Key Considerations Relating to Issuances of Contingent Convertible Instruments in or into the United States

Introduction

As a result of the various capital reforms arising out of the recent financial crisis, there has been increasing interest by non-US banks to issue contingent convertible instruments ("**CoCos**").[1] Some commentators have estimated that the market for CoCos could range between Euro 500 billion and Euro 1 trillion, although the decision of the Basel Committee on Banking Supervision (the "**Committee**") to require ordinary share capital to meet the proposed capital surcharge of 1 to 2.5 percentage points (as discussed below) for the 30 largest banks may reduce their use.[2] As capital reform measures applicable to non-US banks stabilize, we expect that interest in accessing US capital markets with CoCos will increase considering the potential size of the market.[3] Alternatively, it is expected that hybrid capital will continue to be issued which will include certain features similar to CoCos (e.g., exchange/conversion triggers), although such hybrid securities may not fully comply with the Loss Absorbency Requirements (as defined below). This memorandum discusses certain key considerations under the US Securities Act of 1933, as amended (the "**Securities Act**"), for issuances of CoCos eligible to satisfy regulatory capital requirements under the Basel III package of capital and liquidity reforms ("**Basel III**")[4] by non-US banks in the United States.[5] These considerations would also generally apply to hybrids incorporating the exchange/conversion features of CoCos.

Background – CoCos and Basel III

CoCos are instruments that are either written off or automatically converted into common equity upon the occurrence of certain "trigger events". These instruments have developed, in part, as a potential remedy to a perceived problem of the recent financial crisis, during which the infusion of public sector capital necessary to protect distressed banking institutions' depositors prevented, in many cases, certain

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[1] For example, although the terms and reasons for each issuance have differed, Lloyds Banking Group, Unicredit, Rabobank and Credit Suisse Group have each issued CoCos since the financial crisis. The Tier 2 Buffer Capital Notes due 2041 ("**BCNs**") issued by Credit Suisse Group (Guernsey) I Limited, guaranteed by Credit Suisse Group AG ("**Credit Suisse**"), are novel, however, in that they are designed to be the first Basel III compliant CoCos which would convert into ordinary shares upon the occurrence of a trigger event.

[2] Although we note that jurisdiction specific regulation may establish capital requirements more stringent than Basel III, in which case CoCos may be eligible to satisfy such additional capital requirements. For example, under the requirements of proposed Swiss legislation, the two largest Swiss banks would be required to maintain a total capital requirement of 19% of risk-weighted assets, a ratio in excess of anything required by Basel III. The Swiss proposals contemplate, however, that CoCos could comprise up to 9% of the required amount.

[3] For example, on May 16, 2011, Credit Suisse filed an automatic shelf registration statement registering BCNs and other CoCos with the SEC for possible public offerings in the United States.

[4] CoCos eligible to satisfy regulatory requirements under Basel III would generally qualify as regulated capital under the Capital Requirements Directive IV, proposed by the European Commission on July 20, 2011 (the "**CRD IV**"), subject to additional requirements relating to the minimum trigger events.

[5] The Committee argued under the Loss Absorbency Proposal that because the qualifying CoCos would not give holders equity risk outside of a failure situation, they should not be viewed as "traditional convertible debt by investors, accountants or tax authorities." However, because we expect tax treatment under applicable US tax regulation to prohibit deductions for coupon payments, it is unlikely that CoCos will be issued by US banks.

regulatory capital instruments from suffering losses that would have otherwise occurred in bankruptcy or receivership. In general, because the trigger event would give rise to automatic write-down or conversion of the CoCos, holders of this category of regulatory capital would absorb losses prior to public funding being required. Trigger events can range from systemic events (e.g., financial sector loss rates) or institution specific events (e.g., capital ratios or share prices). Depending on the trigger event, write-down or conversion will occur at different points of time, giving rise to two principal categories of CoCos: "*going concern*" CoCos which serve to safeguard an institution from insolvency and "*gone concern*" CoCos which primarily serve to prevent taxpayer losses and financial sector contagion when the institution becomes insolvent.

On December 16, 2010, the Committee released the final text of Basel III, which (among other things)[6] raises both the quality and quantity of the required regulatory capital base of banking institutions.[7] Consistent with the Committee's August 2010 consultative document entitled *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability* (the "**Loss Absorbency Proposal**"), Basel III contemplates that CoCos meeting certain criteria might be issued by banking institutions to partially satisfy the increased quality and quantity of required regulatory capital. On January 13, 2011, the Committee issued its final *Minimum requirements to ensure loss absorbency at the point of non-viability* (the "**Final Loss Absorbency Requirements**") setting forth the minimum criteria for CoCos to qualify as regulatory capital.[8]

The Loss Absorbency Proposal and the Final Loss Absorbency Requirements principally establish benchmark criteria for gone concern CoCos; however, because going concern CoCos have trigger events that sequentially precede gone concern trigger events, CoCos can be structured to function as going concern and still meet regulatory criteria of gone concern CoCos. In addition, under the Final Loss Absorbency Requirements, CoCos eligible to qualify as regulatory capital are required to meet the following criteria:[9]

- *Trigger Event*. Eligible CoCos must contain a provision that requires them to be written off or converted into common equity upon the earlier of (x) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant regulatory authority, and (y) a decision that write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority.[10]

[6] Basel III also introduces requirements relating to the leverage and liquidity ratios of banking institutions, which are outside of the scope of this memorandum.

[7] The final text of Basel III can be found here.

[8] Notwithstanding the Final Loss Absorbency Requirements, at its meeting of June 25, 2011, the Group of Governors and Heads of Supervision (the "**GHOS**"), the oversight body of the Committee, agreed a set of measures for assessing the systemic importance of globally systemically important banks ("**GSIBs**") and additional capital requirements for GSIBs. The GHOS concluded that the additional loss absorbency requirements that will apply to GSIBs would be met with a progressive common equity tier 1 capital requirement ranging from 1% to 2.5% to be phased in between January 1, 2016 and January 1, 2019. It had been expected that CoCos could have been used to meet these additional loss absorbency requirements.

[9] The Final Loss Absorbency Requirements provide the minimum requirements for CoCos to qualify as regulated capital. It is expected that jurisdictional regulators will implement further criteria that may be more fulsome or robust with respect to CoCos, including guidance relating specifically to "going concern" CoCos. For example, CRD IV would require write down or conversion of the CoCos upon the relevant institution's common equity tier 1 capital ratio falling below 5.125% (e.g., "going concern" CoCos), and the Swiss Financial Market Supervisory Authority (FINMA) proposed in December 2010 that the required trigger event be the institution's common equity tier 1 capital ratio falling below 7%.

[10] Although there is ongoing debate about whether market based triggers (e.g., share prices, credit default swap spreads, etc.), capital based triggers (e.g., tier 1 capital ratio) or regulatory based triggers are preferable, the Final Loss Absorbency Requirements require regulatory based triggers. However, both the CRD IV and proposed Swiss legislation contemplate both regulatory based (*cont.*)

- *Conversion*. Any compensation paid to the holders of the CoCos as a result of the conversion/write-off must be paid immediately in the form of common stock (or its equivalent).
- *Corporate Authorization(s)*. The issuer must maintain at all times all prior authorization(s) necessary to issue the relevant number of shares specified in the terms and conditions of the CoCos immediately upon the occurrence of the trigger event.
- *Timing*. The issuance of any new shares as a result of the trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.

Importantly, the Final Loss Absorbency Requirements do not specify or establish criteria relating to the conversion rate, which ultimately is the variable affecting the incremental costs and risks borne by shareholders relating to CoCos. The Loss Absorbency Proposal contemplates that conversion rates will fall on a spectrum: on the one end zero shares would be issued upon the occurrence of a trigger event (i.e., write-off) and on the other a high number would be issued upon the occurrence of a trigger event. Ultimately, the coupon and other commercial terms of CoCos, as well as the extent of shareholder dilution, will depend, in part, upon the conversion rate.

Issuing CoCos in the United States[11]

Under the Securities Act, no offer or sale of securities may be made in the United States unless such offer and sale has been registered with the US Securities and Exchange Commission (the "**SEC**") or an exemption from the Securities Act's registration requirements is available. The SEC takes the view that a sale occurs when the investment decision is made and, in the case of a convertible or exchangeable security, such as CoCos, where the conversion or exchange is mandatory upon the occurrence of a trigger event,[12] the investment decision with respect to both the debt and underlying equity components of the CoCos is made at the time of purchase of the CoCos.[13] As a result, under the SEC's guidance, the underlying equity component, as well as the debt component, of the CoCos will need to be registered with the SEC at the time of issue or an exemption from the registration requirements of the Securities Act must be available for both components.

Registered (Public) Offerings of CoCos in the United States

In a public offering of CoCos in the United States, the issuer will need to file a registration statement on the required form. The applicable form will depend on whether the issuer (or its parent) is currently subject to ongoing reporting obligations under the US Securities Exchange Act of 1934, as amended (the "**Exchange Act**") (a "**SEC Registrant**") and certain other eligibility criteria (e.g., market capitalization), but in each case the registration statement will need to cover both the debt and underlying equity

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triggers as well as capital based triggers. As evidenced by the issuance of BCNs by Credit Suisse, which contain both capital based and regulatory based triggers, neither the market for CoCos nor regulators, at this point, appear to favor market based triggers.

[11] Because we expect CoCos with conversion terms as opposed to write-down terms—e.g., BCNs issued by Credit Suisse—to predominate any market for CoCos that develops, this memorandum assumes CoCos of the convertible variety. We note, however, that the US securities law analysis with respect to write-down CoCos would be more straightforward.

[12] Depending on the structure, CoCos will be either convertible or exchangeable. Where a subsidiary of the bank issues the CoCos, the CoCos would be *exchangeable* into the bank's ordinary shares upon the occurrence of a trigger event (e.g., the BCNs issued by a special purpose finance subsidiary of Credit Suisse). In contrast, where the bank issues the CoCos directly, the CoCos would be *convertible* into the bank's ordinary shares upon the occurrence of a trigger event. Assuming a full and unconditional guarantee of the CoCos in the case of exchangeable CoCos, the securities law analysis of convertible CoCos and exchangeable CoCos is the same.

[13] This would be true even for CoCos where the relevant financial regulator maintained some discretion with respect to declaring the occurrence of a trigger event.

components of the CoCos.[14] If the issuer is a SEC Registrant who is also a "well-known seasoned issuer" (a "**WKSI**"), it should be able to register both the debt and underlying equity components of the CoCos on an automatic shelf registration statement which is effective (and can be used) on its filing with the SEC. If the WKSI SEC Registrant has a shelf registration statement on file, it can file a post-effective amendment, which would be automatically effective upon filing, to register the CoCos. As both the debt and equity components of the CoCos would be registered, any shares issued upon mandatory conversion would be freely tradable.

Consistent with all registered offerings in the United States, the registration statement would need to include a prospectus (or a prospectus supplement in the case of a WKSI with a shelf registration statement) meeting enumerated disclosure requirements under the Securities Act. In particular, financial statements of the issuer and guarantor, if applicable, for the required periods would need to be included.[15] A WKSI SEC Registrant would be able to incorporate its SEC filings in any prospectus supplement or other filing required in order to facilitate registering the CoCos.

As noted below, since existing SEC Registrants with ordinary shares (or American Depositary Shares representing ordinary shares) listed on a US exchange will not be able to utilize Rule 144A to sell CoCos in the Unites States, we expect that such financial institutions will use a registration statement to offer and sell CoCos. As this will permit public offers in the United States, we may see offerings of CoCos targeted at retail investors as was the case for certain classes of Tier 1 and Tier II hybrid securities that were popular prior to the financial crisis due to their higher yield. We do not expect non-SEC Registrants to use the SEC registered route for offering CoCos in the United States as they will be able to utilize Rule 144A. See "Unregistered Offerings of CoCos in the United States".

Unregistered Offerings of CoCos in the United States

Unless an offering of CoCos in the United States is registered under the Securities Act and made pursuant to an effective registration statement, the offering needs to be made pursuant to an exemption from the registration requirements of the Securities Act. The offering and sale of both the debt (including any guarantees) and underlying equity components of the CoCos need to benefit from an exemption. The exemptions available to offer CoCos in the United States depend, in part, on whether the issuer (or its parent) is a SEC Registrant or not.

Non-SEC Registrants

Rule 144A. Non-SEC Registrants should be able to conduct an offering of CoCos in the United States pursuant to Rule 144A under the Securities Act as the underlying equity will not be fungible with a security listed in the United States.[16] Consistent with the requirements of Rule 144A, the non-SEC

[14] In addition, if the CoCos are issued by a special purpose finance vehicle or other subsidiary and guaranteed by the parent-registrant, the registration statement would also need to cover the guarantee. For example, Credit Suisse's registration statement filed on May 16, 2011 covers the guarantees by Credit Suisse of the BCNs and other CoCos to be issued by its subsidiaries named therein.

[15] If, however, the issuer is a wholly-owned subsidiary and the guarantee is full and unconditional, financial statements of the issuer would not be required if the parent's consolidated financial statements include a condensed consolidating footnote as described in Rule 3-10 of Regulation S-X. This would apply whether it issues through a special purpose finance vehicle or a bank where the bank was a wholly-owned subsidiary of a holding company.

[16] Non-SEC Registrants should also be able to privately place CoCos with investors in the United States pursuant to Section 4(2) of the Securities Act consistent with the requirements and procedures outlined below with respect to SEC Registrants. However, as a practical matter, we would expect the availability of Rule 144A for offerings of CoCos by non-SEC Registrants to cause Section 4(2) to be used by non-SEC Registrants primarily in circumstances where the issuer directly targets a select number of identified U.S. institutional investors and otherwise intends to conduct an offshore offering of the CoCos. In the context of a targeted approach in (*cont.*)

Registrant would need to limit participation in the offering to "qualified institutional buyers" (as defined in Rule 144A under the Securities Act) ("**QIBs**") and agree to provide investors with ongoing access to reasonably current financial statements and other information about the issuer. The non-SEC Registrant would also need to impose customary Rule 144A restrictions on publicity, advertising, contents of the issuer's website and contacts with media and analysts. CoCos sold pursuant to Rule 144A could be done on the basis of deemed representations and warranties and would be restricted securities that could be resold by investors pursuant to an exemption from, or in a transaction not subject to, the registration requirements of the Securities Act such as to other QIBs pursuant to Rule 144A or in an offshore transaction in compliance with Regulation S under the Securities Act.

Section 3(a)(9). Section 3(a)(9) provides an exemption from the registration requirements of the Securities Act for a conversion or exchange of securities meeting certain conditions. Section 3(a)(9) will be available for the issuance of the underlying equity upon the mandatory conversion or exchange (in the case of CoCos issued by a subsidiary and benefitting from a full and unconditional guarantee of the non-US bank or holding company) in connection with a trigger event. Further, assuming that the trigger event does not occur during the twelve-month period following issuance of the CoCos (i.e., the applicable holding period under Rule 144 under the Securities Act), the underlying equity issued upon the occurrence of the trigger event pursuant to Section 3(a)(9) will be freely tradable as it will be deemed to be issued at the time the CoCos are issued due to the mandatory convertible/exchange feature and will therefore have the same twelve-month holding period.[17]

SEC Registrants

Rule 144A. In contrast to non-SEC Registrants, SEC Registrants are not able to conduct an offering of CoCos in the United States pursuant to Rule 144A under the Securities Act. In order to be eligible to use Rule 144A, the security being offered cannot be fungible with a class of securities listed or quoted on a US national exchange. This disqualifies CoCos because the underlying equity would be fungible with a security listed in the United States.[18]

Section 4(2). Section 4(2) of the Securities Act provides an exemption from the registration requirements of the Securities Act for "transactions by an issuer not involving any public offering." CoCos could be privately placed by the SEC Registrant issuer pursuant to Section 4(2) of the Securities Act. As with offerings conducted under Rule 144A, Section 4(2) offerings require that the issuer avoid any public offer of the securities in the United States and not engage in a general solicitation or in activities that might reasonably be expected to condition the market in the United States for the offered CoCos. In addition, the issuer will need to ensure that investors participating in the private placement meet certain sophistication standards.

As a practical matter, private placements under Section 4(2) limited to QIBs and conducted in accordance with customary procedures for Rule 144A offerings should generally comply with the publicity and investor-sophistication requirements of Section 4(2). Given the nuance and complexity of the terms specific to CoCos, we would expect that private placements of CoCos pursuant to Section 4(2) that are distributed following Rule 144A procedures will be documented with substantive offering materials (e.g., offering memorandum), a standard comfort package and 10b-5 opinions. It will also be necessary to obtain investor letters from the US purchasers of the CoCos. CoCos privately placed pursuant to Section 4(2) will be restricted securities that could be resold by investors pursuant to an exemption from, or in a

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the United States, the need for customary Rule 144A documentation and comfort could be specifically negotiated on a case-by-case basis.

[17] Assuming the holder is not an affiliate of the issuer.

[18] Convertible or exchangeable securities with a conversion/exchange premium greater than 10% could be offered under Rule 144A. The triggers on CoCos will not permit such a conversion or exchange premium.

transaction not subject to, the registration requirements of the Securities Act such as to other QIBs on a "4(1½)" basis or in an offshore transaction in compliance with Regulation S under the Securities Act. The CoCos privately placed pursuant to Section 4(2) will become freely tradable six months after issuance (i.e., the applicable holding period under Rule 144 under the Securities Act for US reporting companies).[19]

Section 3(a)(9). Section 3(a)(9) will be equally available to SEC Registrants for the issuance of the underlying equity upon the occurrence of a trigger event on the same basis as described above except that the holding period under Rule 144 is six months (as noted above) for SEC Registrants compared with twelve months for non-SEC Registrants.

Disclosure

In the case of unregistered offerings of CoCos in the United States, as noted above, we would expect issuers to prepare, and underwriters to insist on, offering documentation customary for Rule 144A offerings. As is customary in Rule 144A offerings, such offering documentation would include disclosure about the issuer and guarantor, if applicable, including a detailed management's discussion and analysis of the business, a full business description, disclosure of significant risk factors for the business and other market risk disclosures and bank statistical data. In addition, we would expect the offering documentation to provide a detailed description of the unique characteristics of the CoCos, and, in particular, discuss in depth the specific trigger events, conversion/exchange ratios and expected involvement or discretion of the applicable financial regulator in the business and solvency of the issuer or guarantor (if applicable). Specific risk factor disclosure relating to the financial regulator's discretion would likely be merited; further, such disclosure could change from jurisdiction to jurisdiction depending on the facts and circumstances relating to the specific guidance that the relevant regulator has published with respect to CoCos and regulated capital.

Other Considerations

In addition to the considerations identified above, offering CoCos in the United States will raise other legal and marketing issues that should be considered and may, in certain cases, need to be approved by the relevant financial regulator of the non-US bank.

Indenture. Under the US Trust Indenture Act of 1939, as amended (the "**Trust Indenture Act**"), CoCos registered with the SEC will need to be issued under an indenture that has been qualified under the Trust Indenture Act.[20] Further, as required by the Trust Indenture Act, the qualified indenture will need to appoint a trustee that meets certain standards. In addition, as a substantive and practical matter, the Trust Indenture Act provides investors with certain substantive rights that may need to be cleared with the applicable financial regulators in the issuer's home jurisdiction.[21]

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[19] Assuming the holder is not an affiliate of the issuer.

[20] The terms of any guarantee of the CoCos, if applicable, would need to be included in the qualified indenture. For example, although the issuance of BCNs by Credit Suisse in February, 2011 was pursuant to a fiscal and paying agency agreement, its registration statement filed with the SEC on May 16, 2011 contemplates that issuances of BCNs and other CoCos in the United States would be pursuant to a qualified indenture. As described therein, the BCNs and other CoCos registered thereby and the related indentures are to be governed by the law of England, except with respect to the subordination provisions in which case the law of Guernsey will govern. However, the prospectus also notes that to the extent any provisions of the Trust Indenture Act are deemed to be part of and govern the indentures, such Trust Indenture Act provisions will govern such indenture.

[21] For example, Section 316(b) of the Trust Indenture Act provides that the right of any holder of a securities issued under a qualified indenture to receive payment of principal and interest on or after the date due, and the right to enforce such payment, shall not be impaired without such holder's consent (subject to limited exceptions). This right, and other protections afforded by the Trust Indenture Act, might be construed to be in tension with the limitation of remedies included in the CoCos and would need to be (*cont.*)

DTC Settlement. CoCos issued in the United States on a registered basis or in reliance on Rule144A will be issued in the form of a global certificate registered in the name of a nominee for the DTC, and interests in CoCos will be held through DTC.[22] CoCos privately placed under Section 4(2) would not qualify for clearance through DTC.

Listing. Whether or not the CoCos are listed and, if so, where they are listed will need to be considered. In the case of a registered offering in the United States, listing the CoCos on the NYSE would likely be beneficial from a marketing perspective. However, this is likely only to be the case if the offering is targeted at US retail investors.

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The foregoing provides some insights regarding issuances of CoCos under the Securities Act. We would, of course, be happy to respond to specific questions on this topic.

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acceptable to the relevant financial regulator as consistent with the terms of the CoCos and the limited contractual recourse available to investors.

[22] The terms of the CoCos will need to include a right for the beneficial owners to obtain certificated CoCos if an event of default occurred in order to comply with the Trust Indenture Act.

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