

New SEC Rule May Prove Useful to Bankers During Capital Raises

Legal Update

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A recent Securities and Exchange Commission (SEC) change to Rule 506 of Regulation D under the Securities Act of 1933 may provide an additional tool for bankers considering a capital raise. On July 10, 2013, the SEC adopted long-awaited rules eliminating the prohibition on general solicitation and general advertising in securities offerings conducted pursuant to Rule 506. The rule change is one step of a broader rulemaking process underway at the SEC required by the Jumpstart Our Business Startups Act (JOBS Act) enacted on April 5, 2012. The change to Rule 506 should not be confused with the proposed rules to implement crowdfunding under the JOBS Act, which the SEC is likely to adopt sometime in 2014.

Rule 506 in Historical Context

Rule 506 provides an exemption from extensive and costly SEC registration requirements. Bank holding companies wishing to raise capital through a private placement of their stock have historically relied upon Rule 506 to conduct such private placements. Before the July 10, 2013, changes, Rule 506 prohibited general solicitation or advertising in all securities offerings conducted pursuant to Rule 506. Examples of historically prohibited general solicitation and advertising include advertisements published in newspapers and magazines, communications broadcast over television and radio, website sales, and seminars where attendees are invited by general solicitation or advertising. Such restrictions historically limited the people to whom the bank holding company could offer its securities primarily to those with whom the company had pre-existing relationships (typically existing shareholders and a handful of their colleagues) and those who might be introduced to the company by a broker acting as an agent in the offering.

New Rule 506(c) Permitting General Solicitation

The SEC has amended Rule 506 to add a new subsection 506(c) pursuant to which issuers have an option to offer securities through means of general solicitation,

provided that:

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all purchasers of securities must be accredited investors, and

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the issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors.

Regulation D's definition of "accredited investor" includes a person (i) whose individual net worth, or joint net worth with his or her spouse, is in excess of \$1 million, excluding the value of the person's primary residence, or (ii) who had an individual income in excess of \$200,000 in each of the two most recent years, or joint income with that person's spouse in excess of \$300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year.

Issuers will continue to have the ability under Rule 506(b) to conduct Rule 506 offerings in the same manner as permitted before the amendment, without using general solicitation.

Reasonable Steps to Verify that the Purchasers of the Securities Are Accredited

Much of the debate preceding the adoption of the new rule and a good portion of the SEC's release discussing the new rule relates to the question of what constitutes "reasonable steps to verify that the purchasers are accredited investors." It is important to note that this requirement is separate from and independent of the requirement that sales be limited to accredited investors. The SEC has adopted a principles-based approach that is intended to allow issuers to make an objective determination regarding what steps are reasonable to verify that the investor is accredited, based on the particular facts and circumstances of each purchaser and transaction. The SEC also added a non-exclusive list of verification methods that are deemed to meet the reasonable verification requirement.

Regarding the "principles-based approach," the SEC encourages issuers to examine:

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the nature of the purchaser and the type of accredited investor that the purchaser claims to be;

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the amount and type of information that the issuer has about the purchaser;

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the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.

The SEC notes that the more likely it appears that a purchaser qualifies as an accredited investor, the fewer steps the issuer has to take to verify accredited investor status, and vice versa.

The SEC also provides examples of the types of information that issuers could review or rely upon including:

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publicly available information in filings with a federal, state or local regulatory body.

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third-party information that provides reasonably reliable evidence that a person falls within one of the enumerated categories in the accredited investor definition (recent copies of pay stubs, publicly available information regarding average compensation earned at the purchaser's workplace, or third party verifications provided that the issuer has a reasonable basis to rely on such third-party verification).

Clearly bank holding companies relying on new Section 506(c) will have to do more to verify accredited status than has been typical in the past with Rule 506 offerings. The common practice of asking investors to sign representations that they meet accredited investor definitions will not be sufficient without additional information indicating accredited status. Moreover, bank holding companies will not be able to rely on third parties who verify accredited status if the third party's only basis for doing so is asking investors to sign forms claiming accredited status. Bank holding companies could, however, continue to employ these traditional techniques so long as they do not engage in general solicitation and advertising activities.

Non-Exclusive List of Verification Methods Deemed Reasonable

In addition to the principles-based approach for verification of accredited status described above, the SEC has adopted four non-exclusive methods for verification that will be deemed reasonable. The four non-exclusive methods are as follows:

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reviewing copies of any IRS form that reports income, including, but not limited to, a Form W-2, Form 1099,

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Schedule K-1 of Form 1065, and a copy of a filed Form 1040 for the two most recent years, along with a written representation from the potential investor that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year;

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reviewing one or more of the following types of documentation, dated within the prior three months, and obtaining a written representation from the potential investor that all liabilities necessary to make a determination of net worth have been disclosed.

For assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by independent third parties; and for liabilities: a consumer report (also known as a credit report) from at least one of the nationwide consumer reporting agencies;

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obtaining a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a certified public accountant that such person or entity has taken reasonable steps to determine and verify that the potential investor is an accredited investor within the prior three months; or

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obtaining a certification by a current shareholder at the time of sale that he or she qualifies as an accredited investor provided such shareholder invested in the issuer's Rule 506 offering as an accredited investor prior to the effective date of Rule 506(c) and remains an investor of the issuer.

General Observations in the Banking Context

With the addition of Rule 506(c), bankers conducting a Rule 506 offering must now weigh the benefit of a potentially larger investment pool against the burden of additional diligence requirements to decide whether they want to employ general advertising and solicitation techniques. General advertising campaigns may prove very useful for community bank holding companies since such companies generally maintain positive reputations in their communities and potential investors will likely know of, and have a high level of confidence in, their local community bankers. Further, potential investors are more likely to be comfortable turning over personal financial information to bankers, as such communications are typical in many banking transactions and bankers must keep such information confidential under applicable law.

Takeaway

New Rule 506(c), together with related JOBS Act provisions, represent some of the most significant changes to U.S. securities laws in decades. Although banks must consider a number of legal and practical issues prior to raising capital using general

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solicitation and advertising allowed under Rule 506(c), this new option provides greater flexibility in raising capital.