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Securities Act of 1933
Section 5
Rule 144A

March 25, 2019

Office of Chief Counsel
Division of Corporation Finance
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Eligibility of Contingent Convertible Capital Securities for an Offering Under Rule 144A

Ladies and Gentlemen:

We are writing to request that the staff of the Division of Corporation Finance (the "Staff") advise us that the Staff will not recommend any enforcement action to the Securities and Exchange Commission (the "Commission") if offers and sales by non-U.S. financial institutions of contingent convertible capital securities having the characteristics described below are made in reliance on Rule 144A ("Rule 144A") under the Securities Act of 1933, as amended (the "Securities Act"). We believe such relief is necessary given that the conversion features of such contingent convertible capital securities may result in their being deemed to be of the same class as listed securities and, therefore, not eligible for the exemption from Securities Act registration provided by Rule 144A.

Background

In response to the 2008 financial crisis, the Basel Committee on Banking Supervision (the "Basel Committee") proposed reforms to strengthen global capital and liquidity rules to promote a more resilient banking sector.[1] Among other things, the Basel Committee proposed a minimum set of criteria for instruments issued by a financial institution to meet or exceed in order for such instruments to form a part of the institution's regulatory capital.[2] Since the publication of the Basel III framework, regulators in several jurisdictions (including Australia, Brazil, Canada, China, member states of the European Union, Japan, Mexico and Switzerland) have revised their regulatory capital framework, which has led to the issuance of contingent convertible securities designed to qualify as capital that can be counted towards the capital requirements mandated by the relevant national regulator, including by non-U.S. financial institutions with equity listings in the United States.[3] In particular, these fixed income securities are designed to absorb future losses through mandatory conversion to common stock (including shares represented by American depositary shares) or write-down upon the occurrence of a specified trigger event, allowing a financial institution to maintain sufficient common equity tier 1 ("<u>CET 1</u>") capital to continue as a going concern. Although non-U.S. financial institutions with U.S. equity listings have issued contingent convertible capital securities on an SEC-registered basis, it may not always be desirable, or even possible, to do so.[4]

For the purpose of this request, the contingent convertible capital securities (the "<u>Contingent Convertible Securities</u>") and the relevant issuer would have the following characteristics:

- ***Issuers***. Contingent Convertible Securities could be issued by any non-U.S. financial institution.

- ***Regulatory Capital***. The Contingent Convertible Securities would qualify as regulatory capital and would be issued for the purpose of satisfying regulatory capital requirements under the relevant national standards.

- ***Security Type***. The Contingent Convertible Securities would have either subordinated debt or non-participating preferred equity characteristics, and in all cases would not be, when issued, of the same class (as defined in Section 12(g)(5) of the Securities Exchange Act of 1934, as amended (the "<u>Exchange Act</u>")), as securities listed on a

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[1] *See* Basel Committee, *Basel III: A global regulatory framework for more resilient banks and banking systems* (June 2011) (the "<u>Basel III framework</u>").

[2] *See* Part I of the Basel III framework, which, among other things, sets the minimum set of criteria for an instrument issued by a bank to meet or exceed in order for it to be included in additional tier 1 ("<u>AT1</u>") capital and tier 2 capital.

[3] No banks in the United States have issued contingent convertible capital securities to date. Although the Dodd-Frank Wall Street Reform and Consumer Protection Act commissioned a study of such securities by the Financial Stability Oversight Council, the Federal Reserve has not introduced contingent capital requirements. Moreover, potentially unfavorable U.S. tax treatment in respect of interest payments also makes the issuance of such securities unattractive for U.S. banks. As such, relief is not being requested in respect of U.S. financial institutions at this time.

[4] For example, if a foreign jurisdiction were to require the securities indenture to be governed by the law of that foreign jurisdiction (as is currently the case in Switzerland), it is likely to be difficult to qualify the securities indenture under the Trust Indenture Act of 1939, as amended.

national securities exchange registered under section 6 of the Exchange Act or quoted in a U.S. automated inter-dealer quotation system.

In addition, the Contingent Convertible Securities would have regularly scheduled payments of interest or dividends, as applicable. However, the payment of such interest or dividends may be subject to the availability of distributable reserves and the solvency of an issuer,[5] and an issuer may, in its sole discretion, have the right not to make interest or dividend payments, as applicable, at any time.[6] Any such cancelled interest or dividend payments would neither accrue nor be an event of default.[7]

Furthermore, the Contingent Convertible Securities may have issuer call options after a minimum of five years.[8] Contingent Convertible Securities may also include tax and regulatory call options, allowing the issuer to call the Contingent Convertible Securities if there has been an unfavorable change in tax laws or if the Contingent Convertible Securities cease to qualify as regulatory capital, provided such events were not reasonably foreseeable at the time of issuance to the extent the call occurs within five years of their issuance.

Finally, the security would have a minimum original maturity of at least five years and could be perpetual.[9]

- ***Conversion Trigger***. The Contingent Convertible Securities would automatically and mandatorily convert into common stock upon the occurrence of a trigger event outside the relevant issuer's and securityholders' control. A trigger event would be (x) a determination by the relevant national regulator in conjunction with that regulator's assessment of the issuer's viability and/or solvency (a "non-viability trigger event");[10]

[5] *See* paragraph 55, criterion 8, of the Basel III framework's criteria for inclusion in AT1 capital.

[6] *See* paragraph 55, criterion 7, of the Basel III framework's criteria for inclusion in AT1 capital.

[7] *See id.*

[8] *See* paragraph 55, criterion 5, of the Basel III framework's criteria for inclusion in AT1 capital and paragraph 58, criterion 5, of the Basel III framework's criteria for inclusion in tier 2 capital.

[9] *See* paragraph 55, criterion 4, of the Basel III framework's criteria for inclusion in AT1 capital and paragraph 58, criterion 4, of the Basel III framework's criteria for inclusion in tier 2 capital.

[10] This characteristic is consistent with the Basel III framework's requirement that the trigger event be the earlier of "a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority; and (2) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority." *See* Basel Committee, *Minimum requirements to ensure loss absorbency at the point of non-viability* (January 13, 2011) (the "Basel III minimum requirements for loss absorbency"). However, the terms of the instrument do not need to include an explicit non-viability trigger event if the governing jurisdiction has in place laws that require the instrument to be written off upon the occurrence of a trigger event. *See id.*

For example, the terms of AT1 and tier 2 capital securities issued by Swiss financial institutions include a non-viability trigger event. By contrast, such securities issued by EU financial institutions generally do not as, instead, when an issuer reaches the point of non-viability, its contingent convertible capital securities would generally be and/or (y) an issuer's CET1 capital ratio (or similar tier 1 ratio) (the "CET1 Ratio") falling below a specified percentage (a "CET1 Ratio trigger event").[11]

In relation to any CET1 Ratio trigger event:

- The CET1 Ratio would measure the ratio of CET1 capital to risk weighted assets ("RWAs"). CET1 capital and RWAs, in turn, would be based on the definitions under the applicable national regulatory capital requirements.[12]
- The CET1 Ratio trigger event would not exceed 7% given that a percentage equal to or less than 7% is effectively a sign of distress and is unlikely to occur as a result of actions within an issuer's control.[13]
- The CET1 Ratio trigger event would be separate and distinct from the non-viability trigger.[14]

- ***Conversion Price***. The Basel III framework does not seek to regulate the conversion price, instead leaving it to national regulators to choose whether to limit the common stock issued when conversion takes place. As such, the conversion price for the Contingent Convertible Securities would either be determined by the issuer (subject to

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subject to statutory write-down and/or conversion powers pursuant to the requirements of Directive 2014/59/EU (May 15, 2014) establishing a framework for the recovery and resolution of credit institutions and investment firms.

[11] The Basel III framework provides that instruments must include a CET1 Ratio trigger event in order to qualify as AT1 capital. *See* paragraph 55, criterion 11, of the Basel III framework's criteria for inclusion in AT1 capital.

[12] The Basel Committee proposed methodologies for calculating CET1 capital and RWAs under both its International Convergence of Capital Measurement and Capital Standards (commonly referred to as Basel II) and the Basel III framework. The Basel Committee recently proposed amendments to the RWA calculation methodology (commonly referred to as Basel IV). *See* Basel Committee, *Basel III: Finalising post-crisis reforms* (December 2017). As with Basel III, it is left to the relevant legislative bodies/regulators to implement these frameworks. Contingent convertible capital securities, therefore, often define CET1 capital and RWAs by reference to the definitions under the applicable national regulatory capital requirements.

[13] The Basel Committee has indicated that the CET1 Ratio trigger event must be at least 5.125% for AT1 capital. *See* Basel Committee, *Basel III definition of capital – Frequently asked questions*, question 16 (September 2017). The Swiss regime requires a 7% threshold for systemically relevant banks, while the minimum threshold for other financial institutions is 5.125%. CRD IV follows the Basel Committee's recommendation by adopting a minimum CET1 Ratio in respect of AT1 capital securities of 5.125%. Higher trigger levels also are permitted under CRD IV and may be requested by the relevant regulator. *See* Regulation No 575/2013 of the European Parliament and the Council of 26 June 2013 on Prudential Requirements for Credit Institutions and Investment Firms and Amending Regulation (EU) No 648/2012, art. 54. The terms of AT1 securities issued by UK financial institutions, for example, generally include a 7% trigger level.

[14] Although the occurrence of a CET1 Ratio trigger event is a sign of distress, the non-viability trigger event only occurs in what is effectively a failure or likely failure of the bank. And indeed, the Basel III framework requires AT1 capital to separately satisfy the non-viability trigger event requirements discussed *supra* note 10. *See* Basel Committee, *supra* note 13, question 17.

any relevant national regulatory capital requirements or limitations) or reflect a conversion price set by the relevant national regulator.[15]

For purposes of this request, therefore, the terms of the Contingent Convertible Securities would specify either (i) a pre-determined conversion price or (ii) a pre-determined methodology for setting the conversion price after the issuance of the Contingent Convertible Securities.[16]

Given that the terms of the Contingent Convertible Securities may specify a methodology for determining the conversion price, the conversion price would not necessarily be known at the time of issuance and, instead, may be calculated at a later date (although based on the methodology established at the time of issuance). Issuers would consider a variety of factors when setting the conversion price (or conversion price determination methodology), including any relevant national regulatory capital requirements or limitations and the extent to which losses should be borne by shareholders versus securityholders.

- ***Minimum CET1 Ratio***. The issuer's CET1 Ratio at the time of any issuance would exceed the sum of the minimum CET1 Ratio and minimum CET1 capital buffer (together, the "Combined Buffer Requirement") (such minimums as set under the applicable national regulatory capital rules prior to the offering of the Contingent Convertible Securities).[17]

- ***Investor Protection***. The relevant regulator may retain full discretion in respect of a trigger event, meaning that it could choose not to trigger a conversion (or override a

[15] Under CRD IV, for example, the terms of AT1 contingent convertible capital securities must specify either (a) the conversion price and a limit on the permitted amount of conversion or (b) a range within which the securities will convert to common stock. The Swiss Capital Adequacy Rules assign discretion to the issuer of contingent convertible capital securities. Similarly, under the Canadian Capital Adequacy Requirements, the conversion price is to be set by the issuer, although in determining the conversion price, the issuer should consider the market value of the issuer's common stock.

[16] As an example of the pre-determined conversion price, bank issuers in the United Kingdom to date have elected to set a low conversion price at the time of issuance (which in some cases approaches the issuer's lowest historical share price, subject to anti-dilution adjustments). In contrast, some bank issuers in Spain and Switzerland have issued contingent convertible capital securities that use a pre-determined methodology for setting the conversion price. Specifically, these issuers set the conversion price equal to the greater of a specified floor share price (which is set at the time of issuance and represents a premium or discount to the issuer's share price at that time, subject to anti-dilution adjustments) and a reference market price (which represents the daily volume-weighted average sale price of the shares over a 30-day period preceding the conversion trigger).

[17] The Basel III framework requires financial institutions to hold capital buffers in the form of common equity tier 1 capital above the regulatory minimum (which is set at 4.5%). These buffers include (i) the capital conservation buffer (which is set as 2.5%) and (ii) the counter-cyclical capital buffer (which may be up to 2.5%, depending on the level deemed appropriate by the relevant regulator during periods of excess credit growth or other indicators of a build-up of system-wide risk). Under the Basel III framework, financial institutions whose capital levels fall within the buffer range are subject to quantitative restrictions on distributions (*e.g.*, dividends), buy-backs and staff bonus payments. *See* Basel Committee, *Minimum requirements to ensure loss absorbency at the point of non-viability* (January 13, 2011).

conversion), notwithstanding the issuer being deemed to be non-viable by the relevant regulator[18] or the CET1 Ratio falling below the conversion trigger level.[19] An exercise of this discretion would protect investors from the negative effects of a decline in the issuer's stock price, which is likely to occur as the probability of conversion increases.

- ***No Optional Conversion***. Neither the issuer nor securityholders would have the option to convert the Contingent Convertible Securities into common stock of the issuer; the only circumstance under which a conversion could occur would be a contingent conversion based on a trigger event described above.[20]

Analysis

Pursuant to paragraph (d)(3)(i) of Rule 144A ("Paragraph (d)(3)(i)"), securities that, when issued, are convertible into listed securities[21] and that have a conversion premium at the time of issuance of less than 10% are not eligible for the exemption from Securities Act registration provided by Rule 144A. This provision is commonly referred to as the "non-fungibility requirement." At the time Rule 144A was initially proposed, the Rule would have allowed fungible securities to be issued to certain qualified buyers; however, the final rule excluded that provision. The change was made to address concerns that a side-by-side public and private market would exist for the applicable securities (though at the time the Commission indicated that it viewed the development of significant side-by-side markets to be "unlikely").[22]

To date, the conversion premia for a significant majority of Contingent Convertible Securities either have been less than 10% or cannot be calculated at the time of issuance. As discussed further below, however, the Contingent Convertible Securities are fundamentally different in economic terms (and therefore trading characteristics) from the issuer's underlying common stock. Moreover, the terms of such securities help ensure the remoteness of any possibility of conversion of the Contingent Convertible Securities. We view

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[18] The Basel III minimum requirements for loss absorbency provide that the non-viability trigger is at the option of the relevant national resolution authority.

[19] Although the Basel III framework does not provide for such discretion, certain national capital frameworks do provide for such discretion. For example, the terms of many contingent convertible capital securities issued by Swiss financial institutions allow the relevant regulator to override a CET1 Ratio trigger event where such regulator is satisfied that actions, circumstances or events have had, or imminently will have, the effect of restoring the CET1 Ratio to an adequate level above the conversion trigger level.

[20] The Basel III framework does not explicitly address optional conversions into common stock of the issuer, although prohibits call options combined with an investor option to convert the instrument into shares if the call is not exercised. *See* Basel Committee, *supra* note 13, question 7. However, for the purposes of the requested relief, we are not proposing to include instruments that include an optional conversion into common stock by either the issuer or the investor.

[21] The relief requested extends to issuers of Contingent Convertible Securities that have listed ADSs on a U.S. exchange given that the shares underlying the ADSs also would be considered listed and, therefore, securities of the same class as the depositary securities. See SEC Release No. 33-6862 (April 30, 1990).

[22] *See* SEC Release No. 33-6839 (July 11, 1989).

this remoteness as performing a function substantially equivalent to the function served by the conversion premium described in Paragraph (d)(3)(i): to provide at issuance a reasonable basis to conclude that investors will not treat the Contingent Convertible Securities as the commercial equivalent of the underlying common stock and, thus, to decrease the likelihood such an offering would create a side-by-side public and private market for the issuer's common stock.

While an issuer remains in sound financial health, the characteristics of Contingent Convertible Securities will be fundamentally different from the underlying common stock and perceived as such by investors. Contingent Convertible Securities will in all events be structured with economics similar to subordinated debt or non-participating preferred securities rather than common stock. Moreover, investors in Contingent Convertible Securities will be focused on receiving periodic interest or preferred dividend payments during the life of the Contingent Convertible Securities, rather than any potential equity upside in the unlikely event of a conversion into common stock. And indeed, the terms of Contingent Convertible Securities do not include any right of the issuer or securityholders to convert such securities into common stock at their option. These characteristics support issuers' expectations in respect of the Contingent Convertible Securities: namely, that they will price and trade more like traditional fixed-income subordinated debt or preferred equity instruments than conventional convertible instruments.[23]

Additionally, the Contingent Convertible Securities are marketable to investors only if the non-viability and the CET1 Ratio trigger events are remote, which minimizes the risk that a side-by-side public and private market for the issuer's common stock will develop. The more likely it is that an issuer will be adjudged non-viable or that it will suffer a precipitous deterioration in its CET1 Ratio, the less able it will be to market and sell to investors securities that will automatically and mandatorily convert into common stock in a troubled financial institution. A conversion, therefore, must be considered by the market to be truly exceptional at the time of issuance, and the terms of the Contingent Convertible Securities help ensure such remoteness. In particular:

- a CET1 Ratio below 7% is effectively a sign of distress, so it would be highly unlikely that an issuer would take steps within its control to create that trigger event and thus precipitate conversion, including because there would be no financial incentive for an issuer to artificially depress its CET1 ratio below 7% in order to trigger a recapitalization that would subsequently increase that capital ratio above 7%; and

- requiring the issuer's CET1 Ratio at the time of any issuance to exceed the Combined Buffer Requirement (as set under the applicable national regulatory capital rules prior to the offering of the Contingent Convertible Securities) helps ensure that the issuer, at the time of the offering, is deemed to be viable (and, therefore, a non-viability trigger event is unlikely), as well as maintains capital levels that, at the time of the offering, are

[23] In a September 2013 paper published by the Bank of International Settlements, the authors concluded that bond yields of contingent convertible capital securities are most highly correlated with those of other subordinated debt. *See* Stefan Avdjiev et al, *CoCos: a primer*, BIS Quarterly Review, September 2013 at 43-56.

sufficiently above any applicable CET1 Ratio trigger event (especially because of the perceived severity of regulatory sanctions for breaching the Combined Buffer Requirement, financial institutions would target capital levels, and investors would expect them to maintain capital levels, well in excess of the level at which the contingency would be triggered).

Accordingly, we believe the conditions that would trigger a conversion make it highly unlikely that investors will purchase Contingent Convertible Securities to gain exposure to an issuer's underlying common stock and, indeed, will not favor any conversion trigger that at the time of issuance may be considered reasonably likely to occur.

Given the absence of actual or perceived fungibility, a side-by-side public and private market for the common stock of an issuer cannot reasonably be expected to develop, other than in the remote circumstance when an issuer's financial condition deteriorates to the point that the conversion is perceived to be likely to be triggered. We believe it is clear that the likelihood of conversion under the two types of trigger events in the Contingent Convertible Securities described in this letter is at least as remote as under the minimum 10% conversion premium expressly covered by Paragraph (d)(3)(i). The conversion feature of the Contingent Convertible Securities should be no more disqualifying than the likely greater possibility an optional convertible security will become in-the-money before maturity, notwithstanding the requisite 10% conversion premium at issuance.

Conclusion

We believe relief from Paragraph (d)(3)(i) is necessary because otherwise a significant majority of Contingent Convertible Securities would not be eligible for resale under Rule 144A given that the conversion premium may be unknown or less than 10% at the time of their issuance. Because the likelihood of triggering the conversion contingency in Contingent Convertible Securities is at least as remote as for an optional convertible security with a conversion premium of at least 10% at the time of issuance, and an offering of Contingent Convertible Securities would therefore be no more likely to create a side-by-side public and private market for the issuer's equity, we respectfully request that the Staff not recommend any enforcement action to the Commission if offers and sales of Contingent Convertible Securities are made in reliance on Rule 144A.

If you have any questions or need further information, please do not hesitate to contact me (at +1-212-225-2380) or David I. Gottlieb (at +44-20-7614-2230).

Thank you in advance for your consideration of this matter.

Very truly yours,

Leslie N. Silverman

Leslie N. Silverman

cc: David I. Gottlieb, Cleary Gottlieb Steen & Hamilton LLP