CHAPTER 3

TYPES OF BORROWING (2): DEBT SECURITIES AND THE CAPITAL MARKETS

MEANING OF THE TERM 'SECURITIES'

3.1 In the words of one judge, 'there can be no dispute that … the word "securities" has a flexible meaning'.[1] Depending on the context, it can mean security interests (such as mortgages and charges), guarantees,[2] or transferable financial investments.[3] Originally, investments were referred to as 'securities' only if they were supported by security interests or were otherwise 'secure' (eg because they were obligations of the government), but over time the usage of the term has developed to include all types of transferable investments, whether secured or unsecured.[4] Determining which meaning is applicable is merely a matter of construing the context, with no presumption one way or the other.[5] For the purposes of this book, the term 'securities' is used in the sense of transferable financial instruments.[6]

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1 *Re Scorer* [1924] All ER Rep 330 at 333 per P.O. Lawrence J. On the meaning of the term 'securities', see further Benjamin, *Interests in Securities* (2004), p 4 and *Financial Law* (2007), pp 177–179; Wood, *Regulation of International Finance* (2007), pp 283–291; Micheler in Gullifer and Payne (ed), *Intermediated Securities* (2010), ch 5; Gleeson, *Personal Property Law* (1997), pp 196–197.

2 Referred to as personal security.

3 See eg *Re Rayner* [1904] 1 Ch 176 at 189 per Romer LJ ('The word … is widely used as a synonym for "investments"'); *Re Douglas' Will Trusts* [1959] 1 WLR 744 at 749 per Vaisey J ('I think that "securities" means investments'). See also *Fons HF v Corporal Limited* [2014] EWCA Civ 304 at [41] per Patten LJ ('the word "security" has at least two principal meanings: the first is a debt or claim the payment of which is secured by a charge or guarantee; the second is as a more general term for describing investments').

4 On the development of usage of the term 'securities', see Fuller, *The Law and Practice of International Capital Markets* (3rd edn, 2012), pp 5–6.

5 See eg *Taylor Clark International Ltd v Lewis* [1997] STC 499 at 517–518 per Robert Walker J ('"security" … is an imprecise term which takes its colour from its setting. The setting [here] … is that of investments'). In that case, Robert Walker J (at 519–520) described the indicia of a 'debt on a security' as (i) assignability, (ii) a right to interest or a premium on repayment, and (iii) a 'structure of permanence' (i e not merely short term).

6 The term 'security', and variations of it, are also specifically defined for certain statutory and regulatory purposes: see, eg, Criminal Justice Act 1993, s 54 and Sch 2; Taxation of Chargeable Gains Act 1992, ss 104(3), 106A, 132(3)(b), 176(7)(a), 184F(7), 263AA(8) and 263I; Financial Services and Markets Act 2000, s 102A(2); Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, SI 2001/544, arts 3(1), 76–82, 89; Uncertificated Securities Regulations 2001, SI 2001/3755, reg 3(1); Stock Transfer Act 1963, s 4(1); Finance Act 1996, s 186(2); Companies Act 2006, ss 141(4)(d), 400(6), 401(6), 755(5), 783(a), and 953(9); Trustee Act 1925, s 68(1), para (13); Trustee Investments Act 1961, Sch 1, Pt IV, para 4; Ports

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WHAT ARE THE CAPITAL MARKETS?

3.2 The capital markets are not a physical place where participants transact business face-to-face, but instead the term is used to describe a network of domestic and international business relationships through which securities are issued and traded. These securities include both debt and equity securities, together with a number of hybrid instruments: however, given the focus of this book, it is primarily the debt securities markets that will be covered here. The debt securities that are issued and traded in the capital markets are generally medium-term (ie with a life of one to 5 years) and long-term (ie with a life of over 5 years) securities: the markets that deal in short-term instruments (ie with a life of less than one year) are referred to as the money markets.

3.3 As seen earlier, the term 'capital' refers to the money obtained by a company for the purpose of commencing or extending its business. Logically, therefore, a company's capital could include not just money raised through the issuance of securities but also money borrowed from banks under loan agreements, and therefore the 'capital markets' should, strictly speaking, include not just the securities markets but also parts of the banking markets. Historically, though, the term 'capital markets' has been used only to mean the medium-term and long-term securities markets – on the basis that these, traditionally, were the predominant sources for companies wishing to raise capital from outside investors.

3.4 Within the capital markets, the arrangement and launch of new issues of securities is referred to as the primary market, and the subsequent trading of securities as the secondary market. Trading in new securities after the issue has been launched but before the securities are formally issued is referred to as the grey market.

3.5 The capital markets can also be subdivided into domestic and international markets: this is considered further below.

Act 1991, s 40(1); Settled Land Act 1925, s 117(1); Income Tax Act 2007, ss 285(2), 317(4), 559(3), 614ZB, 619, 713, 919(8), 925F(4) and 1005(6); International Development Act 2002, s 6(3); Electricity (Miscellaneous Provisions) Act 2003, s 1(2); Banking Act 2009, s 14; Corporation Tax Act 2009, ss 128(4), 129(8), 556(1) and 819(5)(c); Corporation Tax Act 2010, ss 465(5), 512(3), 751, 937O(3), 1102(6) and 1137(5); Law of Property Act 1925, s 205(1)(xxv); Finance Act 2012, s 121(6). See also *Bristol Airport plc v Powdrill* [1990] Ch 744; *Tarmac Roadstone Holdings Ltd v Williams* [1996] STC (SCD) 409; *Taylor Clark International Ltd v Lewis* [1997] STC 499; *Re Douglas' Will Trusts* [1959] 1 WLR 744 at 749; *Brown, Shipley & Co v IRC* [1895] 2 QB 598; *Re Rayner* [1904] 1 Ch 176; *Re Gent and Eason's Contract* [1905] 1 Ch 386; *Re United Law Clerks Society* [1947] Ch 150 at 152–153; *IRC v Henry Ansbacher & Co* [1963] AC 191 at 207 per Lord Morris; *Savva v Revenue and Customs Commissioners* [2015] UKUT 141 (TCC) at [33]–[37]. For definitions of 'transferable securities', see Financial Services and Markets Act 2000, s 102A(3); Directive 2004/39/EC on markets in financial instruments, Art 4.1(18); *Prospectus Rules* (UK Listing Authority), Appendix 1; *Listing Rules* (UK Listing Authority), Appendix 1.

DISTINCTIONS BETWEEN DOMESTIC AND INTERNATIONAL CAPITAL MARKETS

3.6 Debt securities issued by UK companies can broadly be divided into two types: those issued domestically in the form of 'stock', and those issued internationally in the form of 'eurobonds'. In practice, the distinction is disappearing as issues in the UK domestic market are now usually documented in the form of eurobonds. That said, there still remains a relatively small UK market in domestic stock.

3.7 The two principal differences between stock and eurobonds are as follows:

(a) A domestic stock issue is, traditionally, one made by a UK issuer, denominated in sterling, and targeted principally at UK investors (commonly pension funds and insurance companies). One exception, though, in the 1980s was the so-called 'bulldog' issue (which was sterling-denominated and targeted at UK investors, but made by a foreign issuer).[7] In contrast, an issue of eurobonds is one in which the securities are, or in theory could be, sold internationally to investors across the world and are usually, but not always, denominated in a currency other than that of the country in which the issue takes place.[8] The term 'eurobond' originates from the fact that what is generally agreed to be the first eurobond issue[9] was designed to raise money from the pool of 'eurodollars' that had grown up in Europe since the Second World War. A 'eurodollar' is merely a US dollar on deposit with a bank outside the US.[10]

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7 A variety of terms has grown up to describe domestic issues by foreign issuers: eg, 'matador' in the case of the Spanish domestic market, 'yankee' in the case of the US domestic market and 'samurai' in the case of the Japanese domestic market.

8 Inevitably, there are exceptions: in particular, an issue of eurobonds by an English company on the international markets is still regarded as an international issue even if denominated in sterling (ie 'eurosterling').

9 By Autostrade, the concessionaire and operator of toll motorways in Italy, in 1963. See, eg, Fuller, *The Law and Practice of International Capital Markets* (3rd edn, 2012), pp 101–105; the article by Roberts in *The Times*, 16 January 1993, p 37; Kerr, *A History of the Eurobond Market – The First 21 Years* (1984), pp 11–16; Kynaston, *The City of London, Vol IV: A Club No More 1945–2000* (2002), pp 275–280; Roberts, *Take Your Partners* (2001), pp 8–9; Attali, *A Man of Influence* (1986), pp 223–225; Spira, *Ladders and Snakes* (1997), pp 115–118; Fraser, *The High Road to England* (1999), pp 260–262; Stormonth Darling, *City Cinderella* (2000), pp 64–65; Ferguson, *High Financier: The Lives and Times of Siegmund Warburg* (2010), pp 218–220; O'Malley, *Bonds Without Borders* (2015), pp 22–25. For judicial definitions of the term 'eurobond', see *Cantor Fitzgerald (UK) Ltd v Wallace* [1992] IRLR 215; *European Commission v Belgium* (C-478/98) [2000] STC 830 at [2].

10 See, eg, *Libyan Arab Foreign Bank v Bankers Trust Co* [1988] 1 Lloyd's Rep 259 at 263 per Staughton J ('a credit in dollars outside the United States, whether in Europe or elsewhere'); *Hazell v Hammersmith and Fulham LBC* [1992] 2 AC 1 at 24 per Lord Templeman ('Eurodollars are United States dollars held outside the United States'). On the growth of the eurodollar and the eurobond generally, see Fuller, *The Law and Practice of International Capital Markets* (3rd edn, 2012), pp 101–121; O'Malley, *Bonds Without Borders* (2015); Fisher, *Eurosecurities and their Related Derivatives* (1997), Chapter 1; Tennekoon, *The Law and Regulation of International Finance* (1991), Chapter 1; Kerr, *A History of the Eurobond*

Nowadays, eurobonds are denominated in all the major currencies, which, so long as they are held outside their country of origin, are known as 'eurocurrencies'.

As mentioned above, this distinction is disappearing, as issues by UK issuers to UK investors in the domestic market are now usually documented in the form of eurobonds.

(b) Domestic stock issues are usually in registered form, with a holder's title to stock being determined by the entries in the register of holders maintained by the issuer's registrar. Stock is often held through CREST[11] (in which case, transfers are effected merely by electronic instructions to CREST). Where it is not held through CREST, each holder is issued with a stock certificate evidencing its holding of the stock and a transfer is effected by execution of a stock transfer form and delivery of the transfer form and certificate to the issuer's registrar for registration in the register.[12] Eurobond issues, however, are usually in bearer form (though some are issued in registered form[13]). It is rare, though, for definitive bonds (or certificates, in the case of a registered issue) to be issued to the investors. Instead, the usual practice is for the bonds to be represented by a 'global bond' (ie a single bond representing the entire issue) and held by or on behalf of Euroclear and Clearstream, the European clearing systems.[14] The investors hold the bonds either directly in accounts at the clearing systems or indirectly through custodians who have accounts at the clearing systems. Transfers between accounts are effected by electronic instructions to the clearing systems.[15]

3.8 There used to be a third major distinction, ie withholding tax on interest payments. Prior to 1 April 2001, interest under domestic stock issues would usually be paid subject to deduction of lower rate income tax, whereas eurobond issues would normally be structured so that interest could be paid gross, ie free of any deduction for tax arising in the company's home tax jurisdiction.[16] That distinction has now disappeared and interest may now be paid gross on both domestic stock issues and eurobonds that are quoted on a recognised stock exchange.[17] However, a legacy of the distinction is that, whereas eurobond issues normally contain a gross-up provision (requiring the

Market – The First 21 Years (1984); Kynaston, *The City of London, Vol IV: A Club No More 1945–2000* (2002), passim; Roberts, *Take Your Partners* (2001); Shearlock and Ellington, *The Eurobond Diaries* (1994); Dosoo, *The Eurobond Market* (2nd edn, 1992); Gallant, *The Eurobond Market* (1988).

11 As to which, see further **15.25**ff.

12 See **15.14**ff.

13 Particularly if a private placement in the US is envisaged in compliance with Section 4(a)(2) of, or Rule 144A under, the US Securities Act of 1933 (thereby avoiding the need for a registration of the securities with the US Securities and Exchange Commission): see further **14.32**ff.

14 Or the Depository Trust Company ('DTC') in New York, in the case of an issue, or part of an issue, placed with investors in the US.

15 For more detail on global bonds, see **3.18**ff.

16 See further **18.3**. In contrast, a grossing-up provision in a loan facility relates sometimes to any tax and sometimes to taxes arising in the borrower's home jurisdiction or the jurisdiction through which payments are made (see further **2.10**).

17 See further **18.3(e)**.

company to pay an increased amount if tax is required to be deducted by its home tax jurisdiction) and a prepayment option for the company (in the event that the requirement to deduct results from a change in law or regulation),[18] domestic stock issues (even those issued since April 2001) do not normally contain these provisions.

3.9 A number of other differences are also common:

(c) Domestic stock issues are often long-term, with maturities ranging from 15 to 30 years. One exception, though, is loan stock issued on a takeover as an alternative to cash consideration, which usually has a maturity in the region of 3–5 years.[19] Eurobond issues, however, have maturities ranging from as little as 2 or 3 years to as much as 25–30 years, though the majority range from 5–10 years[20] with short-term issues (ie with maturities of less than one year) usually being made pursuant to ECP programmes[21] rather than in the form of eurobonds.

(d) Domestic stock issues usually bear interest at a fixed rate, whereas eurobond issues can typically bear interest either at a fixed rate or at a floating rate (ie fixed periodically by reference to market rates) and sometimes bear no interest at all ('zero coupon issues').

(e) The procedures for attracting the lenders and fixing the issue price and interest rate differ: these are considered at **13.3–13.13**.

(f) Where, as is common, the issue is to be underwritten, it may, in the case of a eurobond issue, often be underwritten (on a joint and several basis) by a group of financial institutions appointed as the 'managers', whereas, in the case of a domestic stock issue, it will usually be underwritten by only one, or sometimes two, underwriters:[22] see further **13.3–13.13**.

(g) The style of the documentation is very different. For example, in the case of a eurobond issue, the main terms of the issue set out in the offering circular are called 'Terms and Conditions'; they follow a standard format, and, if definitive bonds were to be issued in place of the global bond, would be printed on the reverse of the definitive bonds in full. By contrast, the main terms of issue of domestic stock appearing in the offering circular are called the 'Particulars of the Stock'; they follow their own standard format (which is very different from that for the Terms and Conditions of eurobond issues) and are considerably longer than the 'Conditions of the Stock' that would be printed on the reverse of the stock certificates.

18 For an example gross-up provision, see **18.6**. For an example prepayment provision, see **5.13**.

19 The 'loan stock alternative' is common where there are a number of individual shareholders in the target company who could be liable to capital gains tax. The stock is usually redeemable in instalments. By virtue of the Taxation of Chargeable Gains Act 1992, s 135, a capital gains tax liability will not arise until redemption of the stock (whereas it would arise immediately if the cash consideration was accepted) and the stockholders can thus stagger redemption to utilise their annual exemptions from capital gains tax.

20 Some issues are 'perpetual', ie have no fixed maturity: this is more common in the international than the domestic market; see further **5.1–5.2**.

21 See **Chapter 4**.

22 Usually the company's financial adviser(s).

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(h) Payments to holders of domestic stock are made by the registrar (ie the company's agent responsible for maintaining the register of holders), whereas payments to holders of eurobonds are made by a group of financial institutions acting as 'paying agents'.

(i) Domestic stock issues are often (though by no means always) secured, either by floating charges over all the chargors'[23] undertakings and assets and/or by fixed charges over specific properties, whereas eurobond issues (with the exception of securitisations and other structured finance issues)[24] are usually unsecured.

(j) Domestic stock issues often incorporate borrowing limits and restrictions on disposals of assets and on changes in the nature of the company's business,[25] whereas the only major covenant usually contained in a eurobond issue is a negative pledge.[26]

(k) Domestic stock issues almost invariably involve the appointment of a trustee for the holders, whereas eurobond issues sometimes involve a trustee, sometimes not.[27]

(l) It is common in domestic stock issues for guarantees and/or security to be given by a number of subsidiaries of the company (known as 'guaranteeing subsidiaries' or 'charging subsidiaries', respectively). The purpose of having guaranteeing subsidiaries is to enhance the credit underpinning the stock (in order to achieve a lower interest rate for the company) and/or to give the company and its group some relaxation from the 'inner borrowing limit' (see **9.21–9.23**). The presence of charging subsidiaries, in the case of an issue secured by floating charges, is also intended to increase the attractiveness of the issue to investors whereas, in the case of an issue secured by fixed charges over specific properties, it is merely the result of the properties selected to be charged being held by those subsidiaries rather than by the issuer. In eurobond issues, a guarantee will be given by the issuer's parent if the issuer is merely a finance subsidiary,[28] but guaranteeing and charging subsidiaries are uncommon.

23 As to why security might be given by more than one chargor, see para (l) below.

24 Considered in **Chapter 7**.

25 See further **9.17ff**. In the case of first mortgage debenture stock, capital cover and income cover covenants are usually incorporated.

26 Considered at **9.26–9.30**. This is not the case, however, in relation to 'high yield' eurobond issues, which contain extremely detailed financial covenants. A restriction sometimes also seen in eurobond issues is an 'event risk' provision, under which the holders have a put option (ie a right to require the company to redeem the eurobonds early) if a specified event occurs (eg, a change of control or, most commonly in the case of utility companies, an adverse change to the regulatory regime affecting the company) which results in a sufficiently great downgrading of the ratings assigned to its securities by rating agencies such as Standard & Poor's or Moodys. Another provision giving greater protection to holders that is sometimes seen in eurobond issues is a 'coupon ratchet' provision. This is a provision that adjusts the interest rate in line with changes to the credit rating of the securities. Sometimes, event risk and coupon ratchet provisions are combined so that, if the specified corporate event occurs and results in a rating downgrade, this triggers an adjustment to the interest rate rather than a holder put right.

27 On the role of trustees, see **Chapter 12**.

28 Issues are usually structured in this way if the parent would otherwise have to deduct tax from payments of interest.

STOCK

3.10 In the context of loan capital,[29] stock is:[30]

> '... merely borrowed capital consolidated into one mass for the sake of convenience. Instead of each lender having a separate bond or mortgage, he has a certificate entitling him to a certain sum, being a portion of one large loan.'

3.11 The essence, therefore, is that the whole stock constitutes one single debt, and that the holders do not have fixed indivisible entitlements but rather can transfer their stock in any amount (though usually only integral multiples of £1, in order to avoid complications), and can consolidate several holdings into one larger holding, with a single certificate being issued for the aggregate amount. In order to achieve this effect of one single debt, the covenant to repay and to pay interest, and any accompanying covenants and security, are usually given only to the trustee in the trust deed constituting the stock, rather than to the holders themselves. The trustee holds the benefit of these covenants (and any accompanying security) on trust for the stockholders (with a proviso that the company's payment obligations to the trustee will be satisfied pro tanto by payments to the stockholders). The stockholders are merely beneficiaries under a trust, possessing only equitable interests. The consequences of this are that:

(a) the trustee, and not any of the stockholders, is the creditor of the company for the purposes of a winding up, administration or scheme of arrangement: *Re Dunderland Iron Ore Co Ltd*;[31]

(b) the trustee is responsible for enforcing the obligations of the company, though if the trustee defaults in doing so the stockholders have a residual equitable right to do so by joining the trustee as co-defendant;[32]

(c) transfer of a stockholder's interest can only be effected in writing[33] (hence stock being in registered form, at least where there is a trustee); and

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29 As opposed to share capital, where stock is 'simply a set of shares put together in a bundle' (*Morrice v Aylmer* (1875) LR 7 HL 717 at 725 per Lord Hatherley). In effect, it is the holding expressed in a currency amount instead of in a number of shares. The power of a UK company to convert its paid-up shares into stock was contained in s 121 of the Companies Act 1985. This power was repealed by the Companies Act 2006 with effect from 1 October 2009 (though, in order that companies with existing stock are not disadvantaged, s 620 of the Companies Act 2006 retains the power to reconvert stock into shares).

30 *Lindley on Companies* (6th edn, 1902), p 346. See also *Re Herring* [1908] 2 Ch 493 at 497.

31 [1909] 1 Ch 446. See also *Re Uruguay Central and Hygueritas Railway Co of Monte Video* (1879) 11 ChD 372; *Tomkinson v First Pennsylvania Banking and Trust Co* [1961] AC 1007 at 1039 (per Viscount Simonds) and 1076 (per Lord Morris). See, however, *Palmer's Company Law*, para 14.302, fn 2; *Palmer's Company Precedents*, vol 3 (16th edn, 1952), pp 10–11 and 412.

32 Known as the 'Vandepitte procedure'. See *Franklin v Franklin* [1915] WN 342; *Les Affréteurs Réunis SA v Leopold Walford (London) Ltd* [1919] AC 801; *Lloyd's v Harper* (1880) 16 ChD 290; *Vandepitte v Preferred Accident Insurance Corporation of New York* [1933] AC 70 at 79; *Harmer v Armstrong* [1934] 1 Ch 65; *Barbados Trust Co v Bank of Zambia* [2007] 1 Lloyd's Rep 495.

33 Law of Property Act 1925, s 53(1)(c). The section applies to equitable interests in personalty as well as equitable interests in land: *Grey v IRC* [1960] AC 1; *Oughtred v IRC* [1960] AC 206; *Vandervell v IRC* [1967] 2 AC 291. See also *Green* [1984] MLR 385.

(d) transfer of a stockholder's interest cannot, in principle, give the transferee any better title than the transferor had (*nemo dat quod non habet*),[34] and thus differs from transfer of a bearer negotiable instrument, which can give the transferee a better title.[35] In practice, this does not matter, as trust deeds invariably provide that a person entered in the register of holders shall be treated as the absolute owner of the relevant amount of stock free of all set-offs between the company and the existing or any prior holder.[36]

3.12 If, however, there is no trustee, the concept of one single debt is achieved by the company's obligations being contained in a deed poll[37] (often known as an 'instrument') for the benefit of the stockholders for the time being. A deed poll is a document executed as a deed, expressed to be made only by the person(s) undertaking the obligations, but for the benefit of others (who are not, technically, parties). Prior to the Contracts (Rights of Third Parties) Act 1999, a deed poll represented an important exception to the privity of contract rules, in that it could be enforced by any person for whose benefit the deed poll purported to be made, even though not a party and not even named, provided he was sufficiently designated. As a result of the Contracts (Rights of Third Parties) Act 1999, a person who is not a party to a contract may enforce a term of the contract if the contract expressly provides that he may do so or the term purports to confer a benefit on him (unless it is clear from the contract that the parties did not intend that the third party be able to enforce rights under the contract). However, the rights envisaged by the Act arise where a contract is entered into between two or more parties that is intended to confer a benefit on a third person. Where the intention is for one person (the issuer) to

[34] See, eg, *Mangles v Dixon* (1852) 3 HLC 702; *The Official Manager of the Athenaeum Life Assurance Society v Pooley* (1858) 3 De G&J 294; *Hilger Analytical Ltd v Rank Precision Industries Ltd* [1984] BCLC 301.

[35] See 15.3ff.

[36] Such a provision is valid (see, eg, *Re Agra and Masterman's Bank* (1867) 2 Ch App 391 at 397 per Cairns LJ; *Re Blakely Ordnance Co* (1867) 3 Ch App 154; *Higgs v The Northern Assam Tea Co Ltd* (1869) 4 Ex 387; *Re Northern Assam Tea Co* (1870) 10 Eq 458; *Hilger Analytical Ltd v Rank Precision Industries Ltd* [1984] BCLC 301; *Hong Kong and Shanghai Banking Corporation v Kloeckner & Co AG* [1990] 2 QB 514; *Coca-Cola Financial Corporation v Finsat International Ltd* [1998] QB 43; *John Dee Group Ltd v WMH(21) Ltd* [1998] BCC 518; *Re Kaupthing Singer & Friedlander* [2009] EWHC 740 (Ch); *AXA Sun Life Services Plc v Campbell Martin Ltd* [2011] EWCA Civ 133), except that: (i) it cannot exclude the concept of 'clean hands' (*Quadrant Visual Communications Ltd v Hutchison Telephone (UK) Ltd* [1993] BCLC 442); (ii) it cannot exclude the mandatory set-off in a winding up of the company in respect of mutual dealings (Insolvency Rules 1986, SI 1986/1925, r 4.90 and *National Westminster Bank Ltd v Halesowen Presswork & Assemblies Ltd* [1972] AC 785; *High Street Services Ltd v Bank of Credit and Commerce International SA* [1993] BCLC 360); and (iii) if one of the contracting parties is dealing on the other's written standard terms of business, the provision will be within the scope of s 3 of the Unfair Contract Terms Act 1977 (as extended by s 13) and therefore subject to a reasonableness test (*Stewart Gill Ltd v Horatio Myer & Co Ltd* [1992] 1 QB 600; *AXA Sun Life Services Plc v Campbell Martin Ltd* [2011] EWCA Civ 133 at [52]). Such a provision is also often inserted in bearer debt securities: see 15.3.

[37] As to which, see 19.7.

confer rights unilaterally on a fluctuating group of other persons who are not parties (the stockholders), a deed poll remains the most efficient means of achieving this.

3.13 Market practice is to refer to the stock as 'loan stock', 'unsecured loan stock' or 'ULS' where it is unsecured,[38] as 'first mortgage debenture stock' or 'FMDS' where it is secured by first-ranking fixed mortgages or charges, and as 'debenture stock' where it is secured only by floating charges.

EUROBONDS

Generally

3.14 A eurobond,[39] unlike stock, represents an entitlement to a fixed and indivisible sum. However, a number of the characteristics of stock are retained if a trustee for the holders is appointed. If there is a trustee, the covenant by the company to repay and to pay interest is given to the trustee in the trust deed, and, as with stock, the trustee holds the benefit of this covenant on trust for the holders. However, in the case of bearer eurobonds, it was historically considered important that the bonds constitute negotiable instruments[40] in order to provide certainty to purchasers of the bonds. As will be seen below,[41] the bond must contain an obligation owed to the holder for it to be negotiable, and thus it contains a covenant by the company to pay the holder. In order to preserve the advantages of having a trustee,[42] the terms of the bonds provide that the holder may not sue the company to enforce that covenant unless the trustee has been directed by the holders to sue the company to enforce the covenant in the trust deed and has failed to do so.[43] Thus eurobonds are similar to stock in that the trustee, rather than the holders, is primarily responsible for enforcement. Whether, like stock, the trustee, rather than the holders, is the creditor for the purposes of a winding up, administration or scheme of arrangement is not clear. In the *Dunderland* case,[44] the court placed reliance on

[38] And 'CULS' where it is convertible, and 'SULS' where it is subordinated.

[39] On eurobonds generally, see Fuller, *The Law and Practice of International Capital Markets* (3rd edn, 2012); Wood, *International Loans, Bonds, Guarantees, Legal Opinions* (2nd edn, 2007), Chapters 10–15; Tennekoon, *The Law and Regulation of International Finance* (1991), Part III; Fisher, *Eurosecurities and their Related Derivatives* (1997); Gullifer and Payne, *Corporate Finance Law: Principles and Policy* (2nd edn, 2015), pp 372–410; Hudson, *The Law of Finance* (2nd edn, 2013), Chapter 34; Adams, *Banking and Capital Markets* (2015), Chapters 17–21.

[40] As to which, see 15.3ff. The need for the bonds to constitute negotiable instruments is less important nowadays, since (as will be seen later) the bonds are now usually represented by a global bond held on behalf of the clearing systems, with the investors holding the bonds either in accounts at the clearing systems or through custodians who have accounts at the clearing systems. Since no physical transfers of documents of title take place, negotiability is in practice no longer relevant: but the structure and wording of bond issues still follows the form developed when negotiability was relevant.

[41] At 15.8.

[42] Considered at 12.4ff.

[43] For the form of wording, see 12.3(a).

[44] See 3.11.

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the fact that, in the context of stock, there was no contractual link between the company and the holders. Such a contractual link is, however, present in eurobonds, but clearly it would be odd for both the trustee and the holders to be regarded as creditors, and common sense suggests that the trustee should be regarded as the creditor.[45] In other respects, though, eurobonds, even where there is a trustee, differ from stock: since the holder has a direct contractual right and not merely an equitable interest, transfers need not be effected in writing, and a transferee can acquire a better title than the transferor had.[46]

3.15 Where there is no trustee, though, each eurobond constitutes a separate contract between the company and the holder. Consequently, each holder can decide whether or not to accelerate the repayment obligation of its own eurobonds if an default occurs (with the result that part of the issue may be accelerated and part not) and is responsible for taking its own enforcement action.

3.16 The term 'eurobond' is a generic one and is in fact used collectively to describe a variety of internationally issued securities which may themselves individually be called, amongst other things, either notes or bonds. Current commercial practice is, broadly speaking, to refer to the securities as 'notes' if they have a maturity of less than 5 years, and 'bonds' if they have a longer maturity. However, securities which bear interest at a floating rate (ie fixed periodically by reference to market rates) are invariably called 'floating rate notes' or 'FRNs' regardless of their maturity.

EMTN programmes

3.17 An important development in the eurobond market since the mid-1980s has been the emergence of 'euro medium-term note programmes' (or 'EMTN programmes'),[47] designed to standardise the terms on which the company issues securities and consequently to minimise the documentation and cost of each issue. This is done by setting out in the documents constituting the programme all the provisions which it is envisaged may be applicable to the company's

[45] Cf *Re Olathe Silver Mining Co* (1884) 27 ChD 278, where a bearer was entitled to petition for winding up. The decision may be distinguishable if the securities in question did not limit the bearer's rights to take action to the situation where the trustee had become obliged to take action and had failed to do so, as described above; but whether they contained such a limitation or not is unclear. It could be argued that the holders should be regarded as contingent creditors (ie that their rights are contingent on the trustee having been directed by the holders to sue the company and having failed to do so). However, the normal principles relating to double-proof would presumably have the result that, as the trustee clearly has the better claim, the holders cannot prove unless the trustee fails, or agrees not, to do so.

[46] See 15.3ff.

[47] The term is, technically, a misnomer, since most programmes allow for securities to be issued with maturities from one month to 30 years, and the securities issued may themselves be called either notes or bonds. On the growth of the EMTN market, see, eg, Fuller, *The Law and Practice of International Capital Markets* (3rd edn, 2012), pp 114–115. The International Capital Market Association and the International Capital Market Services Association have both published a number of recommendations as to the provisions of, and procedures applicable to, EMTN programmes.

issues, with the documentation for a particular issue (usually called a 'final terms' document or a 'pricing supplement')[48] needing only to set out the commercial terms (such as maturity date, interest rate, issue price, etc) and to apply or disapply provisions of the programme documentation as appropriate.[49] Like conventional eurobonds, the programme can be established either with or without a trustee. Issues are made to financial institutions who have been appointed in advance as 'dealers' under the programme, though provision is usually made for other institutions to be appointed as dealers, either permanently or for the purposes of a single issue. Most programmes also allow for issues to be sold by means of a syndicate of financial institutions, equivalent to a management group in a conventional eurobond issue. One important difference from a loan facility is that, whereas at least some of the banks under a loan facility are usually committed to lend, EMTN programmes are uncommitted, in that the dealers are not under any prior obligation to purchase the securities, and it is a matter for agreement between the company and a dealer at the time of each proposed issue.[50]

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Global notes

3.18 As seen earlier,[51] the notes or bonds are usually represented by a 'global note' (ie a single note representing the entire issue) and held by or on behalf of the international clearing systems. The investors hold the notes either directly in accounts at the clearing systems or indirectly through custodians who have accounts at the clearing systems. Transfers between accounts are effected by electronic instructions to the clearing systems. The main international clearing systems are Euroclear in Belgium and Clearstream in Luxembourg. The main US clearing system for securities sold into the US is DTC (the Depository Trust Company) in New York.[52]

3.19 In the case of a bearer issue, the global note is issued to, and held by, a financial institution acting on behalf of both Euroclear and Clearstream. This institution is referred to as the 'common depositary' or, if the New Global Note structure – described below – is being used, the 'common safekeeper'.[53] In the case of registered securities held through Euroclear or Clearstream, the global note is issued to, and held by, a common depositary or, if the New Safekeeping

[48] Usual practice is to call the document 'final terms' where the programme is listed on a regulated market (as to which, see **Chapter** 13) and a 'pricing supplement' otherwise.

[49] If the issue is to be syndicated, a syndication agreement will also be required.

[50] On the issuance process under EMTN programmes, see further **13.10–13.13**.

[51] At 3.7(b).

[52] From 17 September 2014, transferable securities may not be traded on regulated markets, multilateral trading facilities or organised trading facilities unless they are recorded in book-entry form in a clearing system (Regulation (EU) No 909/2014, Art 3(2)). This requirement (which is already in force) overlaps with a further requirement (not in force until 1 January 2023) that EU issuers of transferable securities which are traded on regulated markets, multilateral trading facilities or organised trading facilities must ensure that the securities are either in dematerialised form or immobilised and held through intermediaries (Art 3(1)).

[53] If the securities are intended to constitute Eurosystem eligible collateral (as to which see below), the common safekeeper will be Euroclear or Clearstream itself.

6.69 Once the charge crystallises, so as to become fixed, priority in relation to charges and other interests arising after crystallisation will be determined in the manner set out at 6.66, subject to two exceptions:

(a) a landlord levying distress for rent, even after crystallisation, will, it appears, still have priority;[259] and

(b) crystallisation does not alter the relationship with preferential creditors, who remain in priority.[260]

[259] *Rhodes v Allied Dunbar Pension Services Ltd* [1989] 1 All ER 1161; *Goode on Legal Problems of Credit and Security* (5th edn, 2013), p 204. Cf *Re Roundwood Colliery Co* [1897] 1 Ch 373 at 393 per Lindley LJ. The position is different for a local authority levying distress for rates: *Re ELS Ltd* [1995] Ch 11.

[260] Since the relevant statutory provisions (Insolvency Act 1986, ss 40, 175 and 251 and Companies Act 2006, s 754(1)) refer to a charge which 'as created' was a floating charge.

CHAPTER 7

STRUCTURED FINANCE

7.1 A notable feature of the international securities markets in recent years has been the growth of structured financing techniques, and in particular the issuance of asset-backed securities. These have received wide public attention in the context of the global financial crisis that began in autumn 2007, the growth and complexity of these transactions being perceived by many as a major factor in the development of the crisis. The asset-backed securities markets have shrunk considerably as a result of the financial crisis, but the general expectation is that the markets will revive in due course,[1] though in a more simplified form and subject to greater regulation.[2] The purpose of this chapter is to give a brief description of three of the main types of asset-backed securities: repackagings; securitisations; and CDOs (collateralised debt obligations). There used also to be a fourth type, namely SIVs (structured investment vehicles). These have been a prominent casualty of the global financial crisis, and are no longer seen.

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OVERVIEW

Structured finance generally

7.2 All three of these types of structured finance transactions are essentially variations of one basic theme, namely the use of a single or special purpose entity, company or vehicle (SPE, SPC or SPV – the term used in this chapter is

[1] Notwithstanding the downturn in the markets, the 'repackaging' of financial instruments into securitisation and other asset-backed structures, and the transfer of the resultant asset-backed securities to central banks, has been one of the main sources of finance for banks and other financial institutions during the financial crisis. One part of the asset-backed securities markets that has already seen a significant revival in recent years is the market for collateralised loan obligations (CLOs), one of the types of CDO described later.

[2] The principal EU regulatory initiatives (the detailed provisions of which are beyond the scope of this chapter) relate to risk retention, due diligence and disclosure requirements. Articles 404–410 of the EU Capital Requirements Regulation (575/2013) restrict EU regulated credit institutions and investment firms from taking on exposure to the credit risk of a securitisation (e g as investor or counterparty) unless certain requirements are met. The main requirement is that the originator, sponsor or original lender in respect of the securitisation explicitly discloses to the institution that it will retain, on an ongoing basis, a material net economic interest of not less than 5% in the transaction. In addition, the institution must conduct due diligence on the transaction (in order to be able to demonstrate that it has a comprehensive and thorough understanding of the transaction), regularly perform stress tests in relation to its position, and establish appropriate formal policies and procedures to analyse and record information on the transaction and the underlying exposures.

SPV) to convert cashflows arising from underlying assets or debts ('receivables'[3]) into a smoothed payment stream on bonds or notes issued by the SPV to investors ('asset-backed securities', or 'ABS').[4] The purpose can be: to raise finance for the originator (the entity which created the receivables) on cheaper terms than would apply to a conventional borrowing by the originator; to provide an alternative source of finance to conventional borrowing; to remove the receivables from the balance sheet of the originator, thereby (in the case of a financial institution) reducing the amount of regulatory capital that the institution needs to maintain; or to exploit an arbitrage or mismatch between the yield derived from the receivables and that payable by the SPV on the ABS, in order to create a profit. The differences in the various structures derive principally from: which of these purposes is applicable; the nature of the underlying assets; how the profit is generated; who is intended to receive the profit; and how losses are to be allocated.

7.3 There is a tendency (particularly as a result of the global financial crisis) to regard structured finance and the use of SPVs with suspicion. But that is to misunderstand the nature of structured finance and the role of SPVs. In themselves, they are merely neutral techniques to generate either a profit or a cost-saving for originators, intermediaries and/or investors. There are certainly questions to be answered, in relation to the lead up to the financial crisis, as to how well the structures and the economics of the transactions were understood by those involved and by the relevant regulators. But the mere fact that a car, for example, can be driven dangerously by someone so minded, or carelessly by someone who does not understand how it operates, does not make cars per se dangerous machines.

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3 The term 'receivable' has no specific legal definition, but is used as a general description of amounts owed to a business by its debtors.

4 For judicial descriptions of asset-backed securities, see: *Paragon Finance plc v Pender* [2005] EWCA Civ 760 at [13] per Jonathan Parker LJ; *Citibank NA v QVT Financial LP* [2007] EWCA Civ 11 at [1]–[3] per Arden LJ; *UBS AG v HSH Nordbank AG* [2009] EWCA Civ 585 at [10]–[12] per Lord Collins; *Cassa di Risparmio della Repubblica di San Marino SpA v Barclays Bank Ltd* [2011] EWHC 484 (Comm) at [32]–[44]; *LB Re Financing No. 3 Ltd v Excalibur Funding No.1 plc* [2011] EWHC 2111 (Ch) at [5]–[30]; *Deutsche Trustee Co Ltd v Fleet Street Finance Three PLC* [2011] EWHC 2117 (Ch) at [9]–[15]; *Belmont Park Investments PTY Ltd v BNY Corporate Trustee Services Ltd* [2011] UKSC 38 at [22] per Lord Collins; *Gemini (Eclipse 2006-3) PLC v Danske Bank A/S* [2012] EWHC 3103 (Comm) at [6]–[13]; *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL PLC* [2013] UKSC 28 at [2]–[19] per Lord Walker; *Titan Europe 2006-3 PLC v Colliers International UK PLC* [2015] EWCA Civ 1083 at [3] and [26]; *Forsta AP-Fonden v Bank of New York Mellon SA/NV* [2013] EWHC 3127 (Comm) at [50]–[56]; *Napier Park European Credit Opportunities Fund Ltd v Harbourmaster Pro-rata CLO 2 BV* [2014] EWCA Civ 984 at [1]–[16] per Lewison LJ; *US Bank Trustees Ltd v Titan Europe 2007-1 (NHP) Ltd* [2014] EWHC 1189 (Ch) at [1]–[10]. See also the definition of 'securitisation' in para 1(61) of Art 4 of the EU Capital Requirements Regulation (575/2013) (one of the key elements of which is the tranching of credit risk).

Transaction structures and history

(a) *Repackagings*[5]

7.4 Repackagings are usually the most straightforward of the various types of ABS. They had their origins in 'asset swaps'. A typical asset swap consists of a bank selling bonds (which the bank either currently holds on its books or acquires in the market) to an investor and simultaneously entering into a swap agreement with the investor under which the investor pays the cashflows received by it under the bonds to the bank in return for a different set of cashflows (eg a different currency, or a floating rate instead of a fixed rate). The technique, developed in the early 1980s, was designed to make unattractive or illiquid bonds more saleable. However, it had a number of disadvantages, principally due to the fact that the two elements of the transaction (the bonds and the swap) are in fact separate transactions and not interdependent. Thus, even if the bonds were in default, the investor would still have to make payment under the swap. In addition, if the investor wished to sell, it would have to transfer the bonds and assign its rights under the swap in two separate transactions.

7.5 It was to overcome these problems that repackagings were developed in the mid-1980s.[6] Instead of the investor holding the bonds and entering into the swap, an SPV does so, and issues ABS to the investor. The arranging bank sells the underlying bonds to the SPV, in return for the issue proceeds of the ABS, and acts as the counterparty under the swap. The ABS have a cashflow profile matching the SPV's receipts under the swap, and are secured on the underlying bonds and the swap. If the investor wishes to sell, it can merely transfer its ABS through the clearing systems in the normal way.

7.6 Transactions have since become considerably more complex, with portfolios of underlying assets and linkage with credit default swaps, for example, now common features.

7.7 The primary purpose of a traditional repackaging is to facilitate an investment in particular securities for an investor which is prepared to take the credit risk associated with those securities but prefers a different interest rate or currency profile. The motivation for the bank in arranging the deal is to make a profit through (sometimes) the price at which it sells the underlying bonds to the SPV or (more usually) through the pricing of the swap.

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5 On repackagings generally, see further Das, *Structured Products*, Vol 1 (3rd edn, 2006), pp 144–148, 182–193; Das, *Credit Derivatives, CDOs and Structured Credit Products* (3rd edn, 2005), pp 275–298; Deacon, *Global Securitisation and CDOs* (2004), pp 131–133; Choudhry, *Structured Credit Products: Credit Derivatives & Synthetic Securitisation* (2nd edn, 2010), pp 548–551; *Belmont Park Investments PTY Ltd v BNY Corporate Trustee Services Ltd* [2011] UKSC 38 at [22] per Lord Collins.

6 The first two repackagings appeared in September 1985, one arranged by Hill Samuel and the other ('MECS' or Marketable Eurodollar Collateralised Securities Limited) by Merrill Lynch (Das, *Structured Products*, Vol 1 (3rd edn, 2006), pp 144–145).

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(b) *Securitisations*[7]

7.8 Securitisations have a number of similarities to repackagings, in particular an SPV issuing ABS secured over underlying assets. But whereas in a repackaging the underlying assets are a pool of bonds and a swap agreement, in a securitisation they can be a wide range of assets, so long as they produce regular cashflows. Whereas the usual purpose of a repackaging is to create an end product that is more attractive to investors than the already existing underlying bonds, the usual purpose of a securitisation is to raise finance for the originator on the security of those cashflows and (often) to remove those cashflows from the originator's balance sheet for regulatory capital purposes.[8] Examples of the assets that can be used include mortgage portfolios, credit card receivables, utility receivables, student loans and even ticket receivables. Compared with a pool of bonds backing a repackaging, the receivables backing a securitisation are usually a more disparate group, with a range of payment and credit profiles. Consequently, securitisations usually involve greater structural complexity, to deal with the greater risks involved.

7.9 Though securitisation is often spoken of as having originated in the US in the 1970s, the original securitisation transactions were made in late eighteenth century Prussia. To enable landowners to raise funds in the aftermath of the

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7 On securitisations generally, see further Fabozzi and Choudhry (eds), *The Handbook of European Structured Financial Products* (2004); Jeffrey (ed), *A Practitioner's Guide to Securitisation* (2006); Hudson, *The Law of Finance* (2nd edn, 2013), Chapter 44; Gullifer and Payne, *Corporate Finance Law: Principles and Policy* (2nd edn, 2015), pp 38–39, 467–472; Ellinger, Lomnicka and Hare, *Ellinger's Modern Banking Law* (5th edn, 2011), pp 882–883; Petersen (ed), *Commercial Mortgage-Backed Securitisation: Developments in the European Market* (2006); Choudhry, *Structured Credit Products: Credit Derivatives & Synthetic Securitisation* (2nd edn, 2010), Chapter 12; Lancaster, Schultz and Fabozzi (ed), *Structured Products and Related Credit Derivatives* (2008), Chapters 3–8; de Vries Robbé, *Structured Finance: On From the Credit Crunch – The Road to Recovery* (2009), Chapters 4 and 5; Munoz and Ingram, *The Law of Transnational Securitization* (2010); Haynes, *The Law Relating to International Banking* (2010), Chapter 8; Choudhry, *The Mechanics of Securitization* (2013); McKnight, *The Law of International Finance* (2008), Chapter 12; Watson and Carter (eds), *Asset Securitisation and Synthetic Structures* (2006); Deacon, *Securitisation: Principles, Markets and Terms* (2nd edn, 2000); Wood, *Project Finance, Securitisations, Subordinated Debt* (2nd edn, 2007), Chapters 6–9; Borrows (ed), *Current Issues in Securitisation* (2002); Deacon, *Global Securitisation and CDOs* (2004); Cranston, *Principles of Banking Law* (2nd edn, 2002), Chapter 13; *Paragon Finance plc v Pender* [2005] EWCA Civ 760 at [13] per Jonathan Parker LJ; *Citibank NA v QVT Financial LP* [2007] EWCA Civ 11 at [1]–[3] per Arden LJ; *Deutsche Trustee Co Ltd v Fleet Street Finance Three PLC* [2011] EWHC 2117 (Ch) at [9]–[15]; *Gemini (Eclipse 2006-3) PLC v Danske Bank A/S* [2012] EWHC 3103 (Comm) at [6]–[13]; *Barclays Bank PLC v Unicredit Bank AG* [2012] EWHC 3655 (Comm) at [5]–[37]; *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL PLC* [2013] UKSC 28 at [2]–[19] per Lord Walker; *US Bank Trustees Ltd v Titan Europe 2007-1 (NHP) Ltd* [2014] EWHC 1189 (Ch) at [1]–[10]; *Titan Europe 2006-3 PLC v Colliers International UK PLC* [2015] EWCA Civ 1083 at [3] and [26].

8 These differences are also reflected in the names of the transactions: 'securitisation' refers to the fact that the structure is based on underlying assets that are not securities but the end product is; and 'repackaging' reflects the fact that the underlying assets are securities and the end product is merely another security with different characteristics.

Seven Years War (1756–63),[9] the Prussian government organised landowners into land companies (*Landschaften*). These companies issued bonds secured by mortgages over the estates of the *Landschaft* members, the interest payments on the bonds being funded by the interest payments by the landowners on their mortgages. The first of these bonds, known as *Pfandbriefe*, were issued in about 1770.[10]

7.10 An important feature of modern securitisations, though, is the removal of the assets that are being securitised from the originator's balance sheet. This was achieved in the US domestic market in the 1970s, the first US mortgage-backed securities being an issue by the Government National Mortgage Association ('Ginnie Mae') in 1970 of 'pass-through' certificates in respect of a pool of mortgages.[11] Investors in a pass-through security own undivided interests in the pool of underlying mortgages, and receive pro rata shares of the cashflows. However, these cashflows would include early, unscheduled, repayments of the underlying mortgages by the borrowers, which would lead to early partial repayments of the pass-through securities. The consequent lack of certainty about the length of the investment detracts from the appeal of pass-throughs. The need to deal with this 'prepayment risk' led to the introduction of Collateralised Mortgage Obligations ('CMOs') in 1983.[12] CMOs consist of several tranches of securities, with differing priorities over the underlying cashflows, each appealing to a different category of investor. In the event of early repayment of the underlying mortgages, the lower-ranking tranches get repaid first. The higher-ranking tranches thus carry greater certainty of cashflow, the lower-ranking tranches greater risk of prepayment, with each tranche being priced accordingly.[13]

7.11 The first securitisation of UK mortgages was by Bank of America in 1985.[14] The first that attracted widespread attention, though, was by National

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9 Between Prussia, Britain and Hanover on one side and Austria, France, Russia, Sweden and Spain on the other.

10 Kindleberger, *A Financial History of Western Europe* (2nd edn, 1993), p 130; Homer and Sylla, *A History of Interest Rates* (4th edn, 2005), p 252; Deacon, *Global Securitisation and CDOs* (2004), p 119; Fabozzi and Choudhry (eds), *The Handbook of European Structured Financial Products* (2004), pp 525–526. *Pfandbriefe* are today still widely used in Germany, and are considered further at 7.55(c).

11 O'Malley, *Bonds Without Borders* (2015), p 94; Morrissey, *International Securitisation* (1992), p 8; Stone, Zissu and Lederman (eds), *Asset Securitisation: Theory & Practice in Europe* (1991), p 2; Fisher, *Eurosecurities and Their Related Derivatives* (1997), p 300; Moore, *Autostrade to the Superhighway* (2001), p 78; Henderson, *Asset Securitisation: Current Techniques and Emerging Market Applications* (1997), p 3. The first non-mortgage asset-backed securities in the US market appeared in 1985, with an issue originated by Sperry Lease Corporation and backed by computer lease receivables (Henderson, ibid, p 3).

12 O'Malley, ibid, p 94; Morrissey, ibid, p 10; Stone, Zissu and Lederman, ibid, p 2; Fisher, ibid, p 300; Ferguson, *The Ascent of Money: A Financial History of the World* (2008), p 260.

13 For other techniques that have been developed subsequently to deal with prepayment risk, see 7.54(d). Tranching is considered in more detail at 7.29ff.

14 Ferran, *Mortgage Securitisation – Legal Aspects* (1992), p 2; *Bank of England Quarterly Bulletin*, May 1989, p 260, May 1994, p 134 and May 1996, p 156. The issuer was Mortgage Intermediary Note Issuer (No 1) Amsterdam BV (known as 'MINI').

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Home Loans in 1987.[15] During the 1990s, securitisation techniques began to be applied to a wider range of assets than just mortgages. In relation to UK assets, for example, the first securitisation backed by car loans appeared in 1990;[16] the first backed by personal loans appeared in 1993;[17] and the first backed by credit card receivables appeared in 1995.[18] In 1997 an important new category of securitisation appeared[19] – the 'whole business' securitisation, in which the cashflows derive not from specific assets but from the entire range of operating revenues generated by a business.

(c) CDOs[20]

7.12 CDOs first appeared in the 1990s. The term 'CDO' is in fact a broad category name for a number of different products. Originally, CDOs could be split into two main types, CBOs (or Collateralised Bond Obligations) and CLOs (or Collateralised Loan Obligations). In CBOs, the underlying assets consisted of a portfolio of bonds that was actively managed by a portfolio manager (sometimes referred to instead as a collateral manager), and the primary purpose of the transaction was to make a profit out of the differences

[15] Ferran, ibid p 2; Stone, Zissu and Lederman (eds), *Asset Securitisation: Theory & Practice in Europe* (1991), p 6; Morrissey, *International Securitisation* (1992), p 538; Moore, *Autostrade to the Superhighway* (2001), p 78. The issuer was NHL First Funding Corporation plc, and the issue was rated by Standard & Poor's (whereas the 1985 MINI deal had not been rated).

[16] Stone, Zissu and Lederman, ibid, pp 6–7; Fisher, *Eurosecurities and Their Related Derivatives* (1997), p 29. The loans had been made by Standard Chartered, and the issuer was Cardiff Automated Receivables Securitisation (UK) plc (known as 'CARS UK').

[17] Moore, *Autostrade to the Superhighway* (2001), p 79; O'Malley, *Bonds Without Borders* (2015), p 146. The loans had been made by Barclays Bank, and the issuer was Gracechurch Personal Loan Finance (No 1) PLC.

[18] *Bank of England Quarterly Bulletin*, May 1996, p 157. The credit card accounts were with MBNA International, and issuer was Chester Asset Receivables Dealings No 1 Limited (known as 'CARDS No 1').

[19] The first whole business securitisation was done that year by Welcome Break, a securitisation of 21 motorway service stations (Deacon, *Global Securitisation and CDOs* (2004), p 188). On the development of the whole business securitisation market, see further Fabozzi and Choudhry (eds), *The Handbook of European Structured Financial Products* (2004), pp 330–331.

[20] On CDOs generally, see further Tavakoli, *Structured Finance & Collateralized Debt Obligations* (2nd edn, 2008); Fuller and Ranero, JIBFL, October 2005, pp 343–351; Das, *Credit Derivatives, CDOs and Structured Credit Products* (3rd edn, 2005), Chapter 4; Lucas, Goodman and Fabozzi, *Collateralized Debt Obligations: Structures & Analysis* (2nd edn, 2006); Deacon, *Global Securitisation and CDOs* (2004); Fabozzi and Choudhry, ibid, Chapters 30–34; Watson and Carter (eds), *Asset Securitisation and Synthetic Structures* (2006), Chapters 14–15; Joannas and Choudhry, *A Primer on Synthetic Collateralised Debt Obligations* (2003); Borrows (ed), *Current Issues in Securitisation* (2002), Chapter 5; Hudson, *The Law of Finance* (2nd edn, 2013), pp 1304–1308; Lancaster, Schultz and Fabozzi (ed), *Structured Products and Related Credit Derivatives* (2008), Chapters 8–13; Choudhry, *Structured Credit Products: Credit Derivatives & Synthetic Securitisation* (2nd edn, 2010), Chapter 13; Das, *Structured Products*, Vol 2 (3rd edn, 2006), Chapter 12; *UBS AG v HSH Nordbank AG* [2009] EWCA Civ 585 at [10]–[12] per Lord Collins; *Cassa di Risparmio della Repubblica di San Marino SpA v Barclays Bank Ltd* [2011] EWHC 484 (Comm) at [32]–[44]; *LB Re Financing No 3 Ltd v Excalibur Funding No 1 plc* [2011] EWHC 2111 (Ch) at [5]–[30]; *Napier Park European Credit Opportunities Fund Ltd v Harbourmaster Pro-rata CLO 2 BV* [2014] EWCA Civ 984 at [1]–[16] per Lewison LJ; *UBS AG (London Branch) v Kommunale Wasserwerke Liepzig GmbH* [2014] EWHC 3615 (Comm) at [5]–[9], [110]–[159].

between the returns on the portfolio and the SPV's funding costs, and to share this profit between the portfolio manager and the subordinated noteholders (ie the holders of the lowest tranche of ABS issued by the SPV; tranching is described below). In CLOs, though, the underlying portfolio consisted of loans. CLOs could be characterised as either 'balance sheet' or 'arbitrage' CLOs. In balance sheet CLOs, the primary purpose (as with a traditional securitisation) was to raise finance for the originator (which was usually a bank) whilst at the same time removing the loans from its balance sheet (in order to improve its capital adequacy ratios). Arbitrage CLOs, on the other hand, were driven by similar profit motivations to CBOs, as described above.

7.13 The CBO/CLO distinction has since become blurred, as new CDO structures have been developed and the range of asset classes has widened. Current terminology focuses instead on the purpose for which the CDO is set up, and therefore tends to classify CDOs as either 'balance sheet' or 'arbitrage' transactions. This is not a precise distinction, however, as many transactions can (to varying extents) have both aims. Furthermore, CDOs in which the underlying assets are predominantly loans are still referred to as CLOs. Unlike other parts of the CDO market, CLOs have seen a significant revival in recent years, with growth levels akin to pre-crisis years. This market has evolved into one which is predominantly linked to private equity firms, utilising the CLO market as a source of finance for their leverage loan funds.

7.14 CDOs combine features of both repackagings and securitisations. The underlying assets are often bonds or notes (as in a repackaging), but are also often a diverse pool that is actively managed. Consequently, securitisation techniques are incorporated, to deal with the greater risks involved.

(d) SIVs[21]

7.15 SIVs have been a prominent casualty of the global financial crisis, and are no longer seen. A brief description of them, however, is set out below for completeness.

7.16 SIVs were, in effect, highly structured investment funds. Investors purchased equity or subordinated notes issued by the SPV; the SPV set up secured debt issuance programmes (usually EMTN, ECP, USMTN and USCP programmes) which were rated AAA; and the moneys borrowed under these programmes were invested in a portfolio of bonds, which was managed by an

[21] On SIVs generally, see further Fuller and Collett, CMLJ, Vol 3, pp 376–388; Watson and Carter (eds), *Asset Securitisation and Synthetic Structures* (2006), pp 116–120; Lancaster, Schultz and Fabozzi (ed), *Structured Products and Related Credit Derivatives* (2008), pp 16–24; de Vries Robbé, *Structured Finance: On From the Credit Crunch – The Road to Recovery* (2009), pp 13–20; Das *Structured Products*, Vol 1 (3rd edn, 2006), pp 193–201; Tabe, *The Unravelling of Structured Investment Vehicles: How Liquidity Leaked through SIVs* (2010); O'Malley, *Bonds Without Borders* (2015), pp 148–149; Hamilton and Anderson, 'The 2005 Guide to Structured Finance', IFLR, pp 72–75; Tavakoli, *Structured Finance & Collateralized Debt Obligations* (2nd edn, 2008), pp 401–402; Day and Molnar, IFLR, November 2006, pp 32–33.

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investment manager. Risks associated with the portfolio were hedged through swap agreements, and detailed composition criteria and sensitivity tests had to be satisfied to ensure that the funding programmes retained their AAA ratings. Whereas with a CDO the funding for the structure is usually raised through a series of bond issues at the establishment of the CDO, the funding for a SIV was continuously rolled over and refinanced under the funding programmes throughout the life of the SIV (which, in theory, could be perpetual). The vehicle's profit was made from the difference between the returns generated by the portfolio and the lower rates of interest payable on the AAA debt raised under the funding programmes. The profit was shared between the investment manager and the investors (by way of return on their equity or subordinated notes).

7.17 As stated earlier, SIVs have been a prominent casualty of the global financial crisis. Prior to the start of the crisis, there were approximately 30 in existence, with aggregate assets under management of over US$400 billion.[22] As a result of the financial crisis, all of these SIVs have either gone into default, been restructured or been supported by a bank sponsor.[23] They have also led to a number of cases concerning the correct construction of the documents.[24]

Overview of common themes

7.18 Many of these deals involve a transfer of the receivables from the originator or the arranger to the SPV, in a way that separates the receivables from the insolvency risk of the originator or arranger. This is referred to as a 'true sale' structure. The SPV then issues the ABS (which are secured over the receivables) and transfers the issue proceeds to the originator or arranger by way of purchase price for the receivables. The income stream from the receivables funds the SPV's payment obligations under the ABS. Other structures that can be used involve the SPV making a loan to the originator or a company in its group (with the receivables being charged to the SPV, rather than sold to it), or the SPV gaining exposure to the receivables 'synthetically' through a credit default swap or total return swap.

7.19 The ABS usually have the benefit of security over the relevant assets of the SPV backing the deal.[25] and are 'limited recourse', in the sense that the SPV is only obliged to pay on the ABS to the extent that it receives funds in respect of the assets backing the deal. In addition, the SPV is usually structured as 'insolvency-remote' (ie reducing as much as possible the risk of it becoming insolvent) and is often established in a tax-free or low-tax jurisdiction. This is so that, having isolated the receivables from the insolvency risk of the originator or arranger, there is no additional credit risk, and no additional drain on the cashflows from the receivables, as a result of the insertion of the SPV into the structure.

7.20 The ABS will often be issued in tranches, ie a series of layers with different levels of priority and risk profiles. Risk (and potential return) increase the more subordinated in the capital structure a tranche is, with the most subordinated tranche (known as the 'first-loss' piece) being the first to bear any shortfall on the cashflow from the underlying assets, followed in ascending order by the intermediate or mezzanine tranches. The ABS are usually rated by one or more of the main credit rating agencies (Standard & Poor's, Moody's and Fitch), with the highest tranche(s) having the highest rating and the first-loss tranche having either a very low rating or not rated at all. The ratings address for investors the likelihood of their being paid the amounts due on the ABS, and consequently much of the structuring process for these deals is driven by the rating agencies' criteria for assigning particular levels of rating to the various tranches of the ABS.

7.21 These common themes are described in more detail below, and then the three main transaction types are described in more detail.

7.22 Terminology in relation to structured finance is often imprecise. In particular, the term 'securitisation' is sometimes used in a wide sense to cover all these forms of structured finance (ie meaning, essentially, the issue of ABS that convert the cashflows from a set of receivables into another set of cashflows). In this chapter, however, 'securitisation' is used in its narrower (and original) sense, to mean the second of the three main transaction types referred to above (the main distinguishing feature of which is the issue of ABS backed by receivables that are not themselves securities).

COMMON THEMES

The SPV and insolvency remoteness

7.23 As mentioned earlier, the issuer of the ABS is usually referred to as a special purpose vehicle (SPV), special purpose company (SPC) or special purpose entity (SPE). The SPV may be intended to be used for only the one transaction (a 'single-issuance vehicle') or for a succession of similar transactions (a 'multi-issuance vehicle'). The SPV will ordinarily be structured so as to be insolvency-remote (ie reducing as much as possible the risk of it being declared bankrupt or insolvent), and so as to eliminate any unnecessary drain on the cashflows of the structure.

22 See *Financial Times*, 10 April 2008.

23 For a description of the impact of the financial crisis on SIVs, see Fuller and Collett, CMLJ, Vol 3, pp 376–388.

24 *Re Cheyne Finance plc (No 1)* [2008] 1 BCLC 732; *Re Cheyne Finance plc (No 2)* [2008] 1 BCLC 741; *Re Whistlejacket Capital Ltd* [2008] EWHC 463 (Ch) and [2008] EWCA Civ 575; *Bank of New York v Montana Board of Investments* [2008] EWHC 1594 (Ch); *Re Sigma Finance Corp* [2008] EWHC 2997 (Ch), [2008] EWCA Civ 1303 and [2009] UKSC 2; *Re Golden Key Ltd* [2009] EWHC 148 (Ch). For descriptions of the construction questions involved in some of these cases, see Fuller and Collett, CMLJ, Vol 3, pp 383–388.

25 Being, principally, the receivables themselves (in the case of a true sale deal), the SPV's rights under the loan and the benefit of the security over the receivables (in the case of a secured loan deal), or the credit default swap or total return swap (in the case of a synthetic deal).

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7.24 The latter objective (eliminating unnecessary drains on cashflows) is usually achieved by:

(a) Establishing the SPV, so far as possible, in a zero or low-tax jurisdiction – this is considered further below.

(b) Restricting the SPV from engaging in activities other than the transaction(s) in question, and in particular restricting it from having employees and subsidiaries.

(c) Structuring the SPV's arrangements with its various service providers (the roles of which are considered further below) so as to reduce or eliminate any VAT charges.

(d) Providing in the 'waterfalls' (i e the priorities of payment) that the amounts payable to service providers, etc, in priority to payments on the rated tranches of the ABS are capped at specified levels, with any residual amounts only being payable after the rated ABS tranches have been paid in full.

7.25 The former objective (insolvency-remoteness) is achieved by a combination of elements, including:

(a) Establishing the SPV, so far as possible, in a zero or low-tax jurisdiction, or, if this is not possible, in a jurisdiction where the amount of tax can be agreed with the tax authorities in advance (so that a cash reserve can be maintained in the structure for that amount). This is in order to reduce the risk of the tax authorities being able to wind up the SPV for non-payment of tax.

(b) Prohibiting the SPV from engaging in activities or incurring indebtedness other than under the transaction(s) in question. This is usually done through both contractual limitations in the transaction documents and constitutional limitations under the objects clause in the SPV's memorandum of association.

(c) Prohibiting the SPV from having any employees, and from merging or consolidating with any other entity (since, if that other entity had liabilities, that would increase the risk of insolvency of the resultant merged entity).

(d) Requiring all creditors of the SPV to agree that their claims are limited in recourse solely to the cash derived from the underlying assets backing their ABS (and only in accordance with the priorities of payment in the relevant waterfall), and that any residual shortfall will be extinguished.[26] Whilst these limited recourse provisions are most obviously relevant in the case of a multi-issuance vehicle (in order to prevent the creditors under one

[26] Such limited recourse provisions are in effect a form of subordination (as to the validity of which, see **Chapter 8**). Limited recourse provisions used not to be appropriate in the case of a UK SPV, as HM Revenue & Customs took the view that these provisions made the interest payable by the SPV dependent on the results of a business, with the consequence that the payments would be treated as distributions rather than interest and thus not deductible for the SPV. This effect has been removed by the Taxation of Securitisation Companies

transaction obtaining recourse to the underlying assets backing another of the SPV's transactions[27]), they are also relevant in the case of a single-issuance vehicle. By ensuring that the SPV's liabilities cannot exceed the amount of its assets, the provisions reduce the risk of the SPV's directors feeling obliged to file for winding up or administration as a result of wrongful trading concerns.

(e) The limited recourse provisions are supported by 'non-petition' provisions, i e undertakings from the SPV's creditors not to take any action to seek the winding up of the SPV as a result of any shortfall in amounts payable to them.[28]

(f) Ensuring that the SPV's creditors in relation to the transaction have the benefit of first-ranking security over the underlying assets – so as to act as a disincentive to any third parties who might otherwise seek to wind up the SPV.

(g) Requiring independent directors for the SPV.

(h) The SPV is usually structured as an 'orphan company', whose shares are held by a trustee on trust for a charity. If the SPV is not an orphan company, the rating agencies will wish to satisfy themselves that there is no risk of 'substantive consolidation' of the SPV with the group of which it forms part (i e that it cannot be liable for the debts of other members of the group and that it does not become subject to, for example, tax or pension liabilities as a result of being part of a group).

7.26 Since the SPV cannot have any employees, it has to subcontract all its functions to third-party service providers. The most significant of these functions is usually the servicing of the portfolio of receivables (i e collecting the cash, monitoring the performance of the receivables and, if necessary, taking appropriate enforcement action), and cash management (i e the correct application of the cash in accordance with the relevant waterfalls). In the case of a securitisation, this is generally undertaken by the originator (sometimes with a separate cash manager for the cash management), whereas in a repackaging or CDO these roles are usually performed by the portfolio manager and/or an independent financial institution acting as custodian, collateral administrator and/or cash manager. A corporate services provider is normally appointed to provide independent directors for the SPV and the share trustee. A trustee is appointed to hold the security on trust for the various

Regulations 2006, SI 2006/3296, which allow UK securitisation SPVs that fall within the scope of the Regulations to pay a predetermined amount of corporation tax (or, in some cases, no tax at all), irrespective of deductibility.

[27] This is also addressed by requiring that the transaction documents for each transaction do not contain cross-default provisions (so that one transaction cannot go into default as a result of a default under another of the SPV's transactions).

[28] In principle, if the limited recourse provisions are effective, the non-petition provisions should be as well (since there will be no unpaid debt on which to base the petition). However, a concern is recognised that a court might in reality allow a winding up petition despite contractual agreement to the contrary (on the basis, eg, that the contractual agreement is an attempt to oust the jurisdiction of the court and therefore contrary to public policy).

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transaction parties (in accordance with their priorities under the waterfalls), and (as is usual in bond issues) paying agents are appointed to make the payments to the ABS holders.

7.27 The choice of jurisdiction for the SPV is influenced primarily by local regulatory requirements and tax considerations. Local regulatory requirements generally relate to the transfer or true sale of assets, and may mean that an onshore SPV (ie located in the same jurisdiction as the assets) may need to be used, despite the more complex tax treatment that may result. Tax considerations relating to the assets may also mean that the SPV has to be located either in the same jurisdiction as the assets,[29] or in a jurisdiction where it can obtain double tax treaty relief in respect of the cashflow from the assets. This would rule out most tax-free jurisdictions (as tax havens do not generally have the benefit of double tax treaties), and so a suitable jurisdiction with as low a tax rate as possible will be chosen.[30] Alternatively, where treaty relief is not required, and assuming that it is acceptable to the relevant investors,[31] a tax-free jurisdiction is the most cost-efficient choice.[32]

7.28 As with other corporate entities, the directors of the SPV usually need to satisfy themselves that entering into the transaction has corporate benefit for the SPV. Since, as seen below, the residual profit in the transaction is designed to go to either the originator or the subordinated noteholders, it might seem that the SPV does not derive a corporate benefit from the transaction. However, this is not so, the requirement of corporate benefit normally being satisfied by a combination of the limited recourse provisions (ie demonstrating that there is no 'downside' for the SPV, since it cannot become insolvent as a result of the transaction) and a transaction fee payable to the SPV out of the proceeds of the issue (ie its 'upside').

Tranching and priorities of payment

7.29 As mentioned earlier, a key feature of many ABS issues is the tranching of the liabilities of the SPV under the ABS. The risk on the underlying assets is effectively sliced by the SPV issuing various classes of ABS, each with a different level of priority, and a different level of return, in relation to the cashflows received by the SPV from the assets.

7.30 Investors in the top tranche or tranches (often referred to as the 'senior notes'), for example, will be paid in priority to other investors (after payment of

[29] Eg where the underlying assets are loans to a UK corporate, the SPV usually needs to be subject to UK corporation tax in order to receive the interest free of withholding tax (see further 18.3(a)).

[30] The most commonly used EU jurisdictions with low tax rates for an SPV are Ireland, Luxembourg and The Netherlands. For a discussion of the principles applicable to SPVs seeking to rely on double tax treaty relief, see *Indofood International Finance Ltd v JP Morgan Chase Bank NA* [2006] STC 1195.

[31] Some investors, eg, have constitutional and/or regulatory restrictions that permit them to invest only in securities issued by EU and/or OECD issuers.

[32] The most commonly used tax-free jurisdictions for SPVs are the Cayman Islands and Jersey.

certain priority expenses, such as fees payable to the SPV's service providers, up to a capped amount), as well as being paid first in priority where there has been a default and enforcement (after payment of priority expenses and enforcement expenses – usually on an uncapped basis). Investors in the lower ranking tranches, often referred to as the 'mezzanine notes', are paid a fixed rate of return but are subordinated in right of payment to the senior investors.

7.31 To the extent that there is a residual profit in the SPV after payments to the senior and mezzanine noteholders and the other transaction parties, this profit may (depending on the type of transaction) be paid either to the originator or to the holders of a further tranche of ABS ranking below the senior and mezzanine notes (the 'subordinated notes' or the 'junior notes'). In securitisations, the profit is usually payable to the originator, with the exact characterisation of the payments depending on the originator's preferred tax treatment. Thus the payments may be structured as: payments of deferred purchase consideration for the acquisition of the receivables by the SPV; payments of interest and principal on a subordinated loan provided to the SPV by the originator; payments of interest and principal on subordinated notes held by the originator; fee payments to the originator for the provision of services to the SPV (eg acting as servicer in relation to the receivables); payment of dividends (if the SPV is in the same group as the originator, rather than being an orphan); or payments under a receivables trust (usually regarded as the most tax-efficient method of all).[33] In the case of CDOs, however, the residual profit is usually payable to third-party investors, as holders of subordinated notes.[34]

7.32 Investors in the subordinated notes are subordinated in right of payment to all other investors and are only entitled to any excess proceeds, both in respect of periodic cashflows in respect of the underlying assets and on enforcement. Although commonly structured as a debt instrument, the subordinated notes are economically more akin to a share, in that the investor has no guaranteed rate of return but rather shares in any excess profits, representing a leveraged exposure (and increased potential return) in respect of the portfolio. For this reason the subordinated notes are often referred to as the 'equity'.

7.33 Tranching therefore provides a means for investors to obtain exposure to a certain 'slice' of the risk on the underlying assets depending on their appetite for risk, each slice representing a different risk/reward trade-off. It is also used as a form of credit enhancement for the senior tranches (on the basis that the

[33] A receivables trust involves the originator selling the receivables to a trust (rather than to the SPV issuing the ABS), with beneficial ownership split between the originator and the SPV. Proceeds from the receivables are held on trust for the SPV to the extent that it needs funds to service the ABS, with the surplus being held on trust for the originator. By structuring the receivables trust as a bare trust, it is fiscally transparent and therefore prevents the originator's share being taxed twice.

[34] Repackagings normally involve the issue of only one tranche of ABS, with the residual profit usually being taken by the swap counterparty through the pricing of the swap.

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lower tranches absorb losses first, thereby reducing the risk of a shortfall in the amounts required to service the senior tranches).

7.34 Payments may be made 'sequentially' (ie in sequential order from the senior notes downwards) or 'pro rata' (ie paying several tranches pro rata notwithstanding the levels of seniority). The rationale for pro rata payment is that the lower tranches (because of their greater risk of loss in the event that there is a shortfall in the amounts received from the assets) carry a higher funding cost for the SPV, and therefore repayment of the senior tranches while the lower tranches remain outstanding could lead to a disproportionately higher funding cost for the SPV relative to the level of its outstanding debt. Where pro rata payment is permitted, it is usual for the occurrence of specified trigger events (often referred to as 'early amortisation events'), indicating, for example, a deterioration in the quality of the receivables, a reduction in the yield they generate or an insolvency-related event in relation to the originator, to lead to the order of payments switching to a sequential basis.

7.35 Another variable relates to how prepayments of the assets or (in the case of short-term assets) repayments at maturity of the assets should be dealt with. In some cases, principal receipts from the assets lead to an early partial redemption of the ABS: this is often referred to as a 'pass-through' structure. Alternatively, principal receipts may be used by the SPV for a specified period (known as the 'revolving period' or 'reinvestment period') to purchase fresh assets or, in some cases, for a specified period following the revolving period (known as the 'accumulation period') to be held in an interest-bearing account. The revolving period may terminate early on the occurrence of a specified trigger or early amortisation event.

7.36 The priorities of payment (often referred to as the 'waterfalls') are a vital feature in ensuring that the correct level of risk allocation is achieved at any given time in the life of the transaction. They control the allocation of cash to the different transaction parties, give effect to the relevant repayment approach described above, and ensure that the various tranches of ABS achieve the intended levels of relative creditworthiness. There are often three (or maybe more) waterfalls built into a transaction: application of interest proceeds prior to enforcement of the security; application of principal proceeds prior to enforcement; and application of all proceeds following enforcement. Enforcement of the security would occur following an event of default under the ABS – in essence, occurrence of an event regarded as sufficiently serious to justify bringing the transaction to an end and enforcing the security over the assets. Additional waterfalls may be included as appropriate (eg to take account of a trigger or early amortisation event). Though it is common for the various waterfalls to be set out separately, it is also common for some of them to be combined into a composite waterfall.

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Cash v synthetic structures

7.37 One of the key structural objectives is to separate the credit risk of the receivables from the credit risk of the entity that created them and/or transfers them to the SPV for the purposes of the transaction. The traditional way of achieving this in many cases is to effect a 'true sale' of the receivables to the SPV. In such a transaction, the proceeds of issue of the ABS are used by the SPV to purchase the underlying assets, 'true sale' legal opinions are required by the rating agencies (confirming that the acquisition cannot be either set aside on a subsequent insolvency of the transferor or recharacterised as a disguised security interest – which would be void for non-registration), the SPV grants security over the assets in favour of the transaction parties in accordance with their priorities of payment, and the cashflows generated by the assets are used to fund the payments on the ABS.

7.38 An alternative true sale structure is the 'master trust' or 'undivided interest' structure. Instead of the assets being acquired by the SPV that issues the ABS, they are acquired by another SPV, acting as trustee. The trust property is held by the trustee on trust for the originator and the issuing SPV, who each have a joint and undivided interest in each asset in the trust property. The size of the percentage shares that they each have in the trust property is recalculated periodically, and their entitlement to proceeds from the trust property is in proportion to their respective shares in the trust property. The proceeds of issue of the ABS are paid by the issuing SPV to the originator in return for an increase in the issuing SPV's share of the trust property (ie increasing the issuing SPV's share and decreasing the originator's share). The structure is used where the size of the receivables varies significantly from one period to the next (and is designed to avoid the need for the issuing SPV to have a fluctuating level of funding in order to match fluctuations in the size of its assets). The master trust structure allows amounts to be redrawn by the obligors under the receivables (by means of the originator funding the redraws and then adjusting its share of the trust property when the shares are next recalculated), without the issuing SPV having to fund the redrawn amounts by issuing fresh ABS. The structure is most often seen in credit card securitisations, commercial mortgage-backed securitisation (CMBS) deals, and residential mortgage-backed securitisation (RMBS) deals involving flexible mortgages.

7.39 As an alternative to a true sale structure, the SPV may use the proceeds of issue of the ABS to make a loan to the originator or another member of its group.[35] The cashflows generated by the underlying assets are used to fund the payments on the loan, which in turn funds the payments on the ABS. Instead of the SPV having title to the underlying assets, the ABS holders rely on rights of control over the underlying assets through grants of security by the originator's group to a security trustee on behalf of the transaction parties. This approach is sometimes referred to as 'true control', and is seen, for example, in certain

[35] Some master trust structures may combine elements of true sale and secured loan structures, with the issuing SPV making a secured loan to an intermediate SPV that then uses the proceeds to acquire the undivided interest in the trust property.

13.103 Any ancillary stabilisation must be done within the specified limits of Art 11, for example, any overallotment not covered by a greenshoe option[127] may not exceed 5 per cent of the original offer and any over-allotment covered by a greenshoe facility may not amount to more than 15 per cent of the original offer.

Non-regulated market safe harbour

13.104 The requirements for use of the non-regulated market safe harbour are narrower than those for the regulated market safe harbour.[128] These are based on the same articles of the EU Stabilisation Regulation as modified by r 2.4 of the Price Stabilising Rules. In particular, r 2.4 modifies references to 'adequate public disclosure'; for the purposes of stabilisation in relation to the non-regulated market safe harbour this includes any public announcement which provides adequate disclosure of the fact that stabilisation may take place in relation to the offer. Rule 2.4.4 of the Market Conduct Sourcebook of the Financial Conduct Authority Handbook sets out examples of wording to be included in both screen-based announcements and offering documents.

[127] An option granted by the offeror in favour of the investment firm(s) or credit institution(s) involved in the offer for the purpose of covering overallotments, under the terms of which such firm(s) or institution(s) may purchase up to a certain amount of relevant securities at the offer price for a certain period of time after the offer of the relevant securities.

[128] Section 2.4 of the Market Conduct Sourcebook of the Financial Conduct Authority Handbook.

CHAPTER 14

US SECURITIES AND TAX LAWS

OVERVIEW

14.1 Securities transactions in the US are regulated by both federal and state securities laws. In addition, federal tax legislation seeks to discourage the holding by US investors of bonds in bearer form. In both cases, the legislation is relevant to an issue of debt securities if either:

(a) the issue is marketed in the US or to US investors; or

(b) there is a risk that the securities might subsequently be bought by US investors.

14.2 The legislation could also potentially apply to the syndication of loans, but only if the loan constitutes a 'security': generally, a commercial loan will not be regarded as a 'security' for these purposes. Accordingly, this chapter deals only with the applicability of the legislation to non-US issuers of debt securities.

14.3 Federal securities legislation purports to have extraterritorial effect, in the sense that it extends to offers or sales to US persons outside the US.[1] Regardless of whether non-US jurisdictions would recognise this extraterritorial effect, the importance of the US market and the desirability of avoiding civil (and/or, in certain circumstances, criminal) liability in the US, where many market participants have assets and operations, make it prudent to include appropriate restrictions in all international offerings of securities, even where there is no apparent US connection. These restrictions are usually in a standard form, and are described at 14.76ff.

14.4 The two principal federal securities law statutes that are applicable to the offer and sale of securities in the US or to US persons are the Securities Act of 1933 (the 'Securities Act') and the Securities Exchange Act of 1934 (the 'Exchange Act'). The Securities Act and the Exchange Act are administered by the US Securities and Exchange Commission (the 'SEC'), which is headquartered in Washington DC. The two principal federal tax statutory provisions applicable to such offers and sales are the Tax Equity and Fiscal

[1] But only if 'jurisdictional means' are used. These include the use of the US mail or telephone systems, and the sending of emails into the US.

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Responsibility Act of 1982 ('TEFRA') and Sections 501 and 502 of the Hiring Incentives to Restore Employment Act of 2010 (the 'HIRE Act').

Securities Act

14.5 The Securities Act controls the primary offering of securities to the public (ie new issues and not, in principle, secondary market dealings), and it does this by requiring that publicly offered issues must be registered with the SEC, unless an appropriate exemption applies. An important point to note is that the Securities Act is essentially a *disclosure* statute. The SEC has no authority to decide whether a particular security may be offered to the public, but can merely require that the issuer make full disclosure of all material facts. The Securities Act is considered at **14.15**ff.

Exchange Act

14.6 The Exchange Act is generally concerned with the public securities markets in the US. It regulates the US securities exchanges and broker-dealers, specifies periodic reporting requirements for public companies, imposes liability for manipulative and deceptive practices, and establishes the rules for proxies and tender offers. In the context of international bond issues being offered to US investors, the provisions of the Exchange Act most relevant are those exposing the managers to potential liability if the offering circular contains inaccurate or misleading information. These are considered at **14.41**ff.

TEFRA and the HIRE Act

14.7 TEFRA was introduced, inter alia, to limit tax evasion by US taxpayers. One of the principal purposes of the legislation is to discourage the issue of bearer bonds in the US and to encourage US investors to hold bonds in registered form. The legislation (as supplemented by regulations issued by the US Internal Revenue Service (IRS)) may be enforced by the IRS by the imposition of sanctions on the issuer and the holders of bearer bonds.

14.8 Section 502 of the HIRE Act provides for the repeal and replacement of certain rules made under TEFRA, and Section 501 provides for the introduction of withholding tax and information reporting requirements for 'foreign financial institutions' (which, in the context of international bond issues, could include any financial intermediary through which payments are made, eg paying agents, common depositaries/common safekeepers, clearing systems and custodians). TEFRA and the HIRE Act are considered at **14.62**ff.

Other statutes and laws

14.9 The following may also be relevant.

(a) *Investment Company Act of 1940*

14.10 This regulates the activities of collective investment schemes, including their management, marketing and financing. 'Investment company' is broadly defined and can include many entities that bear little resemblance to conventional mutual funds and investment companies. The Act is particularly relevant where asset-backed issues are being offered to US investors, as an SPV issuer would be likely to fall within the definition of an 'investment company'.

(b) *Investment Advisors Act of 1940*

14.11 This regulates persons who give advice about securities, other than as an incident to a brokerage business (which is regulated by the Exchange Act).

(c) *Trust Indenture Act of 1939*

14.12 This applies to bond issues which are required to be registered with the SEC under the Securities Act. It requires the inclusion of certain terms in a trust deed (or indenture) for the securities and imposes certain mandatory duties on the trustee.

(d) *Sarbanes-Oxley Act of 2002*

14.13 This applies to all issuers that have registered securities under the Exchange Act, are required to file reports under the Exchange Act or have filed and not withdrawn a registration statement under the Securities Act that has not yet become effective. It has significantly modified a number of features of US corporate governance and business practice.

(e) *Blue sky laws*

14.14 In addition to the above, which are all federal statutes, offers and sales within the US will be subject to the state securities (or 'blue sky') laws of the states in which such offers and sales are made.[2] Unlike the federal legislation, many state securities laws entitle the relevant regulators to assess not only the adequacy of disclosure but also the merits of the particular investment.

SECURITIES ACT

14.15 As mentioned earlier, the Securities Act requires that publicly offered issues must be either registered with the SEC or exempt from the registration requirements.[3]

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2 The term 'blue sky' came into being, so it is said, because the laws were necessary to curb speculative schemes that had no more basis than 'so many feet of "blue sky"': *Hall v Geiger-Jones Co* 242 US 539, 550 (1917).

3 Section 5. Sales in violation of s 5 are subject to a right of rescission by the purchaser (s 12(a)) as well as a fine of up to US $10,000 and 5 years' imprisonment (s 24).

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14.16 Registration under the Securities Act is a time-consuming and expensive process, that subjects an issuer to ongoing SEC regulation, including the obligation to prepare financial statements in accordance with, or reconciled to, US GAAP (Generally Accepted Accounting Principles) or in accordance with IFRS (International Financial Reporting Standards), triggers the wide-ranging provisions of the Sarbanes-Oxley Act of 2002 and exposes an issuer to potential class-action litigation in the US by disappointed investors. Accordingly, where practicable, a non-US issuer will generally seek to ensure that an offering of its securities falls within an exemption from the registration requirements.

14.17 Where an issuer is not directly targeting US investors but wishes to protect itself against an inadvertent breach, Regulation S provides a 'safe harbour' from the registration requirements. Where an issuer is directly targeting US investors, but does not wish to register the issue under the Securities Act, the two most important exemptions are Rule 144A and Section 4(a)(2). Rules 901–905 of Regulation S and Rule 144A are rules adopted and enforced by the SEC under its rule-making powers.

Regulation S

14.18 Regulation S of the Securities Act provides a 'safe harbour', in the sense that, if its requirements are satisfied, the participants in the offering, including the issuer, will be protected from liability even though an inadvertent breach of the Securities Act registration requirements occurs.[4]

(a) Requirements

14.19 The two fundamental requirements of Regulation S are that the offering (and sale) be an 'offshore transaction' and that there be no 'directed selling efforts' in the US.[5] There may be additional requirements depending on the 'category'[6] into which the securities fall.

(i) Offshore transactions

14.20 An offering will qualify as an 'offshore transaction' if:

(x) the offer is not made to a person in the US; and
(y) either:
 (A) at the time the buy order is originated, the buyer is outside the US or the seller (and any person acting on the seller's behalf) reasonably believe that the buyer is outside the US; or
 (B) the transaction is executed in, on or through a physical trading floor of an established foreign securities exchange located outside the US.[7]

(ii) Directed selling efforts

14.21 These are activities undertaken for the purpose, or that reasonably could be expected to have the effect, of conditioning the US market for the securities being offered. This includes mailing printed material to US investors, conducting promotional seminars in the US, or advertising in publications with general circulation in the US.[8]

(iii) Additional requirements

14.22 As will be seen at **14.26ff**, Regulation S divides securities into three categories.

14.23 If Category 1 applies, there are no requirements other than the two mentioned above.

14.24 If Category 2 applies, two further restrictions must be observed, namely 'offering restrictions' and 'transaction restrictions':

(x) *Offering restrictions*. These require that:
 (A) each distributor must agree in writing that all offers and sales of the securities during the 'distribution compliance period' (defined as the period of 40 days beginning on the later of the closing date and the commencement of the offering) shall be made only (i) in accordance with Regulation S, (ii) pursuant to registration of the securities under the Securities Act, or (iii) pursuant to an available exemption from registration (such as Rule 144A or Section 4(2)); and
 (B) the offer documents must include certain prescribed selling restrictions and warnings.
(y) *Transaction restrictions*. These require that, during the 40–day distribution compliance period:
 (A) offers and sales cannot be made to a US person or for the account or benefit of a US person (other than a distributor); and
 (B) participants in the offering selling to a distributor, dealer or other person receiving a selling concession or fee must send a confirmation to the purchaser stating that the US selling restrictions apply.

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4 However, the Regulation S safe harbour will not be available if the offering, although in technical compliance with Regulation S, is part of a plan or scheme to evade the registration requirements of the Securities Act.

5 Rule 903(a). The term 'United States' is defined in Regulation S to include the United States of America, its territories and possessions, any State of the United States and the District of Columbia.

6 See **14.26ff**.

7 Rule 902(h). In addition, certain offers and sales to designated entities are deemed to be 'offshore transactions': see Rule 902(h)(3).

8 Rule 902(c). Preliminary Note 7 to Regulation S and Rule 135e under the Securities Act (which provides a 'safe harbour' for certain offshore press contacts) give guidance as to certain types of press briefings that will not constitute 'directed selling efforts'.

14.25 If Category 3 applies, the Category 2 restrictions must be observed as well as certain additional restrictions.[9]

(b) Categories

14.26 As mentioned above, Regulation S divides securities into three categories,[10] on the basis of which the restrictions that will apply are determined. Which category is applicable in any case depends upon the type of securities being sold and the likelihood of them being resold into the US. In the case of a guaranteed issue where the guarantor is the parent of the issuer, the status of the guarantor determines the applicable category. If the guarantor is not the issuer's parent, the relevant category is the most restrictive category applicable to either the issuer or the guarantor.[11]

(i) Category 1

14.27 This applies to offerings by a non-US non-governmental issuer which reasonably believes that there is no 'substantial US market interest' (SUSMI) in respect of its debt securities. There will be SUSMI in respect of its debt securities only if all three of the following statements are true:

(x) the issuer's debt securities[12] are held by 300 or more US persons;

(y) US $1 billion or more in nominal amount of its debt securities is held by US persons; and

(z) 20 per cent or more in nominal amount of its debt securities is held by US persons.

14.28 If any one of the above statements is not true, then there is no SUSMI in respect of the issuer's debt securities, and it is therefore a Category 1 issuer. If all three are true, there is SUSMI, and it is a Category 2 issuer. However, even if an issuer is a Category 1 issuer, it is permissible to adopt Category 2 selling restrictions as well. In fact, this has been an accepted approach where there is any doubt as to whether or not SUSMI exists or where the Regulation S offering will be combined with a placement with US investors under Rule 144A or Section 4(2).

14.29 Category 1 also applies to offerings by non-US governmental issuers and non-US issuers guaranteed by a sovereign, whether or not there is SUSMI.

9 These are not considered in detail here, since issues by non-US issuers of non-convertible debt securities will fall into either Category 1 or Category 2.

10 Rule 903(b).

11 The situation is different though if the guarantor is a sovereign: in that case the issue will always fall in Category 1, regardless of SUSMI.

12 For these purposes, 'debt securities' includes non-participating preferred stock and asset-backed securities but not US commercial paper and other securities issued under the exemption in Section 3(a)(3) of the Securities Act.

(ii) Category 2

14.30 This applies, in effect, to debt securities of foreign issuers where there is SUSMI.

(iii) Category 3

14.31 This is a residual category that applies to any securities that do not fall within either Category 1 or Category 2. In practice, therefore, in relation to offerings of non-convertible debt securities, it only applies to US issuers.

Rule 144A

14.32 Rule 144A exempts from the registration requirements of the Securities Act certain resales (not original sales by the issuer) of securities to US institutional investors where certain conditions are met. Since Rule 144A only exempts resales and not original sales by the issuer, a private placement to US investors relying on Rule 144A is typically structured as a two-stage transaction: the securities are issued to the managers in reliance on Section 4(a)(2);[13] and the managers then resell the securities in reliance on Rule 144A.

(a) Conditions

14.33 To fall within Rule 144A, four conditions must currently be met, as follows.

(i) Eligible securities

14.34 To be eligible, the securities must not be, at the time of issue, of the same 'class' as securities listed on a national US securities exchange, or quoted in a US automated inter-dealer quotation system, such as NASDAQ. Securities that are convertible or exchangeable into securities that are so listed or quoted must meet additional requirements. Securities issued by an open-end investment company, unit investment trust or face amount certificate company that is or is required to be registered under Section 8 of the Investment Company Act of 1940[14] are not eligible for Rule 144A resales.

(ii) Sale to QIBs

14.35 The securities are sold only to 'qualified institutional buyers' (QIBs), or to persons that the seller and anyone acting on its behalf reasonably believe to be QIBs. QIBs include certain institutions that own or invest on a discretionary basis in securities of unaffiliated issuers in an amount of at least US $100 million and certain registered broker-dealers.

13 Considered at **14.44ff.**

14 Ie not falling within an exemption to the Investment Company Act.

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(iii) Information furnishing

14.36 Subject to certain exemptions, the issuer must agree to make 'reasonably current' financial information and certain other information available upon request to the holders of the securities and prospective purchasers from those holders.

(iv) Notice of reliance

14.37 The seller (and any person acting on its behalf) must take reasonable steps to ensure that the QIB purchaser is aware that the sale is being made on the basis of Rule 144A. This is usually done by a statement to this effect in the offering circular.

(b) Other considerations

14.38 Certain other considerations should be borne in mind in connection with a Rule 144A placement, as follows.

(i) Registered form

14.39 Because of TEFRA and the HIRE Act (considered at **14.62ff**), the securities sold under Rule 144A must be in registered form.

(ii) Blue sky laws

14.40 State securities (or 'blue sky') laws may in some cases be applicable to Rule 144A resales and therefore may also need to be considered.

(iii) Due diligence

14.41 The managers of a Rule 144A offering are subject to a risk of liability under the Exchange Act if the offering circular contains inaccurate or misleading information. The applicable provisions are Section 10(b) of the Exchange Act and Rule 10b-5 (made by the SEC under Section 10(b)). Rule 10b-5 provides that, in connection with the purchase or sale of a security, it is unlawful for any person directly or indirectly (inter alia) 'to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading'.

14.42 However, for liability to arise, the plaintiff must show that the misstatement or omission was made with 'scienter'. 'Scienter' was defined by the US Supreme Court in *Ernst & Ernst v Hochfelder*[15] as 'intent to deceive, manipulate or defraud'. Recklessness has also since been held to be sufficient.[16] As the managers are involved in detail in the issue process (including the preparation of the offering circular and the marketing of the securities to

[15] 425 U.S. 185 (1976) at 193.

[16] *Sundstrand Corp. v Sun Chemical Corp.* 553 F.2d 1033 at 1040, cert. denied 434 U.S. 875 (1977); *Rankow v First Chicago Corp.* 870 F.2d 356 (1989) at 366–367.

potential investors), they would be exposed to potential liability under Rule 10b-5 if the offering circular contained a material inaccuracy and the requisite 'scienter' on their part could be shown. Consequently, the managers normally conduct an extensive 'due diligence' exercise, so that they will be able to rebut the allegation of 'scienter'.

14.43 Standard 'due diligence' procedures have been developed in the context of Rule 144A offerings, in order to demonstrate that the managers have taken reasonable care, and therefore are not acting with 'scienter'. These usually involve a physical inspection of the issuer's sites, meetings with the issuer's senior management, enquiries of the issuer's principal customers and suppliers and its auditors, and detailed drafting meetings in relation to the offering circular. In addition, the managers receive a 'comfort letter' from the issuer's auditors regarding the financial information in the offering circular, and letters from both the issuer's and the managers' lawyers stating that their investigations have not revealed any material misstatements in, or omissions from, the offering circular (ie 'negative assurance'). The letters from the lawyers are commonly called '10b-5 letters' or 'disclosure letters'.

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Section 4(a)(2)

14.44 Section 4(a)(2) of the Securities Act exempts 'transactions by an issuer not involving a public offering'. 'Public offering' is not defined in the Securities Act, but is generally construed as a public offering in the US or to US residents. What constitutes such an offering, however, has been the subject of much debate over the years.

14.45 To clarify the applicability of Section 4(a)(2), the SEC adopted Regulation D, which provides a non-exclusive 'safe harbour' for private placements under Section 4(a)(2). In other words, an offering in compliance with Regulation D is deemed to fall within the Section 4(a)(2) exemption; but an offering can still fall within the Section 4(a)(2) exemption if it does not satisfy Regulation D.[17]

14.46 Regulation D is available only to issuers and their agents. Consequently, private placements falling within Regulation D are structured on an agency basis (ie, with all sales being made into the US by the managers on behalf of the issuer).

(a) Requirements of Regulation D

14.47 Five requirements must currently be satisfied in order to fall within Regulation D, as follows.

[17] But in practice an offering in reliance on Section 4(a)(2) rather than Regulation D will still follow the general principles of Regulation D, with many issuers electing to omit the filing of a Form D with the SEC.

(i) Accredited investors

14.48 Sales may only be made to 'accredited investors' or up to 35 other persons, provided that the issuer reasonably believes that each purchaser that is not an accredited investor (either alone or with his purchaser representative(s)) 'has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment'.[18] 'Accredited investor' is defined in Regulation D as including most major institutions such as banks, insurance companies and investment companies and also certain wealthy individuals.

(ii) No general solicitation or advertising

14.49 Unless the securities are sold exclusively to accredited investors or the aggregate amount of the offering does not exceed US$1 million, neither the issuer nor any person acting on its behalf may offer or sell the securities by any form of general solicitation or general advertising. What will constitute general soliciting or advertising will depend on the circumstances. The SEC takes the view, for example, that there is no general solicitation or advertising if the offeror and offeree have a sufficiently important pre-existing relationship. In practice, however, most Regulation D placements are made only to accredited investors, and therefore this restriction would not normally be applicable.

(iii) Information furnishing

14.50 Prospective purchasers who are not accredited investors must receive certain specified information prior to the sale (similar to that which must be included in an offering registered under the Securities Act). In practice, however, most Regulation D placements are made only to accredited investors, and therefore this requirement would not normally be applicable.

(iv) Not underwriters

14.51 The issuer must exercise reasonable care to ensure that prospective purchasers are not underwriters – persons acquiring securities with a view to, or offering or selling for the issuer in connection with, a distribution of the securities.[19] This is normally satisfied by: placing an appropriate legend regarding the transfer restrictions on the securities; requiring purchasers to sign investment letters (see **14.54**); instituting 'stop-transfer orders' to enforce the transfer restrictions; requiring a legal opinion in relation to any proposed transfer; and permitting transfers only in large amounts in order to ensure that only sophisticated investors will be purchasing.

[18] Securities Act, Rule 506(b)(2)(ii).

[19] This requirement can still be satisfied where the Section 4(a)(2) placement is the first stage of a Rule 144A offering (see **14.32**), since Preliminary Note 7 to Rule 144A provides: 'The fact that purchasers of securities from the issuer thereof may purchase such securities with a view to reselling such securities pursuant to this section will not affect the availability to such issuer of an exemption under Section 4(a)(2) of the Act, or Regulation D under the Act, from the registration requirements of the Act.'

(v) Form D

14.52 A notice of sale of securities (known as Form D) must be filed with the SEC, in electronic format, no later than 15 days after the first sale of securities.[20]

(b) Other considerations regarding Section 4(a)(2)

(i) Interaction with Regulation D

14.53 As mentioned earlier, an offering can still fall within Section 4(a)(2) even if it does not satisfy all elements of Regulation D (although it will in practice still follow the general principles of Regulation D). The usual practice in relation to such an offering is to comply with the requirements in **14.48–14.51**, but to omit the filing of a Form D with the SEC.

(ii) Investment letters

14.54 Purchasers buying securities under Regulation D or Section 4(a)(2) are generally required to sign an investment letter in which the purchaser: acknowledges that the securities have not been registered under the Securities Act and cannot be resold except pursuant to registration or an exemption therefrom; certifies that it is an accredited investor (where the sale is being made to an accredited investor) and a sophisticated investor; certifies that it is purchasing the securities for its own account for investment purposes and not with a view to any resale or distribution; and confirms that it has made its own investigation into the merits of its investment and is not relying on representations by the managers. In the light of that confirmation, the risk of Rule 10b-5 liability[21] for the managers is significantly reduced, and therefore, unlike a Rule 144A offering, the managers would not usually conduct a 'due diligence' exercise.

(iii) Integration

14.55 In analysing whether an offering of securities falls within the exemption in Section 4(a)(2), the SEC will also consider other offerings (whether registered or exempt) by the same issuer or by related issuers and may aggregate them together. Offerings more than 6 months apart, however, generally will not be integrated.

(iv) Registered form

14.56 Because of TEFRA and the HIRE Act (considered at **14.62**ff), the securities sold under Section 4(a)(2) must be in registered form.

[20] In practice, many issuers relying on Section 4(a)(2) do not file this notice, as the information required in it is relatively onerous: this illustrates the non-exclusive nature of Regulation D.

[21] As to which, see **14.41**ff.

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