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Alerts

Congress (Hopefully) Moving to Make Raising Capital Easier

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Corporate / Financial Institutions Alert

In an effort to make capital raising easier for small companies (including community banks and bank holding companies), the U.S. House of Representatives has approved four pieces of legislation discussed below. This legislation still must be approved by the U.S. Senate.

H.R. 1965

Bank holding companies (like all companies) with more than 500 shareholders of record must register their securities with the U.S. Securities and Exchange Commission (SEC) and file periodic reports (10-Ks, 10-Qs) and proxy and other materials with the agency. Similarly, banks with more than 500 shareholders of record must register their securities with the appropriate federal banking agency (the Federal Reserve (Fed), Federal Deposit Insurance Corporation (FDIC) or Office of the Comptroller of the Currency (OCC)) and file periodic reports (10-Ks, 10-Qs) and proxy and other materials with the appropriate federal banking agency.

Registering and complying with various securities regulations can be costly for small banks and bank holding companies. As a consequence, as such entities approach the 500 shareholder limit, they may be reluctant to seek out new investors when they need to raise capital.

H.R. 1965 significantly increases the number of shareholders of record a bank holding company may have before it has to register with the SEC or that a bank may have before it has to register with the FDIC, the Fed or the OCC.

This legislation would increase the registration threshold from 500 to 2,000 shareholders of record. This will allow such entities to bring in new shareholders and help bank holding companies and banks avoid the time and expense of registering with the SEC or the Fed, FDIC or OCC.

Under current rules, in order to deregister from the SEC (or the FDIC, Fed or OCC), a bank holding company or bank must have fewer than 300 shareholders of record. H.R. 1965 increases the deregistration threshold to 1,200 shareholders of record, thereby making it easier for such entities to escape the registration regimen.

It should be noted that when selling securities in a private placement, bank holding companies must secure a federal exemption and an exemption in each state where prospective investors reside. Securing such exemptions can be

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difficult. H.R. 1965 does not address this issue. Click here for: a discussion of some of the federal and Illinois exemptions available for the sale of securities.

Sales of bank stock are exempt under federal law and most state laws. Therefore, in most cases, banks do not have to secure such exemptions.

H.R. 2167

This legislation would increase the registration threshold to 1,000 “shareholders of record" for all companies, including banks and bank holding companies. H.R. 2167 also provides that the definition of “held of record" will not include:

- securities held by persons who qualify as “accredited investors" (as that term is defined by the SEC); or
- securities that are held by persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of Section 5 of the Securities Act of 1933 (Securities Act).

The SEC's Rule 701 exempts from the registration requirements of Section 5 (of the Securities Act) securities offered to employees under written benefit plans by companies that are not registered with the SEC.

H.R. 2167 directs the SEC to revise the definition of “held of record" to implement this legislation. The SEC must also adopt safe harbor provisions that companies can follow when determining whether holders of their securities are accredited investors or received the securities pursuant to an employee compensation plan in transactions that were exempt from the registration requirements of Section 5 of the Securities Act.

The increase in the number of shareholders of record, coupled with the exclusion of accredited investors and employees acquiring securities pursuant to an employee compensation plan when counting holders of record, will allow such entities to bring in new shareholders and should help bank holding companies and banks avoid the time and expense of registering with the SEC or the Fed, FDIC or OCC.

H.R. 2167, unlike H.R. 1965, does not change the deregistration threshold.

It should be noted that bank holding companies when selling securities in a private placement must secure a federal exemption and an exemption in each state where prospective investors reside. Securing such exemptions can be difficult. H.R. 1965 does not address this issue. Click here for: a discussion of some of the federal and Illinois exemptions available for the sale of securities.

Sales of bank stock are exempt under federal law and most state laws. Therefore, banks in most cases do not have to secure such exemptions.

H.R. 2930

H.R. 2930 would exempt private placements from the registration requirements of Section 5 of the Securities Act, provided that:

- the aggregate amount sold within the previous 12-month period in reliance upon this exemption is:
  - $1 million; or
  - if the company provides potential investors with audited financial statements, $2 million;
- the aggregate amount sold to any investor in reliance on this exemption within the previous 12-month period does not exceed the lesser of:
  - $10,000; and
  - 10 percent of such investor's annual income;
- in the case of a transaction involving an “intermediary" between the company and the investor, such intermediary complies with the requirements discussed below under “**Intermediaries**;" and
- in the case of a transaction not involving an intermediary between the company and the investor, the company complies with the requirements discussed below under “**Company Offering Without Intermediaries**."

Securities held by persons who purchase such securities in transactions described above would not be deemed to be “held of record." Therefore, such persons will not count when determining whether the company must register with the SEC.

In addition, such securities may be sold through the internet.

A company or intermediary may rely on certifications as to annual income provided by the person to whom the securities are sold to verify the investor's income.

With respect to a transaction relying on the exemption contained in H.R. 2930, a purchaser may not transfer such securities during the one-year period beginning on the date of purchase, unless such securities are sold to:

- the company that issued the securities; or
- an accredited investor.

The SEC would have to adopt regulations to implement this provision with six months of the adoption of H.R. 2930.

Intermediaries. For purposes of the exemption offered by H.R. 2930, a person acting as an intermediary must, among other things:

- warn investors, including on the intermediary's website used for the offer and sale of such securities, of the speculative nature generally applicable to investments in startups, emerging businesses and small companies, including risks in the secondary market related to illiquidity;
- warn investors that they are subject to the restriction on re-sales discussed above;
- provide the SEC with the intermediary's physical address, website address and the names of the intermediary and employees of the intermediary, and keep such information up to date;
- provide the SEC with continuous investor-level access to the intermediary's website;
- require each potential investor to answer questions demonstrating:
  - an understanding of the level of risk generally applicable to investments in startups, emerging businesses, and small companies;
  - an understanding of the risk of illiquidity; and
  - such other areas as the SEC may determine appropriate by rule or regulation;
- require the company to set a target offering amount and a deadline to reach the target offering amount and ensure the third-party custodian described below withholds offering proceeds until the aggregate capital raised from investors other than the company is no less than 60 percent of the target offering amount;
- provide the SEC and potential investors with notice of the offering, not later than the first day securities are offered to potential investors, including:
  - the company's name, legal status, physical address and website address;
  - the names of the company's principals;
  - the stated purpose and intended use of the proceeds of the offering sought by the company; and
  - the target offering amount and the deadline to reach the target offering amount;
- outsource cash-management functions to a qualified **third-party custodian**, such as a broker or dealer registered under section 15(b)(1) of the Securities Exchange Act of 1934 or an insured depository institution;
- make available on the intermediary's website a method of communication that permits the company and investors to communicate with one another;
- provide the SEC with a notice upon completion of the offering, which shall include the aggregate offering amount and the number of purchasers; and
- not offer investment advice.

An intermediary participating in a transaction exempted by H.R. 2930 is not required to register as a broker under the Securities Exchange Act of 1934 solely by reason of his participation in such transaction.

Company Offering Without Intermediary. For purposes of the exemption offered by H.R. 2930, a company must, among other things:

- warn investors, including on the company's website, of the speculative nature generally applicable to investments in startups, emerging businesses and small companies, including risks in the secondary market related to illiquidity;
- warn investors that they are subject to the restriction on re-sales discussed above;
- provide the SEC with the company's physical address, website address and the names of the principals and employees of the companies, and keep such information up to date;
- provide the SEC with continuous investor-level access to the company's website;
- require each potential investor to answer questions demonstrating:
  - an understanding of the level of risk generally applicable to investments in startups, emerging businesses and small companies;
  - an understanding of the risk of illiquidity; and
  - such other areas as the SEC may determine appropriate by rule or regulation;
- set a target offering amount and ensure that the third-party custodian described below withholds offering proceeds until the aggregate capital raised from investors other than the company is no less than 60 percent of the target offering amount;
- provide the SEC with notice of the offering, not later than the first day that securities are offered to potential investors, including:
  - the stated purpose and intended use of the proceeds of the offering sought by the company; and
  - the target offering amount and the deadline to reach the target offering amount;
- outsource cash-management functions to a **qualified third-party custodian**, such as a broker or dealer registered under Section 15(b)(1) of the Securities Exchange Act of 1934 or an insured depository institution;
- make available on the company's website a method of communication that permits the company and investors to communicate with one another;
- not offer investment advice;
- provide the SEC with a notice upon completion of the offering, which shall include the aggregate offering amount and the number of purchasers; and
- disclose to potential investors, on the company's website, that the company has an interest in the issuance.

H.R. 2940

One of the exemptions available to companies selling securities is set out in Rule 506 of Regulation D. Rule 506 allows a company to sell any amount of securities in a private placement to an unlimited number of accredited investors and up to 35 nonaccredited investors. The benefit of Rule 506 is that securities sold under it are “covered securities" exempt from state securities laws.

However, a company issuing securities under Rule 506 may not sell the securities by form of general solicitation or general advertising. This prohibition includes any advertisement, article, notice or other communication published in a newspaper or similar media or broadcast over television or radio. Rule 506 also does not allow a company to conduct any seminar or meeting where the attendees have been invited by any general solicitation or advertising.

H.R. 2940 directs the SEC to revise its rules to provide that the prohibition against general solicitation or general advertising contained in Regulation D does not apply to offers and sales of securities made pursuant to Rule 506, provided that all purchasers of the securities are accredited investors. The revised rules must also require the company to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the SEC.

The lifting of the prohibition on advertising will allow companies to use various media to contact a larger number of accredited investors.