivable and other debt obligations or servicing debt obligations.

¹³ Section 165(j)(3) provides that a holder of bearer obligations will be exempt from the holder sanctions if it (i) holds the obligations in connection with its trade or business outside the United States, (ii) holds the obligations as a registered broker dealer for sale to customers in the ordinary course of its trade or business, (iii) complies with reporting requirements with respect to ownership, transfers and payments on the obligations, or (iv) promptly surrenders the obligations to the issuer for the issuance of a new obligation in registered form, but only if such obligations are held under arrangements designed to ensure that if such obligations are delivered to U.S. persons, such U.S. persons would also fall into one of these four categories.

on such date (i) the obligation is owned by a person that is not a U.S. person; (ii) the obligation is owned by certain exempt U.S. persons (including foreign branches of U.S. financial institutions or a U.S. person that acquired the obligation through such branch and holds the obligation through such financial institution on the date of certification); or (iii) the obligation is owned by a financial institution for purposes of resale during the restricted period and such financial institution certifies in addition that it has not acquired the obligation for purposes of resale directly or indirectly to a U.S. person or to a person within the United States or its possessions.

The TEFRA D regulations allow certification to be made electronically under certain circumstances. The recipient of electronic certificates must keep adequate records for a period of four calendar years. Additionally, a written agreement between the sender and recipient providing that electronic certification has the effect of a written certification must be entered into before electronic certification begins. The written agreement can include the written membership rules of a clearing organization such as Euroclear or Clearstream.

The TEFRA D regulations contain an exception from certification for certain single foreign country offerings. This exception only applies to obligations denominated in the foreign currency of a single foreign country and where principal and interest are payable only in that country. There are certain other requirements that must be met. However, this exception is not widely available because it currently only applies to instruments issued in the Republic of Germany and Switzerland.

As discussed above, compliance with the TEFRA D regulations will allow an issuer and investor to avoid the Issuer Sanctions and the Holder Sanctions, respectively. In addition, compliance with the TEFRA D regulations will exempt the obligation from U.S. federal withholding tax, backup withholding tax and information reporting. Debt obligations issued with a maturity of one year or less are not subject to the Issuer Sanctions and the Holder Sanctions, as discussed above. However, if an obligation with a maturity of 183 days or less (“short-term debt”) is sold to a non-U.S. person, the obligation will be subject to backup withholding tax and information reporting unless the issuer receives an Internal Revenue Service (“IRS”) Form W-8 (Certificate of Foreign Status) from the beneficial owner. The issuer can avoid having to collect Forms W-8 if the short-term debt is issued under the commercial paper exception discussed below. For obligations with a maturity in excess of 183 days, the issuer will have to offer debt obligations under the TEFRA D regulations to avoid collecting a Form W-8.¹⁴

For additional information on TEFRA D, please refer to the Sidley Austin LLP memorandum on the TEFRA D Eurobond Regulations, which is available upon request.

¹⁴ There are four versions of Form W-8. They are as follows: IRS Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding; IRS Form W-8ECI, Certificate of Foreign Person’s Claim for Exemption From Withholding on Income Effectively Connected With the Conduct of a Trade or Business in the United States; IRS Form W-8EXP, Certificate of Foreign Governments and Other Foreign Organizations for United States Tax Withholding; and IRS Form W-8IMY, Certificate of Foreign Intermediary, Foreign Partnership, and Certain U.S. Branches for United States Tax Withholding.

COMMERCIAL PAPER OFFERINGS

Generally, foreign private issuers have issued commercial paper through an operating U.S. subsidiary or a U.S. finance subsidiary incorporated in Delaware. Thus, the following discussion assumes that the commercial paper will be offered by a U.S. entity even though the proceeds ultimately may be loaned to a non-U.S. entity.

Commercial paper may be issued in either registered or bearer form. Where a significant amount of commercial paper is expected to be sold to non-U.S. persons the commercial paper program generally provides for bearer instruments. The Issuer Sanctions and Holder Sanctions do not apply to commercial paper because it generally has a maturity of less than one year. Thus, registered or bearer commercial paper may be issued in the United States.

Generally, there are no unusual tax consequences to the issuer or investor if the commercial paper is sold to a U.S. investor. However, unless a non-U.S. investor submits the applicable IRS Form W-8, or a substantially similar form, to the issuer, commercial paper issued by a U.S. entity and purchased by the non-U.S. investor may be subject to a back-up withholding tax at a rate of 28 percent and information reporting requirements. The back-up withholding tax and information reporting rules may be avoided for commercial paper issued under the guidelines discussed below.

Commercial paper issued at a discount with a maturity of 183 days or less, whether in registered or bearer form, is generally exempt from back-up withholding tax and information reporting requirements. However, the following conditions must be satisfied:

- (1) payment on the commercial paper is made outside the United States;
- (2) the face amount of the commercial paper is not less than \$500,000 (determined by reference to the spot rate on the date of issuance, in the case of an obligation not denominated in U.S. dollars);
- (3) the commercial paper satisfies the TEFRA D provisions (as if the obligation would otherwise be a registration required obligation), although the non-U.S. person certification is not required;
- (4) the commercial paper, if in registered form, is registered in the name of an exempt recipient described in Treas. Reg. § 1.6049-4(c)(1)(ii); and
- (5) the commercial paper contains the following statement (or a similar statement having the same effect): “By accepting this obligation, the holder represents and warrants that it is not a United States person (other than an exempt recipient described in section 6049(b)(4) of the Code and the regulations thereunder) and that it is not acting for or on behalf of a United States person (other than an exempt recipient described in section 6049(b)(4) of the Code and the regulations thereunder).”

COMMERCIAL PAPER FINANCE SUBSIDIARIES

A primary concern of non-U.S. commercial paper borrowers accessing the U.S. capital markets through a U.S. finance subsidiary is whether the subsidiary will be subject to an entity level tax. Generally, corporations are subject to a U.S. federal income tax at a rate of 35 percent. Federal and state taxes on a U.S. finance subsidiary can be minimized through one of several strategies (one such strategy is discussed below). However, a foreign borrower should seek specific tax advice from its U.S. counsel on its particular facts. There may be factors not discussed herein which may subject the U.S. finance subsidiary to U.S. federal or state income taxes.

It may be possible to set up the U.S. finance subsidiary so that the U.S. finance subsidiary is treated as the agent of the parent corporation. Under this analysis, the U.S. finance subsidiary should not have any income (except possibly a fee as compensation for its duties as an agent of the parent) that will be subject to U.S. federal income tax.

In order for the U.S. finance subsidiary to be treated as agent of the parent, the issuer may want to take all or substantially all of the following steps:

- (1) The parent should guarantee the commercial paper issued by the U.S. finance subsidiary.
- (2) The commercial paper proceeds should be loaned to the parent on terms that are the same as the terms on which the U.S. finance subsidiary has sold the commercial paper to investors.
- (3) If the commercial paper proceeds are to be loaned to another affiliate of the parent, the parent should direct the U.S. finance subsidiary in doing so.
- (4) The commercial paper proceeds to be loaned should be lent to non-U.S. entities.
- (5) The U.S. finance subsidiary should have no employees.
- (6) The U.S. finance subsidiary's articles of incorporation or bylaws should be limited to raising capital for the benefit of the parent company or the parent's affiliates.
- (7) The original books and records of the U.S. finance subsidiary should be kept outside the United States.
- (8) The parent and the U.S. finance subsidiary should enter into an agreement whereby the parent assumes the commercial paper liabilities of the U.S. finance subsidiary in consideration for the loan of the commercial paper proceeds to the parent or affiliates of the parent.

This type of finance company is usually formed in the State of Delaware. Delaware will normally exempt the U.S. finance subsidiary from the Delaware state franchise (income) tax and will collect a nominal filing fee on an annual basis. However, it is possible that the U.S. finance subsidiary may become subject to tax in another state if management or operational decisions are

made within such state's taxing jurisdiction. For this reason, the management of the U.S. finance subsidiary should take place outside the United States or from a state which will not seek to tax the U.S. finance subsidiary. As discussed above, a non-U.S. borrower should seek specific advice on the tax structuring of the U.S. finance subsidiary.

PARENT GUARANTEED DEBT

Thin Capitalization

Historically, a U.S. subsidiary of a non-U.S. entity that offers debt to unrelated investors would have the foreign parent guarantee principal and interest on its debt. The guarantee generally offers the issuer and underwriters economic advantages and, on a practical basis, investors are offered protection against the parent depleting the subsidiary's assets. The guarantee usually confers the parent's credit rating on the subsidiary's debt, enabling the subsidiary to sell its debt at a lower interest cost. The higher rating benefits the underwriters in that they have a higher credit quality product to sell to investors.

A parent guarantee may create tax problems if the issuer itself is not credit-worthy because it is thinly capitalized. In this situation, it is possible that the IRS would assert that parent-guaranteed debt is an obligation of the parent because no creditor would have lent the subsidiary the funds without the parent guarantee. Additionally, as discussed below, the Revenue Reconciliation Act of 1993 (the "RRA") extended the reach of the earnings stripping rules to guaranteed debt.

In order to understand why a thinly capitalized U.S. subsidiary is subject to attack by the U.S. tax authorities, it is important to understand the U.S. tax policy considerations. Section 163 of the Code allows an income tax deduction for all interest paid or accrued on indebtedness but allows no deduction for dividends paid on stock. Moreover, absent a lower treaty rate or a treaty exemption, dividends paid to a non-U.S. shareholder are subject to a 30 percent withholding tax.¹⁵ Thus, the U.S. tax law creates a powerful incentive for a parent corporation to capitalize its U.S. subsidiary with debt rather than equity to reduce the subsidiary's and the parent's overall tax liability. A taxpayer's desire to minimize its tax burden by substituting debt for equity has the effect of reducing the overall tax collections by the United States. Consequently, there is tension between a taxpayer's goal of minimizing its tax burden and that of the United States where an entity is substituting debt (including parent guaranteed debt) for equity capital. As discussed further below, determining whether a company is thinly capitalized is not a precise mechanical calculation. The stakes, however, can be high.

In determining whether guaranteed debt should be treated as debt of the guarantor, the key case is Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir.), cert. denied, 409

¹⁵ For example, the U.S.-Japan tax treaty reduces the 30 percent withholding tax rate to 10 percent (and to 5 percent for corporate shareholders who own at least 10 percent of the voting shares) for dividends paid to a resident of Japan.

U.S. 1076 (1972).¹⁶ While the case does not yield any definitive guidelines, the important factors seem to be whether:

- (1) the subsidiary was adequately capitalized;
- (2) the advanced funds were at the risk of the business;
- (3) there was a reasonable expectation that the issuer could repay the advanced funds;
and
- (4) an independent creditor would have advanced funds absent the guarantee.

If the IRS were to prevail under a Plantation Patterns-type analysis of a thinly capitalized subsidiary, the subsidiary would lose its interest deductions for any interest payments made (or OID accrued) by the subsidiary. In addition, if the debt were to be recharacterized as a capital contribution by the foreign parent guarantor, the IRS might assert that any interest payments made by the subsidiary were, in effect, paid on behalf of the parent, and thus constituted a deemed dividend to the parent. The deemed dividend would be subject to a 30 percent withholding tax (unless reduced or exempted by an applicable tax convention).¹⁷

If the parent was a U.S. corporation filing a consolidated return with its subsidiary, the effect of a Plantation Patterns-type analysis would be less severe. The parent, as a member of the same consolidated group as the subsidiary, would be allowed the interest deduction and would in effect offset income of the subsidiary if the parent could not utilize the interest deduction. In addition, the consolidated return rules eliminate intercompany dividends.¹⁸

In the case of a U.S. subsidiary owned by a non-U.S. parent, the issuer should be able to avoid any recharacterization of debt as equity on the basis of thin capitalization if the U.S. finance subsidiary is structured so that it is treated as the agent of the parent.

Application Of the Plantation Patterns Factors

The determination of whether an instrument is viewed as a loan to the parent-guarantor instead of a loan to its subsidiary is dependent on the facts and circumstances of each case. Thus, there are no definitive mechanical guidelines which can be applied to determine the

¹⁶ In Plantation Patterns a purported loan to a corporation by a third party was recharacterized as a loan to the shareholder (who had guaranteed the original loan) followed by a capital contribution to the corporation by the shareholder. Plantation Patterns was a newly organized corporation which acquired a wrought iron furniture manufacturer. The shareholders contributed \$5,000 in equity and borrowed approximately \$760,000 to finance the purchase of the furniture operations. The court looked to: (i) the purported borrower's high debt-to-equity ratio (125:1), (ii) the fact that a substantial portion of the borrowings were expended on capital assets necessary to launch the venture, (iii) the fact that, because of the borrower's capital, the lenders looked solely to the shareholder guarantee for repayment, and (iv) the fact that the debt was subordinated to almost all other creditors.

¹⁷ See sections 881 and 1442.

¹⁸ Treas. Reg. § 1.1502-13.

ultimate mix of debt and equity for a foreign-owned U.S. corporation. As a result, the final determination of what is an acceptable mix of debt and equity for federal income tax purposes is based upon an analysis of each of the Plantation Patterns factors listed above. It should be kept in mind that, although there may be non-tax business reasons to keep the equity investment in a foreign-owned U.S. entity to a minimum, the lower the capitalization, the greater the risk that the IRS may scrutinize the transaction. A high debt to equity ratio alone, however, may not be unreasonable depending upon the facts. The Plantation Patterns factors are discussed in greater detail below.

Adequate Capitalization

The IRS and the courts will look to whether a U.S. subsidiary was adequately capitalized in determining whether the funds advanced to the U.S. subsidiary should be considered debt of the issuer or debt of the parent (or potentially subject to section 163(j), the earnings stripping rules). In performing this analysis, the courts generally have reviewed the capital contributions (*i.e.*, the equity investments) to determine whether they were adequate to cover the initial start-up costs (including the cost of capital assets) and the anticipated capital needs for the type of venture the taxpayer has entered. In addition, the courts will review whether there is sufficient capitalization (*i.e.*, net assets), taking into account the nature of the taxpayer's business, when each new debt instrument is issued.

A high debt to equity ratio may not be problematic if it is within U.S. industry standards or the issuer has a long history of profitability. In addition, a high debt to equity ratio may be acceptable if the issuer is in a business, such as the finance business, that traditionally has a high debt to equity ratio.¹⁹

Risk of the Business and Expectation of Repayment

Whether the funds advanced are subject to the risk of the business and whether there is a reasonable expectation of repayment are significant factors in determining whether the advances to the U.S. subsidiary should be viewed as debt of the issuer or debt of the parent (or potentially subject to section 163(j)). The analysis of these two factors is similar, and thus, we have presented them together.

Generally, a debt holder expects to be repaid notwithstanding the success of the debtor's business. Thus, at the time each loan is made to the U.S. subsidiary, a creditor's repayment must not have been dependent upon the success of the U.S. subsidiary's business. Even if the U.S. subsidiary was not profitable in a particular year, a creditor should be able to expect repayment out of the U.S. subsidiary's assets. Whether there is a reasonable expectation that a creditor of the U.S. subsidiary could get paid without utilization of the guarantee is dependent upon the riskiness of the U.S. subsidiary's business, the U.S. subsidiary's cash flow and the nature and

¹⁹ Several courts addressing the thin capitalization issue have noted that the finance business is a special type of business, and the traditional cases relating to acceptable debt to equity ratios, where the debt to equity ratio has been relatively low, should not apply. See P.M. Fin. Corp. v. Comm'r, 302 F.2d 786, 788 (3rd Cir. 1962); Sec. Fin. & Loan Co. v. Koehler, 210 F.Supp. 603, 605 (D. Kan. 1962); Jaeger Auto Fin. Co. v. Nelson, 191 F. Supp. 693, 698 (E.D. Wis. 1961).

quality of the U.S. subsidiary's assets. Thus, the U.S. subsidiary will need to determine whether there is a reasonable expectation that funds advanced to the U.S. subsidiary will be repaid without utilization of the guarantee.

Advancement of Funds by Third Parties Without Guarantee

The most significant factor of those listed above is whether an independent third party would have advanced funds to the U.S. subsidiary without the guarantee. This factor is probably the most important test for whether a parent guarantee is merely being used to gain better terms from creditors or whether the lender is, in effect loaning money to the parent which then makes an equity contribution to the U.S. subsidiary. Thus, the U.S. subsidiary will have to determine whether an independent creditor would have advanced the funds without a guarantee. An advance by an independent creditor would be favorable even if the terms of the advance were less advantageous than an advance with a guarantee. For example, the unguaranteed advance may have a higher interest rate and more restrictive covenants.

If the U.S. subsidiary determines, after considering the various factors above, that its debt to equity ratio is not within U.S. industry norms, and that an independent third party creditor would not have (1) a reasonable expectation of being repaid, and (2) advanced funds without a guarantee, then the parent should consider making an additional capital contribution to the U.S. subsidiary in order to assure that these tests could be met. The additional capital contribution could be made in cash or property, or alternatively, the parent could contribute its own note to the U.S. subsidiary in lieu of cash.

Earnings Stripping Rules

Section 163(j) limits the deductibility of interest paid or accrued to certain related persons to the extent no U.S. federal income tax (or withholding tax) is imposed on such interest. A related person includes (but is not limited to) a foreign parent corporation and a more than 50 percent owned (vote or value) subsidiary.

Section 163(j) can also apply to debt sold to third parties which is subject to a disqualified guarantee and on which no gross basis tax (*e.g.*, a withholding tax) is imposed. Subject to certain exceptions, a "disqualified guarantee" means any guarantee by a related foreign person or a related domestic tax-exempt entity.

In 1991, the U.S. Treasury Department released proposed regulations under section 163(j).²⁰ In its notice of proposed rulemaking, the IRS indicated that it would publish regulations addressing the treatment of guarantees under section 163(j) (which might also include provisions concerning back-to-back loans and other types of supported debt (*e.g.*, intercompany support agreements)). It further stated that the rules with respect to guarantees will be prospective. However, the IRS warned that, in cases with fact patterns similar to that in

²⁰ In 1991, the U.S. Treasury Department issued proposed regulations which offer detailed guidance on the application of section 163(j). However, as of August 2009, the U.S. Treasury Department has not finalized these proposed regulations and it remains unclear when, and, if so, in what form, these proposed regulations will be finalized.

Plantation Patterns, it will continue to seek the recharacterization of purported guaranteed debt as equity.

Assuming there is a disqualified guarantee which would trigger application of the earnings stripping rules under section 163(j), certain tests must be met to determine if an interest deduction will be disallowed. Section 163(j) disallows interest deductions for disqualified interest in excess of a threshold amount if a U.S. corporation has (for the tax year in question):

- (1) a ratio of debt to equity greater than 1.5 to 1;²¹ and
- (2) excess interest expense.

Thus, if a corporation fails to meet either test described above in a particular tax year, section 163(j) will not impose an interest deduction limitation for that taxable year. If a corporation satisfies both tests, then a deduction for disqualified interest will be disallowed in an amount equal to the lesser of (1) the disqualified interest paid or accrued for the tax year, and (2) the excess interest expense. Put another way, the portion of disqualified interest paid or accrued in a tax year in excess of the amount of excess interest expense will remain deductible. Any amount of disqualified interest which is not deductible under these rules may be carried forward into the next tax year and will be treated as disqualified interest paid or accrued in such year.

A corporation has “excess interest expense” for any taxable year if its net interest expense (interest expense less interest income) exceeds 50 percent of (i) its adjusted taxable income (“ATI”) for the taxable year, plus (ii) any excess limitation carryforward from the prior three taxable years. The “excess limitation carryforward” is an amount equal to 50 percent of ATI less the net interest expense (if any) for the three previous years (computed on a yearly basis) to the extent such excess limitation carryforward was not previously absorbed.

A corporation’s ATI for any taxable year generally equals such corporation’s taxable income (gross income less expenses) computed by disregarding:

- (1) any deduction for net interest expense,
- (2) any net operating loss deduction,
- (3) any deduction allowable under section 199, and
- (4) any deduction allowable for depreciation, amortization or depletion, and with such other adjustments as Treasury regulations may prescribe.²²

²¹ For the purposes of section 163(j), a corporation’s ratio of debt to equity is computed by dividing (1) its total indebtedness by (2) the sum of its money and all other assets less its total indebtedness. In the case of a debt having original issue discount, the amount included in total indebtedness is its issue price plus the portion of the original issue discount previously accrued without reduction for any acquisition premium paid by a holder of the debt instrument. Section 163(j)(2)(C)(ii). Other assets are included at their adjusted tax basis. Section 163(j)(2)(C)(i).

²² See *supra* footnote 20.

It should be noted that if a corporation's gross interest income exceeds its interest expense for a taxable year, the formula does not produce an interest deduction limitation for that year. Thus, even if a U.S. subsidiary has paid or accrued disqualified interest for any particular taxable year, section 163(j) should not produce a deduction limitation if interest income exceeds interest expense. This should presumably be the case where the U.S. subsidiary's gross income consists mainly of interest paid on credit it has extended.

On November 28, 2007, the Treasury Department issued its "Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties," a Congressionally mandated report on international tax issues, including earnings stripping. The focus of the earnings-stripping study is on excessive payments of deductible interest by foreign-controlled U.S. corporations to related persons in whose hands that interest is partially or fully exempt from U.S. tax. While the study notes that it is not possible to quantify accurately the extent of earnings stripping generally, it concludes that strong evidence exists of earnings stripping by foreign-controlled domestic corporations that have undergone so-called "inversion" transactions, in which the U.S. parent company of a multinational corporate group is replaced with a foreign parent in a low-tax or no-tax country. The study did not find conclusive evidence of earnings stripping by foreign-controlled domestic corporations that had not inverted, and concludes that more information is needed to reach a definitive conclusion on that issue. In order to obtain this additional information and to further the administration of the current earnings stripping rules, the study recommends that the relevant tax forms be modified to require more information about earnings stripping. In response to that recommendation, on November 28, 2007, the IRS announced (Announcement 2007-114) that a new proposed Form 8926, "Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information," was posted to its website. Proposed Form 8926 was created to obtain information relating to the application of section 163(j). On February 12, 2009, the IRS released the final version of Form 8926, which a corporation (other than an S corporation) must file if it paid or accrued disqualified interest during the current tax year or had a carryforward of disqualified interest from a previous tax year. Corporations use Form 8926 to calculate the amount of any corporate interest expense deduction disallowed by section 163(j). Corporations also use Form 8926 to calculate the amount of any interest expense deduction disallowed by section 163(j) for a previous tax year that is allowed for the current tax year.

For additional information on the earnings stripping rules, please refer to the Sidley Austin LLP memorandum on the Proposed Earnings Stripping Regulations which is available upon request. In addition, please refer to the Sidley Austin LLP memorandum on the effect of the RRA upon foreign parent-guaranteed debt which is available upon request.

DEBT REOPENINGS

Background

The following discussion summarizes the U.S. federal income tax rules governing reopenings of prior issuances of debt instruments.

In general, for U.S. federal income tax purposes, unless two or more debt instruments are issued on the same day, additional debt instruments that are issued and sold after the original

issue date of the original debt instruments are not part of the original issue and therefore do not have the same issue date, issue price and (with respect to holders) adjusted issue price as the original debt instruments.²³ However, the U.S. Treasury has issued certain regulations under which two or more debt instruments that are not issued on the same issue date will be considered part of the same issue.

Rules

Debt Instruments issued within 13 Days of the Original Issuance

Treas. Reg. § 1.1275-1(f) provides that two or more debt instruments are part of the same issue if the debt instruments—

- (1) Have the same credit and payment terms;
- (2) Are issued either pursuant to a common plan or as part of a single transaction or a series of related transactions;
- (3) Are issued within a period of thirteen days beginning with the date on which the first debt instrument is issued to a person other than a bond house, broker, or similar person or organization acting in the capacity of an underwriter, placement agent or wholesaler; and
- (4) Are issued on or after March 13, 2001.

Debt Instruments issued in a “Qualified Reopening” (as defined in Treas. Reg. § 1.1275-2(k))

Qualified Reopenings Generally

Treas. Reg. § 1.1275-2(k) provides that notwithstanding Treas. Reg. § 1.1275-1(f) described above, “additional debt instruments” issued in a “qualified reopening” are part of the same issue as the “original debt instruments.” As a result, the “additional debt instruments” have the same issue date, the same issue price and (with respect to holders) the same adjusted issue price as the “original debt instruments.”

For this purpose, “original debt instruments” are generally defined as any debt instruments comprising any single issue of outstanding debt instruments.²⁴

Moreover, “additional debt instruments” are debt instruments that without the application of the qualified reopening rules—

- (1) Are part of a single issue of debt instruments;

²³ See 64 F.R. 60395, 60396 (Nov. 5, 1999).

²⁴ Treas. Reg. § 1.1275-2(k)(2).

- (2) Are not part of the same issue as the original debt instruments (as defined above); and
- (3) Have terms that are in all respects identical to the terms of the original debt instruments as of the reopening date (*i.e.*, the issue date of the additional debt instruments).²⁵

Moreover, a reopening of debt instruments will be a “qualified reopening” only if such reopening is described in either Treas. Reg. § 1.1275-2(k)(3)(ii), describing certain reopenings within six months, or Treas. Reg. § 1.1275-2(k)(3)(iii), describing certain reopenings with *de minimis* OID.²⁶ These two situations are described immediately below.

Treas. Reg. § 1.1275-2(k)(3)(ii)

A reopening is a “qualified reopening” described in Treas. Reg. § 1.1275-2(k)(3)(ii), describing certain reopenings within six months, if

- (1) The original debt instruments are publicly traded;²⁷
- (2) The reopening date of the additional debt instruments is not more than six months after the issue date of the original debt instruments; and
- (3) On the date on which the price of the additional debt instruments is established (or, if earlier, the announcement date (*i.e.*, the later of seven days before the date on which the price of the additional debt instruments is established or the date on which the issuer’s intent to reopen a security is publicly announced through one or more media, including an announcement reported on the standard electronic news services used

²⁵ Treas. Reg. § 1.1275-2(k)(2)(ii).

²⁶ Treas. Reg. § 1.1275-2(k)(3)(i).

²⁷ A debt instrument is publicly traded (*i.e.*, traded on an established securities market) if at any time during the 60-day period ending 30 days after the issue date, the debt instrument (A) (i) is listed on a national securities exchange registered under section 6 of the 1934 Act (15 U.S.C. 78f); (ii) is an interdealer quotation system sponsored by a national securities association registered under section 15A of the 1934 Act (15 U.S.C. 78o-3); or (iii) the International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited, the Frankfurt Stock Exchange, the Tokyo Stock Exchange, or any other foreign exchange or board of trade that is designated by the Commissioner in the Internal Revenue Bulletin; (B) the debt instrument is market traded property, (*i.e.*, it is property that is traded either on a board of trade designated as a contract market by the Commodities Futures Trading Commission or on an interbank market); (C) the debt instrument is property appearing on a quotation medium (*i.e.*, it appears on a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers or traders) that provides a reasonable basis to determine fair market value by disseminating either recent price quotations (including rates, yields, or other pricing information) of one or more identified brokers, dealers, or traders or actual prices (including rates, yields, or other pricing information) of one or more identified brokers, dealers, or traders or actual prices (including rates, yields, or other pricing information) of recent sales transactions (a quotation medium)); or (D) subject to certain exceptions, if price quotations for the debt instrument are readily available from dealers, brokers, or traders. For purposes of (C) above, a quotation medium does not include a directory or listing of brokers, dealers, or traders for specific securities, such as yellow sheets, that provides neither price quotations nor actual prices of recent sales transactions. See Treas. Reg. § 1.1273-2(f).

by security broker-dealers, for example, Reuters, Telerate, or Bloomberg)), the yield of the original debt instruments (based on their fair market value) is not more than 110 percent of the yield of the original debt instruments on their issue date (or, if the original debt instruments were issued with no more than a *de minimis* amount of OID, the coupon rate).

Treas. Reg. § 1.1275-2(k)(3)(iii)

A reopening is a “qualified reopening” described in Treas. Reg. § 1.1275-2(k)(3)(iii), describing certain reopenings with *de minimis* OID, if

- (1) The original debt instruments are publicly traded; and
- (2) The additional debt instruments are issued with no more than a *de minimis* amount of OID (determined without the application of the qualified reopening rules of Treas. Reg. § 1.1275-2(k)).

For this purpose, a *de minimis* amount of OID is generally an amount equal to 0.0025 multiplied by the product of the stated redemption price at maturity (*i.e.*, generally the sum of all payments provided by the debt instrument other than qualified stated interest payments)²⁸ of the debt instrument and the number of complete years to maturity from the issue date of the debt instrument.²⁹

Qualified Reopening Rules not Available for Certain Debt Instruments

Pursuant to Treas. Reg. § 1.1275-2(k)(3)(iv), the “qualified reopening” rules of Treas. Reg. § 1.1275-2(k) discussed above are not available for reopenings of contingent payment debt instruments (within the meaning of Treas. Reg. § 1.1275-4) (*i.e.*, generally, and subject to certain exceptions, any debt instrument that provides for one or more contingent payments).

Reopenings Issued at a Premium, at Par or with De Minimis OID

Although the Treasury Regulations governing qualified reopenings do not provide that reopenings of debt instruments that do not qualify as “qualified reopenings” may still be reopened, as a practical matter, there are a few instances where that will be the case. In particular, if the original debt instruments were issued at a premium, at par or with *de minimis* OID and the additional debt instruments are issued at a premium, at par or with *de minimis* OID, the additional debt instruments may be issued (*i.e.*, the original debt instruments may be reopened) without any adverse tax consequences even if the issuance of the additional debt instruments does not technically qualify as a “qualified reopening” because the additional debt instruments will still be fungible with the original debt instruments from a tax reporting perspective.

²⁸ Treas. Reg. § 1.1273-1(b).

²⁹ Treas. Reg. § 1.1273-1(d).

Appendix B

Basic Documents for Securities Offerings in the U.S. Capital Markets

Appendix B

BASIC DOCUMENTS FOR SECURITIES OFFERINGS IN THE U.S. CAPITAL MARKETS

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Every securities offering or program potentially involves a significant number of documents. Set forth below are some of the basic documents that are typically encountered, and a brief description of each.

PUBLICITY MEMORANDUM

As a result of the limitations on publicity that apply to offerings involving the U.S. capital markets, in some types of offerings (particularly IPOs involving the U.S. capital markets), counsel to the issuer or the underwriters of a securities offering may be asked to prepare a memorandum that establishes publicity guidelines for the transaction participants.¹ These guidelines typically apply from the start of the preparation for the offering until the securities have been sold, and for certain purposes for some time thereafter, and cover such areas as restrictions on publicity by the transaction participants about the issuer and the offering (within and outside the United States and on the Internet), and publication of research by the underwriters and their affiliates. The guidelines vary depending on whether or not the U.S. offering is 1933 Act-registered.

¹ For a description of certain limitations on publicity that apply to securities offerings in the U.S. capital markets, see the discussion under the headings “Limitations on Publicity” and “Roadshows” in Chapter 1 (*The U.S. Offering Process*) of the other volumes of *Accessing the U.S. Capital Markets*.

DUE DILIGENCE LISTS AND QUESTIONNAIRES

In offerings and programs where counsel is required to deliver a 10b-5 statement to the underwriters, underwriters' counsel, usually in consultation with issuer's counsel, prepares a list of documents relating to the issuer that it will need to review as well as, in certain cases (particularly in the case of IPOs), officer's and director's questionnaires. In addition, the underwriters or their counsel prepare questions for formal interviews with the issuer's management, auditor and, in certain cases, audit committee, as well as any other experts (*e.g.*, engineers providing an engineering report) and any other parties that are conducted as part of the due diligence process.²

1933 ACT REGISTRATION STATEMENT

In a 1933 Act-registered offering or program, the issuer and its counsel, in consultation with the other parties to the offering or program, including the underwriters or agents and their counsel, prepare a 1933 Act registration statement that is filed with the SEC. The registration statement consists of a prospectus (which is the disclosure document conveyed to investors) and a second part (containing, among other things, undertakings, signatures and exhibits), which is filed with the SEC and available for inspection by investors but is not distributed to investors.³ In cases where the issuer is a WKSI eligible to use a registration statement on Form S-3 or F-3, the potential for execution risk associated with a delay that could be caused by a potential SEC review of the filing is minimized as the registration statement becomes automatically effective upon filing with the SEC.

OFFERING DOCUMENTS

The issuer and its counsel, in consultation with the other parties to the offering or program, including the underwriters and their counsel, typically prepare the offering documents. If the offering is a public offering registered under the 1933 Act, the primary offering document is a "prospectus," and, if the offering is not 1933 Act-registered, the primary offering document is normally referred to as an "offering memorandum" or an "offering circular" (but generally not a "prospectus"). If the securities are offered under a program, there is normally a "base" prospectus or offering memorandum and one or more supplemental prospectuses or offering memoranda describing the specific terms of each individual offering.

The contents of offering documents vary depending upon the type of offering, the type of security and the type of issuer. The disclosure requirements of the 1933 Act and the SEC's rules establish the form and content requirements for prospectuses, including supplements, free

² For a description of the due diligence process for securities offerings in the U.S. capital markets, see the discussion under the heading "Due Diligence" in Chapter 1 (*The U.S. Offering Process*) of the other volumes of *Accessing the U.S. Capital Markets*.

³ For a description of the filing and content requirements of 1933 Act registration statements, see Chapter 3 (*The Securities Registration and Reporting Process*), Chapter 4 (*Disclosure Requirements*) and Chapter 5 (*Shelf Registration*) of the other volumes of *Accessing the U.S. Capital Markets*.

writing prospectuses and terms sheets, used in connection with a 1933 Act-registered offering.⁴ While the 1933 Act contains no information requirements for most private placements and other exempt offerings, in Rule 144A offerings where U.S. counsel is required to deliver 10b-5 statements regarding the offering documents (which is particularly the case for offerings of equity securities and long-term, fixed-income securities), market practice generally is to follow the disclosure requirements for 1933 Act-registered offerings to the extent possible. This practice provides disclosure benefits to investors and helps protect transaction participants against potential investor claims.

There are exempt offerings where the offering documents are not required to satisfy the disclosure requirements for 1933 Act-registered offerings. For example, the offering documents for commercial paper and most extendible note offerings normally contain a limited description of the issuer and a description of securities and tax consequences and other matters that are material to an investor. In such cases, there is typically minimal disclosure about the issuer and information as to where investors can find additional information; many issuers that are not SEC reporting companies refer investors to a website where they post financial information that is referred to, but not incorporated by reference in, the offering memorandum. In these instances, a 10b-5 statement from U.S. counsel is not required. The rationale behind this is that these types of securities are less risky to investors because they have a short term, are highly rated and the natural investor base is very sophisticated, so risk of loss is disproportionately lower than the cost of generating sizable offering documents. In other cases, such as U.S. bank or municipal issuers, a different disclosure and regulatory regime applies, and disclosure is provided to the extent required by and in accordance with the requirements or market practice of that regime.

Base Prospectus or Other Offering Document

A base prospectus or other offering document will, most commonly, include or incorporate by reference the core information about the issuer of the offered securities required by the applicable 1933 Act rules, including a business description, financial information, risk factors relating to the securities, the issuer and the industry, regulatory/legal history and information about management and directors. In addition, the base prospectus or other offering document may give a general description of the types of securities that may be issued.

Preliminary Offering Document, or “Red Herring”

In most cases, the underwriters or agents wish to market the offering and build a book of interested investors before committing to purchase the securities from the issuer. In that case, the underwriters will use a preliminary offering document or “red herring” that includes all the required information other than the pricing information, such as interest or dividend rate and offering price, and in some cases offering size, all of which are to be agreed upon following the marketing and book building process. In the case of offerings under a program or shelf, the base offering document and any base supplemental offering documents may be used to market the

⁴ For a description of the filing and content requirements of prospectuses and supplements used in 1933 Act-registered offerings, see Chapter 3 (*The Securities Registration and Reporting Process*), Chapter 4 (*Disclosure Requirements*) and Chapter 5 (*Shelf Registration*) of the other volumes of *Accessing the U.S. Capital Markets*.

securities without a separate preliminary offering document or any additional supplements if the terms of the securities being marketed are sufficiently described in those documents.

Free Writing Prospectus/Terms Sheet

A free writing prospectus or, in the case of an offering that is not 1933 Act-registered, a term sheet or other supplement may be used to amend or update information in a preliminary prospectus or base offering document without going through the expense or logistical difficulties of revising and re-circulating a lengthy red herring. A free writing prospectus or, in the case of an offering that is not 1933 Act-registered, a terms sheet is also customarily used to convey the price and other final offering terms to investors to avoid having to wait for a final offering document to be produced. Although common in debt and preferred stock offerings, free writing prospectuses are typically used prior to the pricing of common stock offerings only where there has been an unanticipated change in circumstances from those described in the preliminary offering document that the issuer or the underwriters believe should be communicated to investors in writing before the offering is priced, or where the scope of price-related changes is too great to communicate to investors orally.

Final Offering Document

The final prospectus or other offering document contains the final pricing information for the transaction, which, in the case of an equity offering, would include the public offering price per share and, if the number of offered shares has changed since the time of the preliminary offering document, the number of shares to be sold, and, in the case of a debt offering, would include the interest rate, interest payment dates, public offering price, maturity date and other matters. The final prospectus or other offering document is usually not available until after the transaction has priced and investors have committed to purchase securities and, in some cases, is made available, rather than distributed, to investors.⁵

Foreign Supplements or “Wrappers”

In addition to supplemental offering documents prepared to market offerings under a program or shelf registration, supplements or “wrappers” may also be prepared for non-U.S. jurisdictions where the securities are being offered. For example, it is common for underwriters of U.S. IPOs and other significant offerings to offer and sell securities in Canada. In addition, securities may be listed or sold in London, Tokyo, Hong Kong, Australia or elsewhere. In some cases, the offering, sale or listing requires the preparation of a short supplement that is literally wrapped around the preliminary and final offering documents (although some underwriters prefer to include the foreign-required information directly in the primary offering document). The foreign wrapper is typically prepared by foreign counsel to the underwriters or, in some

⁵ Pursuant to the changes introduced by Securities Offering Reform, “access” through EDGAR is deemed to equal “delivery.” Consequently, so long as an issuer has filed a final prospectus with the SEC or “will make a good faith and reasonable effort” to file such a prospectus within the time required by the applicable rules, a confirmation of the sales of the offered securities is not required to be accompanied by a prospectus (though, in the absence of a final prospectus, the confirmation must be accompanied by a notice that the sale was made pursuant to a registration statement).

cases, the issuer and, in the case of a 1933 Act-registered offering, is often not filed with the SEC.

FINRA FILINGS

Unless the offering is specifically exempt from such requirements,⁶ U.S. counsel to the underwriters, with input from the issuer and its counsel, prepare and file with FINRA documentation regarding the underwriting arrangements.⁷

STATE SECURITIES LAW OR “BLUE SKY” FILINGS

Unless the offering is specifically exempt from such requirements,⁸ U.S. counsel to the underwriters or agents, with input from the issuer, prepare and file with various states filings to qualify the offering for sale in those states and territories and prepare a “blue sky” survey for the underwriters or agents indicating the investors to whom and the states in which the securities may be offered and sold.⁹

SELLING SECURITYHOLDER DOCUMENTS

Where existing securityholders are selling securities as part of a primary offering by an issuer, such as a U.S. IPO, the underwriters typically require that the selling securityholders enter into powers of attorney and custody agreements. These agreements must be executed and delivered before the pricing of the offering.

UNDERWRITING OR PURCHASE AGREEMENT AND LOCK-UP AGREEMENTS

This is the agreement between the issuer (or selling securityholders) and the securities firm or firms that the issuer engages to underwrite or place its securities. The scope, content and name of this agreement varies by product and offering and may be referred to as, among other things, an “underwriting agreement,” a “purchase agreement,” a “distribution agreement,” a “dealer agreement,” a “selling agreement” or an “agency agreement.” For ease of reference, unless otherwise noted, we use the term “underwriting agreement” to refer to all such agreements.

The underwriting agreement contains basic representations and warranties by the issuer about its business, financial condition, results of operation and prospects, about the accuracy of

⁶ 1933 Act-exempt offerings, including Rule 144A offerings, and offerings of 1933 Act-exempt securities are normally also exempted from FINRA filings.

⁷ For a further discussion of the FINRA documentation process, see the discussion under the heading “The Securities Registration Process — FINRA Review” in Chapter 3 (*The Securities Registration and Reporting Process*) of the other volumes of *Accessing the U.S. Capital Markets*.

⁸ 1933 Act-exempt offerings, including Rule 144A offerings, of securities that rank junior to securities of the issuer that are listed on a U.S. securities exchange and offerings of 1933 Act-exempt securities are normally also exempted from blue sky laws.

⁹ For further detail, see the discussion under the heading “‘Blue Sky’ or State Securities Laws” in *An Overview of U.S. Securities Regulators and Laws* of the other volumes of *Accessing the U.S. Capital Markets*.

the offering document and about the authorization and, if applicable, the enforceability of the securities and the other transaction documents. It also establishes the pricing and closing conditions, including the officers' certificates, legal opinions and comfort letters required. It will also provide for indemnification and contribution primarily for the benefit of the underwriters in the event of actual or alleged misstatements or omissions in the offering documents, and it will give the underwriters the right to terminate the agreement after pricing but before closing in the event of specified material adverse changes in the issuer or market conditions. If selling securityholders are involved, they will be required to make representations, among other things, as to their ownership of the securities being sold.

The underwriting agreement may also contain procedures that the issuer and the underwriters must follow when making sales outside the United States. In the case of an unregistered offering, the underwriting agreement will also set out procedures that the issuer and the underwriters must follow in order to ensure that the offering in the U.S. capital markets is exempt from U.S. registration requirements.

While each investment bank has its own form of agreement, usually the lead underwriter will agree to adapt its form to a form previously entered into by the issuer if it is substantially consistent with the lead underwriter's form. If the offering is a traditional private placement,¹⁰ a note purchase agreement between the issuer and the investors would also include the purchase terms, as well as the terms and the form of the securities.

In the case of a non-U.S. issuer, some additional provisions are typically included in the underwriting agreement to address issues such as Office of Foreign Assets Control of the U.S. Treasury ("OFAC") compliance matters, the U.S. Patriot Act, anti-money laundering, submission to jurisdiction, appointment of agent for service of process, waiver of immunities, foreign withholding tax gross-up, local legal offering and sales restrictions and similar matters.

For many securities offerings, the underwriters will require the issuer to agree not to sell similar securities for a specified period of time to avoid the adverse impact that could be caused by those sales. In an equity offering, the underwriters also may require key officers, directors and existing shareholders to enter into lock-up agreements imposing a contractual restriction on their ability to sell shares for a period of time after the closing in order to avoid the adverse impact that could be caused by those sales. These lock-up periods often are 180 days after pricing in the case of an IPO, and 90 days in the case of a follow-on offering. However, there may be a variety of reasons why these periods may vary in certain cases.

REGISTRATION RIGHTS AGREEMENT

An issuer may enter into a registration rights agreement for the benefit of the holders of unregistered securities, and agree either to exchange the securities for 1933 Act-registered securities where available, or to establish a resale shelf with the SEC that will allow the holders to sell the securities pursuant to an effective registration statement, and typically allow the securityholders to resell their securities through a 1933 Act registration statement filed by the

¹⁰ See Chapter 12 (*Traditional Private Placements*) of this volume.

issuer in connection with a future securities offering, which is known as “piggy-back registration rights.” In order to exchange the unregistered securities for registered securities, the issuer must register the exchange with the SEC on Form S-4 or F-4.

A registration rights agreement is typically governed by New York law and prepared by underwriters’ or investors’ counsel. The parties are the issuer and the underwriters, and the holders of the securities are third party beneficiaries or successors in interest to the underwriters of the securities. The agreement is relatively standard.

INDENTURES, FISCAL AGENCY AGREEMENTS AND ISSUING AND PAYING AGENCY AGREEMENTS

The agreement between the issuer and the entity (normally a commercial bank or trustee) that, in the case of a 1933 Act-registered offering, acts as trustee for the securityholders is referred to as an indenture and must be qualified under the 1939 Act. In the case of certain offerings not subject to the 1933 Act, although an indenture may be used, the corresponding agreement is often a fiscal agency agreement or an issuing and paying agency agreement. In any case, this document will set forth, among other things, the procedures for the issuance of the securities, certain rights of the securityholders, certain covenants of the issuer and will govern the relationship between the issuer and the trustee, fiscal agent or issuing and paying agent. Under an indenture, the trustee owes certain fiduciary obligations to, and in certain cases is permitted or required to take actions on behalf of, securityholders, whereas a fiscal agent or issuing and paying agent generally acts only as the agent of the issuer and owes no fiduciary duties to securityholders.

The indenture is normally prepared by underwriters’ counsel and generally is not subject to protracted negotiation. The terms that apply to a particular issue of securities are negotiated in the context of preparing the description of securities in the offering document. There are three basic types of indentures. One is a stand alone indenture for one series of debt securities. The other two are open-ended indentures. One type of open-ended indenture permits multiple issues or series of one type of security (*i.e.*, medium-term notes) and the other permits multiple issues or series of any type of debt security. Neither open-ended form limits the principal amount or the number of separate series of debt securities that can be issued under the indenture. The terms of all three forms are generally standard, although certain provisions, such as the negative pledge, sale-leaseback and other covenants, events of default and consolidation and merger provisions, will vary depending upon the issuer, its circumstances and its outstanding borrowing documents.

In the case of Section 3(a)(2) letter of credit-backed commercial paper, the issuing and paying agent agreement will include special provisions for drawing on the letter of credit and will establish special bank accounts in order to ensure that the payments under the letter of credit to commercial paper holders are protected in the event of the bankruptcy of the issuer or, in the case of a U.S. finance subsidiary, the non-U.S. parent. In the case of Section 4(2) commercial paper, the indenture, fiscal agency agreement or issuing and paying agent agreement will include special guidelines to be followed in connection with transfers of outstanding securities.

FORM OF OFFERED SECURITIES

Issuer's or underwriters' counsel, in consultation with each other and any trustee or issuing agent and its counsel, prepares the form or forms of the securities being offered.¹¹ Debt securities sold in the U.S. capital markets are generally governed by New York law. The forms of these securities typically are prepared by underwriters' counsel and are usually attached to the indenture or other issuing document as an exhibit. In many cases, the authentication or endorsement of the authentication agent (typically the trustee, fiscal agent or issuing and paying agent) is required.

PRESS RELEASE

Upon the launch of a capital markets transaction, issuers will frequently publish a simultaneous press release containing a brief description of the transaction. In drafting and publishing a press release, issuers should be mindful of the publicity restrictions affecting the content and timing of communications,¹² and any press release should be reviewed by both issuer's and underwriters' counsel.

DEPOSIT AGREEMENTS AND FORM OF ADR

If the securities are offered by a foreign private issuer in the form of ADRs, issuer's counsel, based on forms provided by the Depositary and in consultation with underwriters' counsel and Depositary's counsel, prepares one or more deposit agreements, which typically will include the form of ADR or GDR and a specimen of the underlying equity security.¹³

DTC LETTER OF REPRESENTATIONS

In the case of book-entry securities to be registered in the name of Cede & Co. on behalf of DTC, issuer's counsel prepares the letter of representations (a standard agreement provided by DTC and based on the type of security and offering being conducted) between the issuer, the issuing agent and DTC.¹⁴ Pursuant to DTC's rules, DTC must receive the original signed copy of the letter of representations from the issuer prior to accepting the securities onto its system (*i.e.*, prior to the closing of the offering). DTC holds the securities for its direct and indirect participants, including Euroclear and Clearstream, Luxembourg, pursuant to standing arrangements.

¹¹ The terms of the securities may be set forth in the security itself or may be set forth in the document (*e.g.*, indenture or organizational document) under which the security is being issued.

¹² See "Limitations on Publicity" in Chapter 1 (*The U.S. Offering Process*) of the other volumes of *Accessing the U.S. Capital Markets*.

¹³ See Chapter 2 (*Depositary Receipts (ADRs and GDRs)*) of this volume.

¹⁴ The DTC letters of representation and various riders are available at DTC's web page at <https://portal.dtcc.com/dtcorg>.

LISTING DOCUMENTS

If the securities are to be listed on a U.S. securities exchange, the issuer and its counsel, with input from the underwriters or agents and their counsel, prepare the listing documentation and file it with the applicable exchange.¹⁵ This documentation would typically include a listing application and, as necessary, an offering document.

LEGAL OPINIONS AND 10b-5 STATEMENTS

In many transactions, the underwriting agreement will call for legal opinions to be delivered to the underwriters at the time of the closing of the transaction. In such circumstances, the legal opinions will cover such matters as:

- due organization and existence of the issuer;
- the validity and enforceability of the transaction documents and the securities;
- effectiveness of the registration statement (if applicable);
- various due diligence matters such as the issuer's ownership of its subsidiaries, its compliance with applicable laws and regulations, the adequacy of its internal controls and the absence of any proceedings expected to have a material adverse impact on the issuer;
- the accuracy of disclosure contained or incorporated by reference in the offering documents relating to the transaction documents, as well as tax and regulatory disclosure;
- the offering and the issuance of the securities will not contravene or require the consent or approval that has not been obtained that are required by any law or regulation, or by certain agreements or instruments (including specified financial arrangements) to which the issuer or any guarantor or securing party is subject;
- in the case of foreign issuers, the absence of withholding taxes on payments on the securities;
- in the case of foreign issuers, the valid submission to the jurisdiction of U.S. federal and New York state courts of those parties for disputes involving the securities; and
- in the case of foreign issuers, enforceability of U.S. judgments in the issuer's home jurisdictions.

In many U.S. capital markets transactions, the underwriters also require issuer's and underwriters' U.S. counsel to provide a so-called "10b-5 statement" to the effect that nothing has

¹⁵ See Chapter 6 (*Listing on U.S. Securities Exchanges*) of the other volumes of *Accessing the U.S. Capital Markets*.

come to such counsel's attention to lead it to believe that the offering documents contain any untrue statement of a material fact or omit to state a material fact required to be made (if 1933 Act-registered) or necessary to make the statements made, in the light of the circumstances under which they were made, not misleading.

In many U.S. IPO transactions, in addition to the typical legal opinions and 10b-5 statements, the issuer's counsel is required to provide a legal opinion to the underwriters covering the due authorization and issuance of all outstanding shares of common stock. For issuers that have been in existence for more than a few years, the factual investigation necessary to give this opinion can be considerable and quite time consuming. The underwriters will also require opinions of counsel for any selling shareholders covering, among other things, the due authorization, execution and delivery of the underwriting agreement, powers of attorney and custody agreements by the selling shareholders and title to the shares to be sold to the selling shareholders.

In commercial paper, medium-term note and other programs, opinions are delivered when the program is established, and are updated periodically when the offering documents are updated or when a selling agent requires in connection with its purchase of notes, as principal, for resale.

ACCOUNTANTS' COMFORT LETTERS AND RELATED DOCUMENTS

For most transactions in the U.S. capital markets, as part of the underwriters' due diligence investigation, the underwriting agreement will require one or more auditor's comfort letters to be delivered in a form consistent with AU Section 634 providing comfort on the financial data included or incorporated by reference in the offering documents. This may require extensive discussions with the auditors. Underwriters' counsel usually identifies the financial information as to which comfort is sought (which generally includes all financial information derived from the issuer's financial statements or books and records) and looks to the issuer for comfort on any figures and other financial data as to which the auditors cannot provide comfort.

If the U.S. offering is not 1933 Act-registered, in order to receive a comfort letter, each of the underwriters will be required to deliver a standard letter to the auditor providing the comfort letter confirming its level of due diligence is consistent with that performed in connection with a 1933 Act-registered offering.

If the offering involves both a U.S. and a non-U.S. component, the issuer's auditors may require that two comfort letters be delivered, and that the comfort letter delivered in connection with the non-U.S. component will only be delivered upon the underwriters signing an engagement letter with the issuer's auditors. These engagement letters have become increasingly standardized in recent years, but often still involve a fair amount of discussion between the lead underwriters and the auditing firm.

OTHER CLOSING DOCUMENTS

In most instances, the underwriting agreement will contain a requirement for a closing bring-down officer's certificate that, among other matters, affirms the representation and

warranties made at the time of pricing in the underwriting agreement and confirms that there has not been any material adverse change in the condition or affairs of the issuer. In addition, the indenture or issuing and paying agent may require the delivery of certain documents, including compliance certificates, incumbency certificates and authentication orders. In connection with giving their legal opinions, counsel will request such items as secretary's and officers' certificates from the issuer covering certain corporate or factual matters. The issuer and the lead underwriter will also execute cross-receipts to evidence receipt of funds and delivery of securities.

Additional closing documents and due diligence, such as engineering, actuarial, industry, patent or regulatory reports or certifications, may be necessary depending upon the issuer and the nature of its business.

RESALE REGISTRATION STATEMENT ON FORM S-3 OR F-3

Resale registration rights from time to time are granted to purchasers in a non-SEC registered offering.¹⁶ The resale registration statement is typically prepared by issuer's counsel. Technically, the underwriters have no involvement in or liability for the resales, but are nevertheless interested on behalf of their customers in seeing that the registration statement is prepared properly and that the registration statement is consistent with the terms required by the registration rights agreement. The disclosure contained in the registration statement should be virtually the same as that contained in the offering document for the unregistered securities. If the issuer is not a reporting issuer under the 1934 Act, it is likely that the SEC will review the registration statement and the issuer will have to go through the SEC's comment process before the registration statement is declared effective.

¹⁶ See “—Registration Rights Agreement” above in this Appendix.

