

# Office of Regulatory Activities

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**Handbooks:** Compliance Activities  
Thrift Activities  
Applications Processing  
**Subjects:** FSLIC Advertising, Oversight by the Board of Directors,  
and Subordinated Debt

Section: 425

140

770

TB 23

April 13, 1989

## Over-the-Counter ("Retail") Sales of Debt Securities

# RESCINDED

*Summary:* Directors and officers are responsible (1) for ensuring that institution offerings and advertisements of retail debt securities comply with applicable Board regulations and Federal and state securities laws, and (2) for establishing safeguards to ensure that an institution is selling such debt only to suitable purchasers. Because of the risks associated with retail sales, including the risk of customer confusion that small denomination debt securities are insured accounts, this Office will generally regard retail sales of debt securities in denominations of less than \$10,000 as an unsound practice. A memorandum providing acceptable advertising guidance for retail debt offerings is attached.

### *For Further Information Contact:*

The FHLBank District in which you are located, or the Policy Analysis Division of the Office of Regulatory Activities, Washington, D.C. 20006.

### *Thrift Bulletin 23*

#### Background

Some institutions have been selling debt securities directly, rather than through an underwriter. Although the "retail" or "over-the-counter" sale of debt securities is a permissible way to raise capital, an institution's direct sale raises special concerns because unsophisticated investors can easily confuse uninsured debt securities with Federally-insured certificates of deposit or deposit accounts, unless institutions take precautions to prevent such confusion. This confusion can arise when the securities are advertised in a manner similar to insured instruments, sold inside the institution, sold by thrift personnel who normally sell insured instruments, or offered in small denominations.

Although advertisements for debt securities must disclose that they are not Federally insured, that they may be subordinated to other claims against the institution, and, if appli-

cable, that no public market may exist, these advertisements may still fail to comply with certain disclosure requirements of Rule 134 and Rule 135 under the Securities Act of 1933. The Bank Board applies these Rules to institutions' offerings through its securities offering regulations at 12 C.F.R. Part 563g. (See attached Bank Board's Office of General Counsel, Corporate and Securities Memorandum No. 2, entitled, "Application of Part 563g to Advertising Materials for Debt Offerings," dated March 21, 1989.)

This Office's particular concern is that the advertisements and offerings are directed towards the general public, many of whom may not understand the full implications of subordinated or uninsured debt or may not be suited to purchase such securities. An uninsured debt security is a far more complex financial instrument than an insured certificate of deposit and, in comparison, is a risky and uncertain investment. The sale of such debt securities to people who may not fully understand the risk factors involved is an unsound practice, may subject an institution and its directors and officers to significant liabilities, and is not in the public interest.

#### Existing Board Consumer Protection Requirements

Board regulations that authorize savings institutions to offer and sell debt securities incorporate consumer protection provisions. These regulations, and some of their protective provisions, are:

##### 1. Disclosure Requirements

Part 563g, "Securities Offerings." This Part provides that when a savings institution offers or sells securities it shall, unless an exemption specified in the regulation applies, do so through the use of an offering circular. The institution must file the offering circular with the Board, and may not offer or sell the securities until the Board declares the circular effective. The regulatory sections include antifraud provisions and, among other things, require a savings institution, in its offer and sale, to comply with securities laws' "full and fair disclosure" requirements.

Section 563.8-1, "Issuances of Subordinated Debt Securities," and Section 563.5, "Securities: Statement of Noninsurance." Section 563.8-1 sets forth a number of eligibility requirements for such securities to qualify as regulatory capital, including no

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supervisory objection. The regulation requires an institution to file an extensive application form and to use a certain form of certificate. Among other things, the certificate must bear on its face, in bold-face type, the legend that, "This security is not a savings account or deposit and it is not insured by the Federal Savings and Loan Insurance Corporation." (This disclosure requirement is similar to the Section 563.8 statement requirement.) Under Section 563.8-1 the certificate must clearly state that, "the security (a) is subordinated on liquidation, as to principal, interest...(and) (b) is unsecured by the assets of the issuing institution...."

In addition, Section 563.27, "Advertising Must Be Accurate," includes a general restriction against misrepresentations in any way of an institution's services or contracts.

## 2. Direct Sales

Section 563g.17, "Direct Sales of Securities at an Office." This Section, which is part of the Board's "Securities Offerings" regulation, provides that an insured institution or an affiliate may offer or sell securities at their respective offices only if (1) regular, full-time employees make the offers and sales, (2) the institution does not pay commissions to any employee or other person, (3) the securities are not sold at teller counters or at similar locations or by tellers or comparable persons, and (4) the institution is in compliance with its regulatory capital requirements during the time of its offering.

## Responsibilities of Directors and Officers

Directors and officers are responsible for ensuring that an institution's marketing of debt securities complies with the above regulatory requirements as well as any other

applicable Federal and state securities laws, and they may be liable for an institution's neglect in these areas. The following sections discuss advertising and customer "suitability" safeguards that institutions should incorporate into their marketing plans.

## 1. Advertising

The attached OGC Corporate and Securities Memorandum No. 2 urges issuers to bear all advertising matters for public sales of debt through the Office of General Counsel. It also provides guidance to issuers as to what will constitute acceptable advertising for retail debt offerings made pursuant to the Board's securities offering regulations.

The OGC memorandum indicates that thrift institutions' advertisements of debt securities are subject to Rule 134 and Rule 135 issued under the Securities Act of 1933. Among other things, the memorandum sets forth (1) advertising disclosure limits and requirements under Rule 134, (2) advertising disclosures that the Board believes institutions must make for "retail" or "over-the-counter" offerings, and (3) advertising disclosures that the Board would consider as being in noncompliance with the requirements of Rule 134. The memorandum also cautions that an institution's failure to follow the requirements of Rule 134 could create substantial liability for a registrant and form a basis for Board enforcement action.

## 2. Establishment of Customer "Suitability" Safeguards

Institutions may also subject themselves to liability if they fail to institute safeguards to prevent situations where customers allege that institution personnel misled them regarding the nature of their debt invest-

ment. These safeguards take the form of "suitability" and "know your customer" standards, such as those that the National Association of Securities Dealers, Inc. (NASD) requires. In summary, these NASD standards provide that a seller shall not recommend to customers certain purchases unless the seller has reasonable grounds to believe (1) that on the basis of information that the customer furnishes, the recommended transaction is not unsuitable for the customer, and (2) that the customer may reasonably be expected to be capable of evaluating the risks of the recommended transaction and is financially able to bear the risks.

Institutions that sell retail debt securities should adopt and maintain appropriate written safeguards for the protection of sellers (employees, directors and officers). The safeguards include, but are not limited to:

- requiring purchasers of retail debt securities to sign an acknowledgment that they are aware that the securities are not Federally-insured and, if appropriate, that there is no public market for the securities.
- establishing a training program for employees selling the securities.
- establishing minimum qualifications for retail sellers.
- adopting antifraud and "know your customer" procedures to assure that:

(1) sellers do not supplement written offering materials that (either orally or with other written material) misstate material facts, use various deceptions or optimistic forecasts, or make unsuitable recommendations for purchase.

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(2) purchasers are well informed as to the nature of the institution's debt securities.

(3) based on reasonable inquiry, the investment is suitable for purchasers with respect to such factors as whether a subordinated debt security, or a long-term, illiquid asset, is appropriate for their personal income or investment needs.

- providing sufficient supervision to prevent overly aggressive and persistent selling efforts.
- designating a director or an officer to be responsible for coordinating and supervising the institution's compliance with its established safeguards, including monitoring or testing over-the-counter seller transactions.

- maintaining appropriate books and records to support the suitability of the retail transactions, including maintaining data on file that the purchasers provide.

When an institution intends to offer or sell subordinated debt securities at its offices, its application for approval to include the securities as part of its regular inventory capital shall include information describing the policies and procedures that it has instituted to insure that it is marketing them with appropriate disclosures regarding the nature of the investment and (2) to financially suitable purchasers. When reviewing the application, the Supervisory Agent shall consider the extent to which the institution has established such safeguards. Because of the sale of small denomination securities

may attract unsophisticated and unsuitable purchasers, and because of the risk of customer confusion that small denomination debt securities are insured accounts, this Office will generally regard retail sales of debt securities in denominations of less than \$10,000 as an unsound practice.

Based on these concerns, this Office intends to recommend to the Board that it adopt regulatory amendments imposing further safeguards on institutions' retail sales of their own debt securities. Such safeguards will include the establishment of a minimum denomination requirement with respect to institutions' retail offering and sale of debt securities.

Attachment

*Darrel W. Dochow*

— Darrel W. Dochow, Executive Director

# Corporate and Securities Memorandum

No. 2

Date: March 21, 1989

## APPLICATION OF PART 563G TO ADVERTISING MATERIALS FOR DEBT OFFERINGS

Concerns have arisen in connection with the use of media advertisements, sales literature, and other forms of publicity by institutions offering debt securities in public offerings pursuant to the Board's securities offering regulations, 12 C.F.R. Part 563g. The purpose of this Memorandum is to highlight the bases for those concerns under the securities offering regulations and to provide guidance to issuers on matters of compliance.

The staff is aware that it is common practice, in "over-the-counter" debt offerings by institutions, to use a variety of sales literature, advertisements and other materials to promote sales of the security. It is also common practice, either overtly or by implication, to liken the debt security being offered to an insured account, like a certificate of deposit. The express or implied characterization of debt securities as certificates of deposit or other types of insured accounts increases the probability that such advertising will be confusing or misleading. Because of these concerns, advertising that tends to blur the lines between insured and uninsured instruments has consistently been discouraged by the staff. Nevertheless, such advertising problems have continued and the staff has determined that it must offer clear and unequivocal guidance as to what will constitute acceptable advertising for "over-the-counter" debt offerings.

Generally, securities offerings by thrift institutions are subject to the Board's securities offering regulations contained at 12 C.F.R. Part 563g. These regulations prohibit any offer or sale of securities unless (1) the offer or sale is accompanied or preceded by an offering circular filed with and declared effective by the Board or (2) an exemption from the offering circular requirements is available. The practical result of these regulations is that certain media advertisements, sales literature and other forms of publicity, depending on their content, could constitute offering materials that either must be filed with and declared effective by the Board, or accompanied or preceded by an offering circular sent to the reader of the publicity which includes the information required by Part 563g and which has been filed with and declared effective by the Board. Obviously, to send an offering circular to every potential reader of a newspaper advertisement, for example, would

## Corporate and Securities Memorandum

be an unworkable burden. However, the rules further provide exemptions for certain types of communications, which would not be deemed to be "offers" for purposes of the regulations. These exemptions, which are similar to the disclosure rules under the federal securities laws,<sup>1/</sup> are available for (1) any notice of the proposed offering used prior to the filing of an offering circular with the Board which meets the requirements of Rule 135 under the Securities Act of 1933; (2) any notice, circular, advertisement, letter or other communication, including media communications such as radio or television advertisements, which meets the requirements of Rule 134 under the Securities Act which is used after the filing with the Board of an offering circular; and (3) oral offers after the filing of an offering circular. Generally, newspaper and other media advertisements fall into the second category and seek to qualify as not constituting "offers" under the standards of Rule 134.

As applied through Part 563g, Rule 134 provides that the term "prospectus" (or "offering circular", as defined in Section 563g.1(c)) shall not include a notice, circular, advertisement, letter or other communication published or transmitted to any person after an offering circular has been filed, if it contains only the statements required or permitted to be included therein by the Rule. The Rule sets forth a very limited "laundry list" of permitted and required disclosures. Any communication outside the parameters of the information contemplated in Rule 134 could be considered a prospectus that would require filing with and review by the staff, and that could, if used and if different from any prospectus declared effective by the staff or if not meeting the requirements for a prospectus under the regulations, both create substantial liability for the institution issuing the securities and form a basis for enforcement action to be taken by the Board.

The Rule permits the following information:

1. The name of the issuer;

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<sup>1/</sup> As a matter of policy, the staff follows the procedures and regulations of the Securities and Exchange Commission as closely as possible in the administration of Part 563g. In particular, the staff has routinely applied the Commission's Rules 134 and 135, promulgated under the Securities Act of 1933, to securities offerings under the Board's jurisdiction. See, 12 C. F. R. Section 563g.2; preamble to 1986 amendments to the Conversion Regulations, 51 Fed. Reg. at 40136 (November 5, 1986).

2. The title of the security;
3. The amount of securities being offered;
4. A brief indication of the general type of business of the issuer (limited to various types of disclosures dependent on the nature of the business of the issuer);
5. The price of the security, the method by which the price will be determined, or the probable price range;
6. If a fixed interest debt security, the yield, or probable yield;
7. The name and address of the sender of the communications and the fact that the sender is participating in the distribution of the security (if true);
8. The names of the managing underwriters, if any;
9. The approximate date upon which the distribution will commence;
10. Whether, in the opinion of counsel, the security is a legal investment for savings banks, fiduciaries, insurance companies or other investors under the laws of any state;
11. Whether, in the opinion of counsel, the security is exempt from specified taxes;
12. Whether the security is being offered through rights, and if so, certain information about the rights offering;
13. Any statement or legend required by state law or administrative authority;
14. For debt securities or preferred stock, the rating from a nationally recognized statistical rating organization and the name of the rating agency, if any.

The disclosures required by the Rule are as follows:

1. If the registration statement (offering circular) has not yet become effective, a prescribed legend is mandated;

2. A statement whether the security is being offered in connection with a distribution by the issuer, or by a security holder, or both, and whether the issue represents a new financing, or refunding, or both;

3. The name and address of a person or persons from whom a written prospectus meeting the requirements of the Securities Act (Part 563g in the case of securities issued by an insured institution) may be obtained.

It is the staff's position that, other than oral offers, all advertisements, sales literature or other "communications" used in the offering of securities subject to the offering circular requirements of Part 563g that are not accompanied or preceded by an offering circular that has been filed with and declared effective by the Board must comply with Rule 134 or Rule 135. In addition, for "over-the-counter" debt offerings, i.e., where the security may be purchased at or through facilities of the institution or an affiliate of the institution, in order for such communications not to be materially misleading, the following disclosures MUST be included in any and all such communications:

1. A legend, in type at least as large as the largest type size used in the communication, that the security is not federally insured;

2. A statement that the investment in such debt securities is subject to certain "investment considerations" or "risk factors" (whichever is appropriate), such as the absence of any indenture, trustee, or market for the securities, the fact that the securities are unsecured and subordinated to all other obligations of the institution, the probability of redemption if interest rates decline, etc.

3. A statement that any "Cash Bonus" or "Cash Premium" offered as a sales incentive could result in certain tax consequences to the purchaser.

4. A legend stating that potential investors should obtain and read a copy of the offering circular before making an investment in the securities.

These disclosures are particularly important given the usually "traffic-stopping type size" of the yield figures for these securities.

The staff will not under any circumstances consider the following types of disclosure as being in compliance with the requirements of Rule 134:

1. Statements designed to have or having the effect of implying that the security is an insured account (i.e., statements that the yield or interest rate of the security being offered is "higher than those offered on our other insured accounts");

2. Statements comparing the security being offered to insured accounts available at the institution. (This would include attention-getting headlines<sup>2/</sup>);

3. Statements implying that the security is likely to remain outstanding until "maturity" (since, if the institution is able to borrow money more cheaply elsewhere, it will likely immediately redeem these high-interest rate debt securities).

Issuers and their counsel are encouraged to continue to submit to the staff for review all proposed sales literature, advertisements, etc. to be used in connection with debt offerings in order to insure compliance with the above standards. Any questions concerning the above requirements and concerns may be directed to Deborah Silberman, Deputy Director for Securities, at (202) 906-7013, Paul Glenn, Staff Attorney, at (202) 906-6203, David Berliner, Deputy Director for Special Projects, at (202) 906-6444, or Howard Bluver, Staff Attorney, at (202) 906-7504.

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<sup>2/</sup> The staff is aware of the provision in Rule 134 (a) (3)(iii) permitting the use of certain "attention-getting headlines" by investment companies, and of the SEC's interpretive position allowing the use of such headlines even if the issuer is not an investment company. However, the staff is also aware that no guidance has been offered by the Commission as to what would constitute an acceptable attention getting headline "designed to direct the reader's attention to the textual materials included in the communication pursuant to other provisions of Rule 134". The staff will not consider circumvention of the otherwise stringent requirements of the Rule through the use of such attention-getting headlines to be acceptable disclosure under the Rule.