ALERT MEMORANDUM

The Application of the U.S. Securities Laws to A Bail-In of a UK or European Bank

October 20, 2023

On October 10, 2023, the Financial Stability Board (the "FSB") published a report (the "FSB Report")[1] that examined the international resolution framework as applicable to global systemically important banks ("G-SIBs"). In its examination, the FSB Report stated that the staff of the U.S. Securities and Exchange Commission (the "SEC") had highlighted certain legal challenges in executing a bail-in under the U.S. securities laws. In this memo, we explain that while there are U.S. securities laws that would be implicated in the event of a bail-in of a UK or European bank, these would not constitute an impediment to bail-in.

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[1] Financial Stability Board, "2023 Bank Failures: Preliminary lessons learnt for resolution" (October 10, 2023), available at https://www.fsb.org/2023/10/2023-bank-failures-preliminary-lessons-learnt-for-resolution/.

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A quick summary of the bail-in power

The bail-in power is one of the tools that UK and European (EU and other EEA) banking regulators have as part of the resolution framework, in addition to transfer powers such as the sale of business or bridge institution tools. The bail-in power is designed to ensure that, in case of failure, the bank's losses are absorbed by its shareholders and creditors (and not by governments or taxpayers). Banks are required to maintain certain levels of capital and eligible liabilities relative to the size of their balance sheets to ensure there are "layers" in place to absorb losses. To provide a simple example, a G-SIB typically has four or five categories of securities forming its capital structure that may be written-down or converted in resolution (listed in descending order of seniority):

1) Senior debt that qualifies towards "total loss-absorbing capacity" ("TLAC") requirements (in the case of U.S. banks) or "minimum requirement for own funds and eligible liabilities" ("MREL") (in the case of UK and European banks);
2) Senior non-preferred instruments that qualify as both MREL and TLAC (in the case of EU and other EEA banks);
3) Subordinated debt that qualifies as Tier 2 capital;
4) Deeply subordinated capital securities that qualify as Additional Tier 1 ("AT1") capital (AT1 securities); and
5) Equity.

The "bail-in tool" is defined in the EU Bank Recovery and Resolution Directive ("BRRD")[2] as the mechanism by which the relevant resolution authority effects the write-down and/or conversion to equity of the liabilities of a bank in resolution (after equity, AT1 and Tier 2 instruments are first written down or converted just prior to resolution, when a bank is failing or is likely to fail). "Bail-inable liabilities" – the liabilities to which the bail-in tool may be applied – are the liabilities and capital instruments that do not qualify as Common Equity Tier 1, AT1 or Tier 2 instruments and are not excluded from bail-in. Applying this to the list above, the resolution authority would only be able to exercise the bail-in tool to (1) and (2) above, but the resolution authority could apply its write-down powers to any of the instruments described in (1) through (5) above. Despite the regulatory distinction between the bail-in and write-down powers and the instruments to which each apply, "bail-in" is often used broadly as a term to refer to the exercise of resolution powers by the resolution authority, including both the bail-in of bail-inable liabilities and write-down of capital instruments. For example, a "full bail-in" of a UK or European bank would entail wiping out all of the bank's shareholders and holders of AT1 securities and other capital instruments (including Tier 2 capital), and writing down the full amount of the bank's bail-inable liabilities in exchange for new shares of the bank.

Bail-in and the U.S. securities laws

The FSB Report states that the SEC staff had highlighted that there would have been legal challenges in executing a bail-in under the U.S. securities laws and in preparing disclosures necessary under the U.S. securities laws (in the case of a bank subject to U.S. reporting obligations). At least one article in the press focused on this discussion in the FSB Report in particular, presenting it as a potentially significant obstacle and seemingly surprised that these issues have not been thought through by regulators, banks and their advisors previously.[3] In fact, there is no such obstacle.

The effective exchange of bail-in bonds for new shares in the bank could be viewed to constitute an offer and sale of securities that would require registration under the U.S. securities laws, or an exemption from

[2] Other EEA countries also apply the BRRD. The bail-in power is implemented in UK law through the UK Banking Act 2009.

[3] See Robin Wigglesworth, "The regulatory nightmare of TLAC," FT Alphaville (October 12, 2023).

registration.[4] Given the speed at which a bail-in may need to be exercised, it will likely not be feasible to register the exchange of bail-in bonds for new shares, as the registration process is lengthy and typically requires several months of review and comment by the SEC. In most cases, however, the exemption from registration under Section 3(a)(9) of the Securities Act should apply to the exchange of bail-in bonds, provided the following requirements are met (which would be expected to be the case in a typical bail-in scenario, as noted below):

— *The issuer of the outstanding securities being surrendered is the same as the issuer of the new securities in the exchange*. The bank would be the issuer of both the bail-in bonds and the new shares.

— *The securityholder must not be asked to part with anything of value besides the outstanding securities.* The bail-in bonds would be written down in exchange for receiving the new shares and no additional consideration would be transferred by the securityholders in such an exchange.

— *The exchange must be offered exclusively to the existing holders of the outstanding bonds.* The new shares would be delivered solely to the existing holders of the bail-in bonds at the time of such an exchange.

— *The issuer must not pay any commission or remuneration for the solicitation of the exchange.* No commission or other remuneration may be paid or given directly or indirectly for soliciting the exchange of bail-in bonds for new shares in such an exchange. In the case of a bail-in, the exchange would happen by operation of the relevant banking law, and holders of bail-in bonds would neither be solicited nor even be notified in advance of such a bail-in, having expressly consented to such an exercise of the bail-in power by the regulator at the time they initially purchased the bail-in bonds.

Other exemptions from registration may also be available. For example, an exchange with bondholders outside the United States may be made in reliance on Regulation S under the Securities Act (the exemption from the registration requirements for transactions in securities outside the United States). In summary, there are exemptions from the registration requirements that would likely apply in the event of a bail-in, and these exemptions have been considered by and discussed among regulators, banks and their advisors. As the FSB Report notes, the SEC staff as a matter of its standard practice will not confirm the availability of an exemption or "grant" an exemption from registration. This does not necessarily mean that the SEC staff has cast doubt on the availability of a particular exemption in the context of a bail-in – only that it is incumbent on the issuer of the securities, with the assistance of its counsel, to determine whether an exemption is available.

The FSB Report also noted that "the SEC staff considered that it would be difficult for an issuer to compile the disclosures required by securities regulations and anti-fraud laws over a resolution weekend." A bank that is subject to reporting obligations under the U.S. Securities Exchange Act of 1934, as amended (the "Exchange Act"), would remain subject to those reporting obligations following the implementation of a bail-in, unless eligible for deregistration. A bank that is not subject to Exchange Act reporting obligations would have no disclosure obligations under the U.S. securities laws. In the case of a UK or European bank, it will continue to be subject to disclosure and transparency rules under its home country law and stock exchange rules (if it has securities listed on a regulated market). A UK or European bank subject to Exchange Act reporting obligations would be required to furnish to the SEC on

[4] See Section 5 of the U.S. Securities Act of 1933, as amended (the "Securities Act"). It should be noted, however, that this would not be the case upon conversion of Contingent Convertible ("CoCo") AT1 securities that under their terms automatically convert into equity of the bank if a specified capital ratio falls below a specified level, as the automatic conversion does not involve a new investment decision. The same reasoning would arguably apply in the case of a forced conversion upon bail-in.

Form 6-K any material information it is required to publish under its home country law or stock exchange rules, or otherwise provides to security holders, in connection with the bail-in. Under UK and European rules, a UK or European bank would also be required to disclose any price-sensitive information to the market in connection with a bail-in, and ensure that its disclosures to the market are materially accurate and not misleading. SEC rules do not impose additional reporting obligations in the context of a bail-in in this respect. Nor do the reporting obligations render unavailable the exemption from registration under Section 3(a)(9), and thus they would not in any event constitute an impediment to bail-in.

In summary, while there are U.S. securities laws that would be implicated in the event of a bail-in of securities of a UK or European bank, there are exemptions from the registration requirements that would likely be available, and, to the extent the bank is subject to Exchange Act reporting obligations, disclosure obligations would be driven by home country law and stock exchange requirements (per Form 6-K) and general considerations to ensure that any disclosures are materially accurate and not misleading.

We note that there are many complex questions and issues relating to the UK and European bail-in power, and while this memo focuses specifically on certain U.S. securities law considerations as raised in the FSB Report, please contact any of the authors or your regular Cleary Gottlieb contacts for further discussion or if you have questions.

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